

ANALYZING THE ANALYSTS

THURSDAY, JUNE 14, 2001

U.S. House of Representatives,
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises,
Committee on Financial Services,
Washington, DC.

The subcommittee met, pursuant to call, at 10:00 a.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker, [chairman of the subcommittee], presiding.

Present: Chairman Baker; Representatives Oxley, Ney, Shays, Paul, Castle, Royce, Barr, Weldon, Biggert, Miller, Ose, Hart, Kanjorski, Bentsen, J. Maloney of Connecticut, Hooley, Mascara, Jones, LaFalce, Capuano, Sherman, Inslee, Moore, Hinojosa, Lucas, Shows, Israel and Ross.

Chairman **BAKER**. I would like to call this hearing of the Capital Markets Subcommittee to order. We're starting promptly on time this morning. We like to have the ability to start trading as soon as the opening bell rings around here.

First, by prior agreement with Mr. LaFalce and Mr. Kanjorski, opening statements today will be limited to Chairman Oxley, myself, Ranking Member LaFalce, and Mr. Kanjorski, who is on his way, to expedite the proceedings of the hearing this morning.

All other Members' statements will be incorporated into the record.

I am appreciative for the courtesies extended by Mr. Kanjorski and Mr. LaFalce in facilitating this meeting this morning.

As we all know, this is an issue of some importance and volatility. There was a question on a recent magazine cover that struck me as particularly appropriate: "Can We Ever Trust Wall Street Again?"

The simple answer to that question is, we must. That is, we must find a way. It's simply not a choice. America's prosperity, as always, is intrinsically bound to the influx of capital investment that fuels business expansion, job growth and technology.

To the extent that American consumers have been temporarily shaken by the recent market downturn, our first goal today here is to begin a process of rebuilding that confidence, not only to reaffirm American consumers' faith in the fairness of the market, but actually to have their trust.

Clearly, I am a pro-market conservative legislator and I am going to be one of the last on the subcommittee, I think, to suggest Federal intervention to solve every problem.

However, the foundation of the free market system is based on the free flow of information which is straightforward and unbiased. I believe this subcommittee has a very high responsibility to safeguard this principle.

I am deeply troubled by the evidence of the apparent erosion by Wall Street of the bedrock of ethical conduct.

It's a new and continually changing marketplace. Since 1995, on-line trading has resulted in enormous growth of investment by working families, some 800,000 trades a day, I am told, with a typical demographic profile of a \$60,000 annual income with net worth less than 50.

These individual investors rely on and believe what they think is objective, professional advice from sophisticated analysts.

There's a message here. These investors are the future of the dynamic growth of the market place. They deserve fair treatment not only for their best interests, but for the growth of the market.

Folks who work hard to pay the house money, pay their taxes, and the grocery bill don't have luxury to be able to speculatively gamble. Over the last few years, Wall Street's insiders have whispered knowingly about a grade inflation, as it's called, resulting in what I think is a very coded language in analysts' recommendations.

A goal of this hearing is to begin speaking openly about what has apparently been unspoken in the past. I'm amazed. I'm the chairman of the Capital Market Subcommittee in the United States Congress. I learned this yesterday. Strong buy does not mean buy, but actually out-perform.

It really makes you wonder what out-perform or accumulate must mean. I am concerned not only about the potential for significant losses by the unwary and misinformed individual investor, but the possibility of overall market volatility that results when a more rational view does return.

Today, we are going to inquire into disturbing media and academic reports about pervasive conflicts of interest, which appear to be compromising the integrity of current market practice.

In fact, I want to enter into the record at this time, a study from the Harvard and Wharton Business School study entitled "The Relationship Between Analysts' Forecasts of Long-Term Earnings Growth and Stock Price Performance Following Equity Offerings."

I want to quote from that report one paragraph: "Our evidence suggests that the coexistence of brokerage services and underwriting services in the same institution leads sell-side analysts to compromise their responsibility to brokerage clients in order to attract underwriting business. Investment banks claim to have Chinese walls to prevent

such a conflict. Our evidence raises questions about the reliability of the Chinese walls. We document that analysts affiliated with the lead underwriter of an offering tend to issue more overly optimistic growth forecasts than unaffiliated analysts. Furthermore, the magnitude of the affiliated analysts' growth forecasts is positively related to the fee basis paid to the lead underwriter. Finally, equity offerings covered only by affiliated analysts experience the greatest post-offering under performance, suggesting that these offerings are the most over-priced."

I have to say this in my own words, as I basically understand it. Maybe there hasn't been a complete erosion in the Chinese walls that traditionally shield analysts from investment banking interests. But I have to say that I believe there are some folks out there manufacturing a lot of Chinese ladders for people to climb back and forth over those walls as they deem appropriate.

A market bubble that bursts is the time when people look for someone to blame. I believe it rather should be an opportunity for all concerned in the activity to step back, take a deep breath, and reexamine their own accountability to make sure it doesn't happen again, and all parties have some shared responsibility.

Today, we focus on the analysts' conflicts. At some point, we will take a look at the investment banks and the institutional investors.

And I must say a word about the financial press. They have much greater impact than many have given them their allocation for. It is irresponsible reporting to quote unquestioningly irresponsible analysts' reports and put them on the cover of magazines and make them into rock stars.

There is some examination due in this area as well. Consequently, while I appreciate the effort of the Securities Industry Association with their best practices proposal, put forward only 2 days ago, I am not yet convinced we have a remedy to our problem.

I take the very drafting of them as a positive sign that the industry accepts that problems may exist and I am naturally going to take a very careful look at any document that, on its face, has a disclaimer, which I'm paraphrasing here, respectfully, we're going to do our best to be honest and straightforward unless of course circumstances dictate we must do something different.

Today is not the end of our discussion, but the beginning. In the next few months, we will access recommendations, converse with regulators and, at the end of the process, the subcommittee, I hope, will come to a bipartisan agreement as to the best practices standard. Make the recommendations to regulators, and only if necessary, in my view, propose legislation, particularly for the sake of the growing number of \$200 investors who are out there this morning on the job, working trying to make the next dollar.

It is far more important to do this very carefully, thoroughly, rather than do it quickly. Therefore, this hearing this morning marks the beginning.

It is my intention to have several hearings over the coming months. At the suggestion of many, we will hear from regulators, we will hear from academicians, we will hear from all those concerned who have a financial interest in seeing trust become the bedrock of our financial marketplace again.

Mr. Kanjorski.

Mr. **KANJORSKI**. Thank you very much, Mr. Chairman.

We meet today to consider the issue of analyst independence, a subject of great significance to our nation's vibrant capital markets. I congratulate you on your diligence in convening this very important and well-timed hearing.

I would make, at this point, two observations, however, Mr. Chairman. As I walked down the hall, it is the first time in my memory that the line is down to the corner and around the corner, and down the other hallway. It reminds me that when I was a little boy, I read the 50 years of the New Yorker cartoon book, which asked a very pungent question: Where are the investors' yachts? I think today's crowd brings that cartoon back into play. Maybe that is why we are meeting here.

The second observation is one of internal process. I do want to register my great disappointment with the House leadership in convening a very important bill involving SEC revenues that is on the floor today at the precise moment we are having this hearing. As you know, Mr. Chairman, several of us on this side of the aisle are opposed to the passage of the bill in its present form, and intended to argue that position on the floor today, as well as offer amendments in accordance therewith. And, as a result of the importance of this hearing, and the conflict with that bill on the floor, we are really put in an impossible situation either to miss our opportunity here and the intelligence we can gather, or to have a bill go through without comment. I hope this scheduling was not intentional, and I hope it never happens again.

With that said, it is a well-timed hearing. I am not attempting to be facetious when I say that. Over the last several years, the perceived immortality of the U.S. economy and the emergence of the Internet have contributed to extraordinary interest and growth in our capital markets.

Investors' enhanced access to financial reporting and their new-found ability to trade electronically also helped to fuel this dynamic expansion. Unlike some other sources of investment advice, the vast majority of the general public has usually considered the research prepared by Wall Street experts as reliable and valuable. With the burst of the high tech bubble, however, came rising skepticism among investors concerning the objectivity of some analysts' overly optimistic recommendations. Many in the media have also asserted that a variety of conflicts of interest may have gradually depreciated analysts' independence during the Internet craze and affected the quality of their opinions.

We have debated the issues surrounding analysts' independence for many years. After the deregulation of trading commissions in 1975, Wall Street firms began using

investment banking as a means to compensate their research departments, and within the last few years the tying of analysts' compensation to investment banking activities has become increasingly popular.

As competition among brokerage firms for IPOs, mergers and acquisitions grew, so did the potential for large compensation packages for sell-side analysts. These pay practices, however, may have also affected analyst independence.

While some brokerage houses suggest that they have erected an impenetrable Chinese wall, which you mentioned, that divides analyst research from other firm functions like investment banking and trading, the truth, as we have learned from many recent news stories, is that they must initiate a proactive effort to rebuild their imaginary walls.

The release of some startling statistics has also called into question the actual independence of analysts. A report by First Call, for example, found that less than one percent of 28,000 recommendations issued by brokerage analysts during late 1999 and most of 2000 called for investors to sell stocks in their portfolio. Within the same timeframe, the NASDAQ composite average fell dramatically. In hindsight, these recommendations appear dubious. Furthermore, First Call has determined that the ratio of buy-to-sell recommendations by brokerage analysts rose from 6-to-1 in the early 1990s, to 100-to-1 in 2000.

Many parties have consequently suggested that analysts may have become merely cheerleaders for the investment banking division of their brokerage houses. I agree. To me, it appears that we may have obsequious analysts instead of objective analysts.

Today's hearing will help us better understand the nature of this growing problem and discover what actions might restore the public's trust and investors' confidence in analysts. Like you, Mr. Chairman, I generally favor industry solving its own problems through the use of self-regulation whenever possible. But in this instance, the press, regulators, law enforcement agencies, and spurned investors have also begun their own examinations into these matters. I suspect that these parties may demand even greater reforms than those recently proposed by the Securities Industry Association, including the need for full and robust disclosure of any and all conflicts of interest. To address these concerns, the industry may eventually need to come forward with a way to audit and enforce the best practices it now proposes. If not, others may seek to impose their own solutions to resolve this problem.

We will hear today from eight distinguished witnesses representing a variety of viewpoints. I am, Mr. Chairman, particularly pleased that you invited a representative from the AFL-CIO to join in our discussions. I would have also liked to learn from the concerns of SEC and NASD, among others.

I was, however, heartened to learn yesterday that you plan to hold additional hearings on this issue in the upcoming months with the concerned parties.

As we determined last year during our lengthy deliberations over Government

sponsored enterprises, a roundtable discussion is often the most appropriate forum for us to deliberate over complex issues. In the future, I urge you to convene a roundtable over the matters related to analyst independence. A roundtable discussion would force the participants to challenge each other's assumptions and assertions in an open environment. It would also provide us with greater insights than testimony that has been scrutinized and sterilized through the clearance process. A roundtable debate would further allow us to more fully educate our Members about the substantive issues involved in this debate.

In closing, Mr. Chairman, let me caution all Members of this subcommittee, and particularly Members on my side. This is an issue that evidently is somewhat sexy and popular just by evidence of the amount of television here today. To people in public office and, quote: "politicians," it may be a great temptation to be a demagogue.

I join you in urging our fellow Members and others in our society to hold back their fire and their conclusions. We have the most successful financial and capital markets in the world.

Because we are in some difficulty economically in the markets, this is not the time to grab a club and take personal advantage by playing the role of lead demagogue. We cannot afford that, and the American economy cannot afford that.

So I look forward to hearing the testimony today. I think that over the next several months, if we use more open fora, we may be able to find a solution to a problem that is self-regulation by the Association and the industry itself. I would join you in that effort and hopefully, that is the best conclusion that we could reach.

Thank you, Mr. Chairman.

Chairman **BAKER**. Thank you, Mr. Kanjorski.

Just by way of assurance, the subcommittee's hearing date was established some time ago without knowledge of the floor consideration. Your point concerning the fee reduction bill on the floor today and the subcommittee hearing simultaneously is a matter of concern, but I assure you it was not an intentioned effort to create difficulty.

I happen to have some interest in the opposite side on that matter, and would like to be there to watch you on the floor very carefully.

Mr. **OXLEY**. Thank you, Mr. Chairman. Let me commend you for holding this hearing.

One of my goals, as the Chairman of this new Committee, is to help investors by improving the way they get information on which they base their investment decisions. Due in large part to the advances in technology that have brought to us the Internet, we've become not only a Nation of investors, but a Nation of self-taught investors.

No longer do investors have to rely on the information they obtain from their broker to

make their investment decisions. Today, there is a veritable smorgasbord of information about the marketplace available to the public through financial websites, print publications, television, and virtually every media outlet.

There is a wealth of data available to investors. I launched this subcommittee's inquiries into improving the way stock market quotes are collected and disseminated into the impact of Regulation FD with an eye toward assuring that investors have broad access to the highest quality information about the marketplace.

Today's hearing continues our work toward that goal. I commend you, Mr. Chairman, for your work on each of these issues and for holding this important hearing today. I heartily agree with the Supreme Court's characterization in the Dirks case of the importance of analysts to investors to the marketplace.

And I quote: "The value to the entire market of analysts' efforts cannot be gainsaid. Market initiatives are significantly enhanced by their efforts to carry it out and analyze information. Thus the analysts' work rebounds to the benefit of all investors."

Yet the important work of analysts is not to the marketplace or investors any good at all, if it is compromised by conflicts of interest. There has been a great deal of concern raised by the media by regulators and by market participants about the perception that analysts are not in fact providing the independent, unbiased research that investors and the marketplace rely on.

We are here today to learn whether the Chinese wall that is long cited as the separation between the research and investment banking arms of securities firms has developed a crack or is completely crumbling.

I am encouraged that Wall Street has recognized that this is not a phantom problem, and has proposed industry best practices guidelines to address these conflicts about which we will hear today.

But I must emphasize that if that Chinese wall is in need of repair, wallpaper will not suffice.

While I am a strong proponent of free market solutions, I and the subcommittee plan to examine these industry guidelines very closely to ensure that they are tough, they are fair, and they are effective.

I am distressed by the statistics that as the markets were crashing last year, less than two percent of analysts' recommendations were on the sell-side.

It is no wonder there is public outcry about analysts' independence when the statistics are so stark. But it seems to me that the problem is not simply biased analysts. The firms that employ these analysts tie their compensation to the analysts' success in bringing in investment banking business.

Then the firms are undermining the independence of their own employees' recommendations.

Similarly, companies that pressure analysts through either the carrot on the stick or of increased or decreased investment banking business in turn for favorable reports exacerbates the problem.

Likewise, institutional investors also exert pressure on analysts to issue rosy reports about the stocks those institutional investors hold in their own portfolios.

We intend to examine every angle of this issue in order to best determine how to resolve it. Our subcommittee's goal here is to improve industry practices and I call on the industry to eliminate the conflicts of interest created by compensation structures and insufficient separation of investment banking and research, and I call on them also to provide meaningful and understandable disclosure to investors that will enable investors to evaluate, for themselves, what weight they should give the recommendations of any particular analyst.

Mr. Chairman, this hearing is this subcommittee's first step in a long-term effort to ensure that the Nation's investors have the best possible information about the stocks in which they invest. Ensuring that investors could rely on the expertise of analysts, without any doubt as to their integrity or independence, could not be more fundamental to that effort.

I yield back the balance of my time.

Chairman **BAKER**. Thank you, Mr. Chairman. I certainly appreciate your leadership on this issue as well.

Mr. LaFalce.

Mr. **LAFALCE**. Thank you very much, Chairman Baker.

Today, our subcommittee confronts the very important question of whether investors are receiving unbiased research from Wall Street securities analysts.

I don't think they are, and I commend the Chairman for holding these hearings. I'm very concerned that investors have become victims of recommendations of analysts who have apparent and direct conflicts of interest relating to their investment advice.

So I think this morning's hearing is extremely important. It is anomalous that as our subcommittee considers this extremely important hearing, the bill that was reported out of our subcommittee is on the floor of the House of Representatives either now or in a matter of moments, reducing the fees of the SEC by approximately \$14 billion over the next 10 years, without regard to the capacity of the SEC to effectively enforce the laws and regulations responsible for investor independence and objectivity, responsible for accounting independence and objectivity, responsible for so many of the other problems

which are probably just the tip of the iceberg of problems existing for investors in this multi-trillion marketplace that the individual citizen is participating in today in the United States in a manner unparalleled in American history.

That's very regrettable, but in any event, I'm glad for the hearing. It's clear that sell-side analysts work for firms that have business relationships with the companies they follow. Most analysts are under increased pressure to look for and attract business and to help the firm keep the business it has.

The analyst is asked to be both banker and stock counselor and these two goals often live in conflict. The individual investor is often unaware of the various economic and strategic interests that the investment bank and the analysts have that can fundamentally undermine the integrity and quality of analysts' research.

The disclosure of these conflicts is often general, inconspicuous, boiler plate, meaningless. In addition, current conflict disclosure rules do not even reach analysts touting various stocks.

For example, on CNBC or CNN, as former Chairman of the SEC, Arthur Levitt noted, I wonder how many investors realize the professional and financial pressures many analysts face to dispense recommendations that are more in a company's interest rather than the public's interest.

I believe it is precisely these pressures that moved many analysts, during the technology boom over the last several years, to recommend companies and assign valuations beyond any relationship to company fundamentals.

In a recent article, a very well-known technology analyst was quoted as responding to questions concerning the legitimacy of the valuation of a particular company, and the analyst said, we have one general response to the word "valuation" these days. Bull market. We believe we have entered a new valuation zone.

The article to which I refer, and many, many, many others like it, make the case that these conflicts may have profoundly undermined analysts' integrity and possibly misled investors. I think possibly should be almost certainly misled investors as analysts held fast to companies, as the market eroded out from under them.

The Securities Industry has suggested new guidelines to address some of the conflicts we will discuss in today's hearing. Their initiative is an important first step. I do not believe, however, that these voluntary guidelines go far enough to address the problem.

I am pleased therefore that today's hearing will begin a process whereby our subcommittee and the regulators can begin to take a hard look at these troubling questions affecting the American investing public.

I look forward to the hearings where the SEC and the NASD, amongst others, where academic analysts, where investors, attorneys, and others can testify on the question of

analyst objectivity.

In my view, the Securities regulators' perspective is especially critical. We cannot fulfill our oversight responsibility if the Government and quasi-government entities, charged by Congress with the protection of investors, have not been heard.

Not only do the Securities regulators have an important perspective on the magnitude of the problem, they also have a view on how the industry is complying with current regulations on information barriers, so-called Chinese walls and the disclosure of conflicts.

In sum, I am increasingly concerned that industry self-regulation may not be sufficient to guard against the problems and abuses we are seeing, and that more disclosure of these conflicts, in itself, may not suffice to protect the individual investor.

So I hope today's hearing is only the first step in confronting these very troubling issues of securities analysts conflicts of interest that mean trillions of dollars to people in neighborhoods across America.

I thank you.

Chairman **BAKER**. Thank you, Mr. LaFalce.

By prior agreement, we had hoped to limit opening statements to the Members previously recognized, and I intend to do so, but I have been requested by Ms. Jones to be recognized for 30 seconds to explain her necessity for departing from the hearing this morning.

Ms. Jones.

Mr. **JONES**. Mr. Chairman, Mr. Ranking Member, Colleagues, I appreciate the opportunity to submit my statement for the record.

This morning, the National Institutes of Health will be naming a building after the Honorable Congressman Louis Stokes, my predecessor. I must go out there and congratulate them. Thank you very much. I submit my statement for the record.

Chairman **BAKER**. Thank you very much, Ms. Jones.

At this time, I would like to proceed with the introduction of our panelists.

Our first to participate this morning, we welcome, is Mr. David Tice, Portfolio Manager, the Prudent Bear Fund, and publisher of the institutional research service known as "Behind the Numbers."

Welcome, Mr. Tice.

For the record, all witness statements will be made part of the record. Please feel free to summarize. We will have a number of questions for the panel during the course of the morning, and we would like to maximize that time as best we can.

Please proceed, sir.

STATEMENT OF DAVID W. TICE, PORTFOLIO MANAGER, PRUDENT BEAR FUND, AND PUBLISHER OF THE INSTITUTIONAL RESEARCH SERVICE "BEHIND THE NUMBERS"

Mr. **TICE**. Thank you very much, Mr. Chairman. David W. Tice & Associates operates two different businesses. We publish "Behind the Numbers," an institutional research service, and serve as investment advisor to two mutual funds.

I started "Behind the Numbers" in 1988 because I realized institutional investors did not receive independent, unbiased research from their traditional brokerage firms, which almost never issued sell recommendations.

To our knowledge, there are now fewer than six other significant firms that concentrate on only sell recommendations.

We like to call ourselves "The Truth Squad" with regard to individual Wall Street recommendations. The truth is, this lack of analyst independence has been great for our business. Currently, more than 250 institutional investors purchase our service. Our 15 largest clients manage more than \$2.3 trillion.

David W. Tice & Associates, Inc., is a modest-sized organization of 17 professionals, yet every 2 weeks we butt heads with the best and brightest from Wall Street's biggest firms with our assessment of company fundamentals.

Of nearly 900 sell recommendations issued between 1988 and 2001, 67 percent have under performed the market with about half declining in price in the biggest bull market in this century.

Usually our analysis makes our research clients uncomfortable as well as potential mutual fund shareholders because it differs from the Wall Street consensus.

However, our research has earned respect because of its quality and because people realize that our conclusions are free of the biases that affect traditional Wall Street research.

Our job is not to be pessimistic or optimistic, but to be realistic and to help protect clients' capital. In this spirit, and with the benefit of our insight into hundreds of U.S. companies that we analyze, the U.S. stock market and economy, we concluded that we had a bubble stock market and a bubble economy.

So we organized the "Prudent Bear Fund" in 1996, the same year that Alan Greenspan

made his famous "irrational exuberance" speech.

We believe the individual investor should be warned and should have access to a vehicle to hedge himself in a market decline. Some will question our objectivity since we manage this bear's fund, and say that I'm just talking "my book."

But I believe passionately in every word of my testimony, and it's all based on fact, rigorous analysis, and solid macro-economic theory.

There is no question, Mr. Chairman, that Wall Street's research is riddled with structural conflicts of interest. Compounding this problem, according to a recent study, those who closely follow Wall Street's stock recommendations have suffered abysmal investment performance as this study showed that from 1997 through May 2001, only 4 out of 19 major Wall Street firms would have generated positive returns over the 4 1/2 year period in the biggest bull market in this century.

In our testimony, we've provided many examples of conflicts. Generally, our perception of this situation today coincides with the Chief Investment Officer of Asset Allocation of a multi-billion dollar asset manager who said, and I quote: "Research analysts have become either touts for their firm's corporate finance departments or the distribution system for the party line of the companies they follow. The customer who follows the analysts' advice is paying the price."

Today, the power structure of most Wall Street firms is simply concentrated too much in investment banking; and even with the supposed Chinese walls, there are still multiple cases of analysts reporting to investment bankers.

This is an outrage. This conspicuous lack of objectivity in research is indicative of what we see as a general lack of responsibility on Wall Street today, one that's having a corrosive effect on the marketplace.

The main emphasis of our testimony has addressed the consequences that arise when capital markets lack integrity, stemming largely from this lack of objectivity. This problem is much larger, Mr. Chairman, than whether or not individual investors are disadvantaged or have suffered losses, or if analysts receive over-sized bonuses.

What's at stake we believe is that a sound and fair marketplace is at the very foundation of capitalism. It is the functioning of the market pricing mechanism that determines which businesses and industries are allocated precious resources, and it is this very allocation process that's the critical determining factor for the long-term economic well being of our nation.

When the marketplace regresses to little more than a casino, the pricing mechanism falters and the allocation process becomes dysfunctional. When the marketplace's reward system so favors the aggressive financier and the speculator over the prudent businessman and investor, the consequences will be self-reinforcing booms and busts, a hopeless misallocation of resources, and an unbalanced economy.

We believe that in an environment of more independent analysis, it would have led to a more efficient capital allocation where we would have financed fewer internet companies less fiber optic bandwidth, and instead perhaps built more refineries in California power plants.

When credit is made readily available to the speculating community, failure to rein in the developing speculation risks ponzi-type investment schemes. Such an environment will also foster a redistribution of wealth from the unsuspecting to those most skilled in speculation.

Such an environment creates dangerous instability, what we refer to as financial and economic fragility.

The financial sector is creating enormous amounts of new debt that's often being poorly spent. Sophisticated Wall Street, with its reckless use of leverage, proliferation of derivatives, and sophisticated instruments, is funding loans that should not be made.

While such extraordinary availability of credit certainly does foster an economic boom, it must be recognized that history provides numerous examples of the precariousness of booms built on aggressive credit growth that are unsustainable and dangerous.

Goldman Sachs' Abby Joseph Cohen has used the phrase "U.S. Supertanker Economy," but the problem is Wall Street has created a ship that has run terribly off course. Wall Street's lack of independence has fostered this misdirection and camouflaged the fact that our U.S. economy is in danger because of our capital misallocation and credit excess.

This may sound ridiculous to most of you with nearly uniform optimism among traditional economists. But if you doubt me, I'll quote ex-Fed Chairman Paul Volker, who more than 2 years ago said, quote: "The fate of the world economy is now totally dependent upon the U.S. economy, which is dependent upon the stock market whose growth is dependent on about 50 stocks, half of which have never reported any earnings."

If I could go to our potential solutions. We do not pretend to be experts in the area of Securities Law and Regulation. We have presented a list of nine solutions in the spirit of general directions to take, not specific laws to change.

Not included in our list of solutions are proposals that try to tinker with analysts' compensation schemes or require some type of peer review. We believe the problems are so significant and so critically important, bold solutions, not incremental change, are required.

Tremendous political courage will be needed to effect change in this area. Those who have benefited from the current broken system have enormous financial resources.

The raw political power of those who favor the current system cannot be underestimated.

The voice of those favoring change will be faint, but well worth listening to. However, we must remember that trust in our institutions is the cornerstone of a vibrant capitalist society, and lies at the heart of a healthy democracy.

Chairman **BAKER**. Can you begin to wind it up, sir?

Mr. **TICE**. Yes. We commend the subcommittee and Chairman for tackling such a difficult and timely issues. The stakes are enormous.

Thank you for the honor of appearing before this subcommittee.

Chairman **BAKER**. Thank you, Mr. Tice. I appreciate your courtesy, sir.

Our next witness to appear is Mr. Gregg Hymowitz, founding partner, EnTrust Capital.

Welcome, sir.

STATEMENT OF GREGG S. HYMOWITZ, FOUNDING PARTNER, EnTRUST CAPITAL

Mr. **HYMOWITZ**. Mr. Chairman Baker, esteemed Members of the subcommittee, I'm Gregg Hymowitz, a founding partner in EnTrust Capital. It's a pleasure to share with you this morning my summarized thoughts and observation.

My comments today represent solely my personal views and not necessarily the views of EnTrust Capital.

Is there a conflict of interest among sell-side analysts and the companies they cover? In my opinion, the answer is yes.

But the relationship between analyst, issuer, and the investing public is a complex network of checks and balances.

Typically, the analyst works for an investment bank whose bankers are attempting to move business from the issuer, often in the form of a capital market transaction. Therefore, most analysts recognize it does not behoove their firm's self-interest to have a negative view on the issuer.

Additionally, most analysts's compensation at investment banks has historically been partially determined by the amount of high margin capital market transaction revenues for which each analyst was responsible.

The communication between analyst and issuers is symbiotic. The issuer needs the analyst's coverage to get potential investors interested in buying, and the analyst's life blood is an open communication channel to the issuer.

One can surmise that communication is easier and more open between parties when they are aligned. The pressures and conflicts on the sell-side analysts during the recent equity bubble were exaggerated by the compressed period of time the capital markets were accommodative.

Investment banks, due to the demand from the investing public, and the supply created by venture capitalists, took hundreds of companies public that, in historical terms, would never have made it out the door.

The need for new valuation metrics became apparent. Free cash flow and earnings metrics were replaced with multiples of sales, developers, and my favorite, web hits.

Now while many of these metrics have turned out to be just plain silly and will continue to remain just plain silly, we need to remember 20 years ago, a now widely recognized metric called EBITDA was created to analyze certain profitless companies.

Investment banks have been recommending stocks to their clients roughly since the 1792 Buttonwood Agreement. Historically, however, the Morning Call was the province of the institutional money manager, who understood where this information was coming from and was able to evaluate its relative importance.

With the rise of the Internet, Wall Street calls are everywhere, rich with a frenzy day trading analyst calls took on exaggerated importance. Often the trading public seized upon these calls and stocks would move significantly. Remember, there was little or no public uproar over analysts' rosy coverage in 1999, when many investors were making in the market hand-over-fist.

For years, the institutional money manager understood from where the sell-side research held, and as it became more dispersed, the individual investor has now caught on.

In this age of information overload, the individual has the responsibility to perform his or her own due diligence. For decades now, the institutional investor has been ranking equity analysts, and today there are dozens and dozens of free websites, which rank analysts.

These resources are doing an excellent job of informing those investors who are willing to invest the time on doing due diligence, and which analysts to follow.

But for the individual who merely sees the stock market as a craps table, without doing any of his or her own research on either the issuer or the analyst, does so at one's own peril.

One idea that may coerce analysts to be more thoughtful in their recommendation is for investment banks to actually urge analysts to own the stocks they suggest, with proper internal safeguards to prevent such things as front running in addition to appropriate disclosure, analysts actually owning the stocks they recommend actually may help

ameliorate the biases that exist.

The old Wall Street adage to analysts is, don't tell me what you like, tell me what you own. Many individuals want to find a causal relationship between the market's crash and the lack of sell recommendations among sell-side analysts.

I believe no causal relationship exists. While there have been many buy ratings on the steel, food, and retail stocks, with little if any sell recommendations, they did not experience the meteoric rise many tech stocks had over the past couple of years, incorrectly many believe that there are few sell recommendations on Wall Street.

There are, however, numerous firms, including Mr. Tice's, that specialize in providing only sell recommendations. Unfortunately, much of this research is not widely circulated to the individual investor because, quite frankly, it is very costly. There are also many countervailing pressures on analysts that work toward providing a balanced view, first and foremost. On Wall Street, reputation and record mean everything.

The analysts over time who are the most thoughtful, responsible and correct earn the respect of the investment community. This institutional pressure for analysts to be correct is the largest force compelling unbiased work.

Another clear way of holding analysts accountable is for the investment bank to publish each analyst's performance record. This will provide more information to the investors and aid those who are superior stock pickers.

Investment bankers should improve the materiality of disclosure statements. It is more important from a potential conflict standpoint to know if the bank is currently engaged by the issuer or is pitching the firm new business, rather than the typical historical disclosures.

The disclosure statement should consist of whether the analyst personally owns the security. Equity ownership by analysts is a positive occurrence, not something to be shunned.

I will sum up. The new information age, combined with Regulation FD, Fair Disclosure, is impacting the role of the analyst, with companies now severely limited to what they can say to analysts.

Prior to generally released news, the importance and edge that analysts have over the investing public has significantly diminished. Unfortunately often, and I know this from personal experience, the only way to learn this business is from mistakes. That costs money.

Investors have learned a hard lesson. With huge rewards come equally huge risks, the bubble has burst. There will be other manias with new and probably evermore fanciful evaluation metrics in our future.

Investors should not believe everything they read, hear, or see. In the new Regulation FD Internet age, the playing field has been leveled, possibly lowered. And therefore the responsibility accordingly must be shared.

Thank you, Mr. Chairman.

I'd be honored to attempt to answer any questions the subcommittee may have.

Chairman **BAKER**. Thank you very much.

Just by way of notice to Members, we have a 15-minute vote on the floor pending, followed by two 5-minutes. It would be my intention to recognize Mr. Glassman for his opening statement, and then recess the subcommittee at that moment to proceed to the votes. We'll be out for about 15 minutes. We will try to get back as quickly as possible.

Mr. **LAFALCE**. Parliamentary inquiry, Mr. Chairman.

I understand what you just articulated. I wonder if we might consider—I suppose this depends upon the schedule of the witnesses of panel one and panel two. The bill that we are considering deals with the SEC and the fees that are being charged. Section 31, Section 6, Section 13, Section 14, peg to parity capacity of SEC for enforcement, and so forth.

I'm wondering if we couldn't recess until completion of debate and passage of that bill, and then return. I suspect it would be about 2:00 o'clock. But I don't know what the schedule of the witnesses is.

Right now, we have two responsibilities; one here and one there. We can't bi-locate, so either we have to give short shrift to one of our responsibilities and they are both great.

Chairman **BAKER**. I understand the gentleman's point. Ordinarily, if we had prior notice to try to make arrangements, we would have just convened at a later hour today, but given the witnesses' traveling arrangements, I respectfully suggest we proceed as announced with a brief recess, come back, and we will do all we can to accommodate appropriate consideration.

I intend to be in the subcommittee most of the day and will miss most of the debate on the floor myself, which I deeply regret. But I think in deference to the eight people who've made arrangements to be here, we need to proceed as we scheduled.

At this time, I'd like to recognize Mr. James Glassman, no stranger to the subcommittee, who is a Resident Fellow at American Enterprise Institute and Host of TechCentralStation.com.

Welcome, Mr. Glassman.

STATEMENT OF JAMES K. GLASSMAN, RESIDENT FELLOW, AMERICAN

ENTERPRISE INSTITUTE, AND HOST WWW.TECHCENTRALSTATION.COM

Mr. **GLASSMAN**. Thank you, Mr. Chairman, Members of the subcommittee.

My name is James K. Glassman. I'm a resident fellow at the American Enterprise Institute, author of financial books and an investing columnist for many years. I've devoted much of my professional life to educating small investors.

This hearing sheds light on an important subject, but I urge restraint in two ways. First, analysts should not be seen as scapegoats for the recent market decline.

Second, this subcommittee should resist the urge to pass legislation in this area.

Analysts and firms have enormous incentives to do their jobs well. The marketplace weeds out the bad from the good as long as the public has the information. That is the function of a hearing like this, and I commend you for holding it.

Many analysts were caught off guard by the recent decline of the stock market, which represented the first bear market in a decade. Some of them were accused of allowing personal financial interests and a desire to cater to the investment banking side of their firms to distort their judgments.

Let me make three comments about this criticism.

First, conflicts of interest pervade the securities industry because they pervade life. You Members, yourselves, cope with conflicts all the time. You have allegiances to family, to donors, to party, but you try to surmount them.

Or consider journalists. Surveys show that most journalists lean to the left of the political spectrum. For example, a study by the Roper Center of 139 Washington bureau chiefs and correspondents found that in 1992, 89 percent of them voted for Bill Clinton, 7 percent for George Bush, yet every journalist to whom I've ever spoken claims that his professionalism overrides these conflicting political leanings.

Does it?

Well, the answer is that we can judge for ourselves by reading the articles that they write or the TV segments in which they appear.

A similar situation prevails for stock analysts, except that their judgments are clear and more easily accessed by the public.

The essential problem with a conflict of interest of any sort is that it leads to poor decisions. In the case of journalists, bias may suddenly color reporting and be difficult to discern.

In the case of stock analysts, it could mean that a company with poor fundamentals is given a high recommendation.

In this case, however, the analysts' judgment is assessed quickly by the public. An analyst who consistently gives bad advice will be rejected as not useful, either to investors or ultimately to the firm that employs her. An analyst cannot hide for very long.

Second, I favor voluntary and extensive disclosure by analysts of personal holdings and other affiliations that might color decisions. But don't exaggerate the benefits of disclosure. What, for example, should an investor make of the disclosure that an analyst owns shares of stock that he recommends?

Is it that the stock may not be all that good, but the analyst is pushing it for personal gain?

Or is it the opposite. That the stock is particularly good because the analyst owns it?

I am not really sure that disclosure is all that helpful. Yet, I do favor it, and I do it myself.

Third, the essential critique is that analysts biased by conflicts have made poor recommendations. Now we can test that theory by looking at the actual performance of analysts.

How well do they do? This question has been examined at length in a study published in the April 2001 issue of the *Journal of Finance*, a highly regarded publication for scholars.

In the article, the articles, Brad Barber of the University of California at Davis and three of his colleagues found that analysts' recommendations were in fact prescient and profitable. This research reinforces earlier studies that have found that professional securities forecasters have acted rationally, that is, with proper judgment.

The authors of the new study looked at a database of 360,000 pieces of advice from 269 brokerage houses and 4,340 analysts from 1986 to 1996. They found that investors buying portfolios of the highest rated stocks by these analysts achieved average annual returns of 18.8 percent to compare with a stock market benchmark return over this period of 14.5 percent.

The lowest rated stocks by analysts achieved a return of only 5.8 percent.

These results are truly exceptional. Rare, for example, is the mutual fund that can beat the Standard & Poor's 500 Stock Index by four points over 10 years. In fact, the benchmark has beaten the majority of funds over the past two decades.

I should add that Mr. Tice likes to criticize analysts, but his own fund, the Prudent Bear Fund, has, according to Morningstar, produced a total return of minus 47 percent

from its inception in 1996 through April 30th, 2001.

The S&P 500, the benchmark, produced a return of positive 120 percent.

The results of the Barber study suggest that analysts are truly able to pick winners.

Now last month, the researchers published an unpublished follow-up for 1997 to 2000. In the first three of those years, the results were even better than they had been in the previous 10 years. But in the final year, 2000, the results were terrible. The most highly recommended stocks fell sharply while the least favored stocks did the best.

Those results of course are at variance with the previous 13 years and certainly we should watch analysts closely, but the longer term results show that, on the whole, analysts do a good job for their clients.

Finally, I worry that this hearing could send three wrong messages to investors, to small investors. The first is that bad stock picks are the result of corruption and bias. In the vast majority of cases, they are not.

Poor picks usually happen because the market in the short term is impossible to predict. No one is right all the time or even much better than half the time.

The second wrong message is that short-term stock recommendations are all that important to investors. Again, they are not. The best advice to investors always is to own a diversified portfolio for the long term.

Concentrating on the day-to-day judgment of analysts is not a profitable pastime for small investors, whether those analysts are pulled by conflicts of interest or not.

And the third wrong message is that the paucity of sell recommendations is a scandal. To the contrary, smart investors buy stocks and they keep them; they don't sell.

Despite the past year, as I said earlier, the benchmark is up 120 percent in 5 years. Investing is a long-term endeavor; done best, it is boring. If I could change anything that analysts do, it would be to encourage them to tell us the best stocks to own unchangingly for the next 5 to 10 years, not the next 5 to 10 weeks.

However, I congratulate this subcommittee for airing such an important issue.

Thank you.

Chairman **BAKER**. Thank you, Mr. Glassman.

We stand in recess for approximately 15 minutes.

Thank you.

[Recess.]

Chairman **BAKER**. I'd like to begin the effort to reconvene our hearing. The good news is we only had two votes instead of three and Members are on their way back. I expect them to be coming in as we proceed.

In order to facilitate the progress in the hearing, I'd like to go ahead and recognize our next witness. It's my expectation that we will have at least another hour before we get interrupted again unless of course things change.

With that caveat, I would like to, at this time, recognize Mr. Marc Lackritz, President of the Securities Industries Association.

Welcome, Mr. Lackritz.

STATEMENT OF MARC E. LACKRITZ, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

Mr. **LACKRITZ**. Thank you, Mr. Chairman. Mr. Chairman, I'm really pleased to be here this morning to have this opportunity to meet with you and the subcommittee.

The subject of today's hearing concerns how this industry fulfills its obligations to its customers, to the nearly 80 million Americans who directly or indirectly own shares of stock.

Our most important goal as an industry is to foster the trust and confidence of America's shareholders in what we do and how we do it.

And we succeed as an industry only when we put investors' interests first, period.

I will refer you to my written testimony for a detailed description of who analysts are and how they help investors and our markets. The value added by securities analysts has been widely appreciated.

For example, both the Supreme Court and SEC have said in the Dirks case, as Chairman Oxley indicated earlier, that the value to the entire market of analysts' efforts cannot be gainsaid.

Market efficiency and pricing is significantly enhanced by their initiatives to ferret out and analyze information. Thus, the analysts' work redounds to the benefit of all investors.

How good a job you can ask do securities analysts do? As a group, they do a pretty good job. As my colleague, Mr. Glassman, said earlier, the recent academic paper that he cited reviewed approximately 500,000 analysts' recommendations from 1986 to 2000, and concluded that the consensus recommendations that analysts make on specific stocks prove both prescient and profitable.

The authors found "sell-side analysts' stock recommendations to have significant value." Aside from this comprehensive study, it's quite notable that 71 percent of recommendations listed in First Call are buys or strong buys.

This seems appropriate, considering that the 12 years from 1988 through 1999 saw the Dow Jones Industrial Average and the Standard & Poor's 500 Index both post an average gain of 16 percent a year.

Critics of analysts were much less vocal then. To be sure, in the past year or so as the market declined and the Internet bubble burst, it seems that securities analysts have a few bloody noses. They certainly do and they are not alone. Just about everyone working, reporting on, and commenting about securities recently has tripped at least a few times.

The question before this subcommittee is whether these analysts can be subjected to direct or subtle pressure to skirt objectivity and shade their conclusions one way or another.

It's a very legitimate question. The answer is, yes, they can. We in the industry, as well as those who regulate us, long have been aware of this. For this reason, there are strong legal mandates in the Securities Exchange Act of 1934. And similar regulations and laws are on the books to ensure research integrity and objectivity.

These are tough regulations as are the internal safeguards, yet it is clear that some doubts may now be clouding the perception of how securities analysts operate. That's why we're meeting today, just to banish these clouds.

The Securities Industries Association has formalized and bolstered the safeguards by endorsing and releasing earlier this week, these best practices for research. In these, we articulate clearly the means to protect the independence and objectivity of securities research and the securities analysts.

We reaffirm that the securities analyst serves only one master, the investor, not the issuer nor the potential issuer.

Let me offer some examples from its main points:

One. The integrity of research should be fostered and respected throughout a securities firm. Each firm should have a written statement affirming the commitment to the integrity of research.

Two. The firm research management, analysts and investment bankers, and other relevant constituencies should together ensure the integrity of research in both practice and appearance. Research should not report to investment banking. The recommendation should be transparent and consistent. A formal rating system should have clear definitions that are published in every report or otherwise readily available, and management should support use of the full rating spectrum.

Three. An analyst should not submit research to investment banking nor to corporate management for approval of his or her recommendations or opinions, nor should business producers promise or propose specific ratings to current or prospective clients while pursuing business.

Four. A research analyst's pay should not be linked to specific investment transactions.

Five. Research should clearly communicate the relevant parameters and practical limits of every investment recommendation. Analysts should be independent observers of the industries they follow. Their opinions should be their own, not determined by those of other business constituencies.

Six. Disclosure should be legible, straightforward and written in plain English. Disclaimers should include all material factors that are likely to effect the independence of specific security recommendations.

Seven. Personal trading and investments should avoid conflicts of interest and should be disclosed whenever relevant. Personal trading should be consistent with investment recommendations.

There are a number of other important points to best practices, copies of which have been submitted to the subcommittee.

In addition to these best practices, Mr. Chairman, we will also continue and renew our efforts to educate investors on the risks and rewards inherent in the market, as well as basic investment precepts.

We have a number of publications that we've put out over the last couple of years. They are available on our website, and we're renewing our efforts to distribute them through our own members to investors directly.

Successful investing is a partnership between securities professionals and the investor. Therefore, just as the securities industry is renewing its commitment to do its part, we ask investors to be educated, informed, and prudent in their investment decisions.

The long-term interests of investors, the securities analysts and the securities firms for which they work are best served by analysts using their most skilled powers of research and best judgment.

The market is a very powerful and unforgiving enforcer. Flawed projections lose customers.

All of us in this industry know only too well the truth of the adage that it takes months to win a customer, but only seconds to lose one.

No securities firm wants to give advice that will hurt a client. Firms that offer bad investment guidance penalize themselves.

We believe the best practices endorsed by so many major firms and continuing throughout our Association demonstrate a vigorous renewed commitment to the investor. We hope they will go a long way toward ensuring that the public maintains and increases its trust and confidence in our markets and our industry.

Thank you very much, Mr. Chairman.

Chairman **BAKER**. Thank you, Mr. Lackritz.

I'll start my questions with you and the recitation of the best practice summary you just concluded. One element of that that I believe I understand, and want to clarify, that the compensation for an analyst should not be tied to a specific transaction, so that a recommendation that leads to a client is an example of something, a favorable recommendation would not be compensated by bringing that client into the bank.

However, I believe this to be accurate, and this is the reason for the question. Either on a quarterly or on an annual basis, the bank may declare bonuses for all affected parties and therefore reimburse or reward the analyst for the year-long effort, as opposed to the specific transactional activity.

That is correct, is it not?

Mr. **LACKRITZ**. Yes. But the specific best practice says that competition is not to be directly tied to any specific banking transaction or trading revenue or sales practice, but should be based on the overall performance of the analyst including the quality of the recommendations that the analyst has made.

So the notion is to make it a merit-based compensation system. Of course, if the firm does better, everybody is going to get some of the rewards from that.

Chairman **BAKER**. I understand that. I'm just reading it critically from a legislative perspective.

I would seem to me that rather than Fed-Exing the reward, we're going to send it by bus. That's my problem. There still is a correlation between the recommendations and bringing business in, as opposed to doing pure analytical work.

I'm merely making that point to say that the best practices are indeed an appreciated step and I want to acknowledge that.

As I told you and others, when it was presented, one of the elements that I believe is missing that we need to figure out how to resolve is the way to confirm or audit the compliance. It's one thing to have a nice book and put it on a shelf; it's another thing for it to actually be utilized.

I think what you have presented there represents the absolute minimum standard for

reasonable professional conduct.

I also understand my criticism about the disclaimer. I've been provided with information in the interim that was intended to preclude potential civil cause of action for someone finding that a particular standard was not complied with and therefore creating unwarranted legal liability.

I respect that, but I have to honestly say I don't believe that disclaimer would get you where you want to be. I think in fact there would be very creative efforts to say that that means nothing.

If we are going to go that route, I'm simply offering this today as a matter for later discussion that really would have to be the subject of legislation to provide for a safe harbor from civil liability in the event that's where we think we need to go in order to get the quality of conduct that we think is required.

Do you have any comment?

Mr. **LACKRITZ**. Maybe I could discuss that from two perspectives. One, your concerned about attracting long-term business to the firm because of these recommendations, and second with respect to the footnote.

The goal of these best practices is to raise the quality of research throughout the industry, not to create a sub-structure of lots of different rules and regulations, but clear standards of behavior for what we can control.

In the long run, firms are going to succeed by the quality of their advice. They will attract business because of the quality of their advice.

Chairman **BAKER**. I think that's true at a modest growth or certainly in an environment where people are worried about losing money. But in a bull market we've just come through, people are going to throw money without regard.

They're going to watch the evening commentators figure out who the hot guys are. I mean, I've watched it. I've had yahoo finance web page and I watch and I say, this is going to be a real comer.

You can see almost instantaneously the level of volatility that comes as a result of that guy's hip-shooting, and I can't say that that's appropriate for the investor to do it, but I'm saying that's what's happening.

And people don't want to miss out on the opportunity to see their wealth increase. It's just logic.

So we look to this analyst group to be the guys who really make sure that we're not being led in the wrong direction.

Mr. **LACKRITZ**. I think that's a very good point, and it's part of the reason we're renewing our efforts toward investor education, because that's so very important to advise investors to get a second opinion, to do the research, to not just immediately buy something.

Chairman **BAKER**. Let me jump, because I've got a couple of other things I want to try to cover before I run out of my own time.

I just can't fathom going through the list you read, which is outstanding, that there would be a circumstance in which any of those minimal requirements would not always be applicable. In other words, what circumstances would I not do this, applying the Louisiana Real Estate Code to my practice?

In all honesty, we've got a way to go here to catch up to that.

Mr. Glassman, let me address your comment about journalism and matters in political office and their ethical conflicts. If you are suggesting that the measure of congressional ethics ought to be the standard, which I think would shock most people in America, let me quickly add, we have to disclose every nickel of public income, every nickel of outside income, which is also limited. We have to disclose what boards we serve on if we choose to serve on boards. We have to disclose what charitable contributions are made to our credit by third parties. We have to report what trips we take if we're not on our own time, where we go. Then we are precluded from eating anything unless we're standing up.

The political contributions, we're limited in what we do. If you're suggesting we should subject the analyst community to the same standards of disclosure as the Congressman, I'm on.

Mr. **GLASSMAN**. In fact, as you may know, Congressman, first of all, I lived in Louisiana for many years myself, and I know what you're talking about.

Chairman **BAKER**. Ethics is always the number one concern in Louisiana. I'm sure you know that.

Mr. **GLASSMAN**. When I was editor of Roll Call, the newspaper that so diligently covers Congress, I editorialized many, many times against these nitpicking kinds of disclosure rules to which Congress is now subjected.

I think at least there's a certain consistency in my view. The only thing I can say is that there are many other conflicts. They have to do with family, and in some cases they have to do with donors, that really are not covered by any rules. And the fact is, you surmount them day after day.

For example, it's no secret, and it's not necessarily terrible that Members of Congress who have Members of their own families who are suffering from a specific disease will advocate more research money for that disease.

Chairman **BAKER**. Sure, but that's only subject to getting 219 votes to make it happen.

Mr. **GLASSMAN**. Exactly right. These conflicts are surmounted I think in most cases by you, because you have to publicly vote. And if you take a vote, and people say, oh, well, he did this because of this donation or because of this conflict or that conflict, it's out on the table.

That's the analogy that I wanted to draw.

I think with journalists, it's the same thing, but basically in spades. The journalists lean to the left based on studies. I think it would be hard to argue with that. And yet every journalist says that he or she is a professional who surmounts those conflicts.

Chairman **BAKER**. But if the journalists was writing about a stock in which he had a financial interest and put it in the paper, that would be grounds of dismissal, would it not?

Mr. **GLASSMAN**. It depends on the publication, frankly. I think that journalists should disclose their holdings, but I think that's really up to them and to the publication. I don't think the Congress should pass a law that says that every journalist must disclose holdings.

When I worked for the Washington Post, I was not even allowed to own stocks, and I thought that was a good rule.

Chairman **BAKER**. My point is that you don't have to have a public disclosure. There is a professional standard which says, you don't play in this game, period.

Second, if you do play in the game and you write about what you own, which is self-serving, you're gone. I don't think that needs to be subject of a rule or regulation. I think that's professional standards, which is what we are trying to pursue here today.

And I'm way over my time. I assure you I'm going to be back.

One caveat that I think, in fairness, I should make an announcement. After discussion with Mr. LaFalce, Mr. Kanjorski, and Chairman Oxley, what we do intend to do with the Fair Practices Standard, not to make a political determination here today, is to, between now and the next hearing, circulate the Best Practices Standard for review and comment by regulators, NASD, the SEC, academic review, to get professional response to us from appropriate interested parties.

Convene a second hearing, at which time we will receive those comments, and a second panel. I spoke last night with Ron Ehsara concerning media concerns was on the air, and he wanted to know if anybody in the media had been invited, and I said, yes, we hadn't had anybody take us up, and he wants to come down.

So we will have a media panel to get their involvement in this. We cannot shoot specific minnows in the barrel. There are a number of people who are in the tank who have shared responsibility.

Before we're done, we're going to look at everybody, and I just wanted to make that announcement for the subcommittee as well.

Mr. Bentsen.

Mr. **BENTSEN**. Thank you, Mr. Chairman. Thank you all for being here. I apologize for missing some of the testimony.

This is an interesting hearing, but I can't think of a time and I would ask the panel when there was a time that you had a run up in the market and then you had a correction, that the fingers didn't start being pointed at one another.

Particularly, it's one thing with retail investors and I think you have to differentiate between retail and institutional investors. But I happen to think of institutional investors as so-called "big boys" as being ones who theoretically and under the law are considered as being sophisticated and know what they are getting into.

And yet I can't think of an instance where there's a correction and sophisticated investors don't turn around and say, why didn't you tell us this? We weren't aware of this.

And yet, there is, under the law, a least in some practice, there's a great deal of disclosure. I guess from my perspective, I'm kind of shocked to find out that stock analysts or equity analysts might well be giving subjective advice as opposed to objective advice.

I would bet that the retail public would be equally shocked to find out that somehow that analysts who work for brokerage houses may well be interested in helping promote some of the stocks or bonds that are being sold by those houses.

You know, I understand if there is an issue that relates to manipulation, but on the other hand, I think we might be erring a little bit in trying to think that analysts employed by firms which are underwriting stocks and bonds are somehow supposed to be auditors and not people who give a subjective viewpoint, and that we don't take this with a grain of salt.

But I would ask anybody, is there a period of time that there hasn't been a correction where people haven't come back and said, things were not done fairly.

Mr. Hymowitz raised the issue of EBITDA went on after the crash of the job market, and people were saying that there wasn't appropriate disclosure, that these deals were oversold, and yet you had some very sophisticated investors who were involved in buying those deals.

Mr. **HYMOWITZ**. Unfortunately, I've had the finger pointed at me by my clients when I lost their money, so your point is well-taken. Obviously, when the market starts going down, people start losing money, you learn very quickly that people take their money very, very seriously.

This is not a perfect business. In a sense, investing is not a science. David does an excellent job and we subscribe to his research, but quite frankly all of our records are mixed. It is not a science.

I will say one thing to a previous question, Mr. Chairman, that you asked. We all have to understand that in the underwriting process, the analyst is extremely important in that process as it relates to the investment banks decision whether or not to proceed with taking a particular company public. It is crucial for the investment banker to get the input of the firm's supposed expert in a particular industry sector or, to use a term of art now, space.

If you want to see a public uproar, divorce the analyst from that role, then have the investment bank take the company public. Then, after the quiet period, have the analyst issue a sell recommendation on that stock, and you will see a public uproar.

It's impossible. I've been in meetings at my previous firm where the analyst with a private company decided, based upon the qualities of a particular company, that it would be unwise to take that company public.

The fact of the matter is, during the most recent bubble, the pressure on banks, the pressure on investment banks to meet the demand of the investor for paper of Internet companies was extreme. That is why, unfortunately, a lot of companies that should never have made it out the door, went out the door and in many respects, as I say in my written testimony, the public equity markets became second-stage venture capital.

And if anyone's ever looked at the venture capital markets, the risk involved is enormous. And that, in many respects I believe, is what happened and what ultimately caused the market correction that we have, besides a whole host of monetary issues also.

Mr. **GLASSMAN**. Can I respond to your question, Congressman Bentsen?

I think we are telling the American public the wrong thing if the idea they get from this hearing is that the reason that stocks have gone down, or their own accounts have declined, is because of some sort of manipulation that's been going on by analysts.

That's not it at all. The truth is that markets go up and they go down. And in the history of the stock market, one out of every 3 or 4 years, the markets go down.

This is an important lesson for people to learn. In fact, this has not been a particularly rough bear market. The Dow was down, which I think is a very good reflection of the market as a whole. The Dow-Jones Industrial Average was down five percent last year; it's up a little bit this year.

That doesn't mean there's not a lot of pain out there. There is, and I think a lot of people unfortunately have learned a tough lesson, and there may well have been and I know there were some people who exaggerated and led them down the wrong path.

That's why this hearing is good. But investors have got to understand that markets go up and markets go down and the way to smooth them out is by holding diversified portfolios for the long term.

Mr. **BENTSEN**. My time is up. But investors, I think, also need to understand that analysts who work for investment firms are not independent auditors and were never intentioned to be independent auditors.

And I think Mr. Hymowitz makes a very important point, that there is another role that applies that analysts play within the firms for credit concerns, underwriting concerns that affect the ability of the firm to function in the future and the risks that it may take.

And I think that all of this needs to be taken into consideration.

Thank you, Mr. Chairman.

Chairman **BAKER**. Thank you, Mr. Bentsen.

Let me make just one comment.

Mr. Hymowitz, I want to acknowledge your comment. I will get back to that subject at a later time.

Mr. Paul.

Mr. **PAUL**. Thank you, Mr. Chairman

I want to direct my comments and questions to Mr. Tice and follow up on his testimony.

This is, to me, a very important subject, but for some reason I think we are really missing the whole point, because we are dwelling on the analysts and the advisors.

That's very important, but I think there's a much bigger problem than the best analysts may be giving the bad advice. But if you added up all the advice of the analysts and the advisors last year, I guess they gave pretty good advice. They told somebody to sell, so I guess more people were selling than buying. Somebody was giving the correct advice.

But, I'm surprised that people are surprised at what's been happening for the past year. Free market economists who understand the business cycle and understand monetary policy knew this stock market correction was coming and anticipated: and they anticipate even more problems down the road.

I see this as more of an attempt to scapegoat, find out who's been causing this problem because people lost some money.

If we had not had a stock market crash, we wouldn't be here. If the bubble kept growing, you know, we would have been blissfully nonchalant about what was happening.

But what we don't ask is, why did we have the bubble? Where did that come from? Was it the analysts that caused the bubble? They were a participant, but they don't cause bubbles; analysts can say a lot of things, but credit causes a bubble, excessive credit, not analysts.

Where does credit come from? Do we go to the bank and borrow money that someone loaned to the bank? No. Nobody saves any money. Credit comes out of thin air from the Federal Reserve System, and we need to concentrate on that.

When the Fed does this, the Fed artificially lowers interest rates and this causes people to do dumb things. It causes people who used to save money not to save. It causes consumers to borrow more money than they should. They cause investors to invest irrationally. And then all of a sudden, we have this bubble.

And then, on top of this, this has been around for a long time, this is nothing new, everybody knows about this, but this time around, of course, it was different. It was unique, because we had a "new era" economy, just like Japan had in 1980, and just like we had in the 1920s, a "new era," a new paradigm. And therefore all the rules were thrown out.

And who pumped this up? Who really said the new paradigm was here? The central bank, the same central bank that created all the credit. The Fed creates the credit, it created all the distortion, and then it says, "Oh, there's so much productivity increase that it's going to solve all our problems."

Therefore, the analysts become the victims. They're victims of bad information and not good judgment, but they're not the cause. They are the symptom of the problem.

So my question is, is this not what you were alluding to? Should we not pay more attention to monetary policy? And is it not true that just regulating analysts is not the answer, because they're doing what they see in their own rational self-interest, under the circumstances. Yes, for 10 years, they made a lot of money, and they made a lot of money for other people.

It's just when the bubble burst that it happened. But it seems to me that regulating analysts is not the answer; it is paying more attention to how we regulate and rein in the power of the Fed to create money and credit excessively out of thin air that we should be dealing with.

Mr. Tice.

Mr. **TICE**. Thank you, Mr. Paul. I agree with you completely. However, I also do believe that there is a Wall Street problem. I believe that Wall Street has been a cheerleader for the bubble.

I share your view that our economy is where it is today due to excessive credit growth. If you look at the telecom and Internet mania that occurred, that was really the first stage of excessive credit growth.

We essentially have financed a number of businesses that should not have been financed, as I talk about in my written testimony.

We kept the cost of capital too low. I'm a believer of the Austrian school of economics, as you are, Dr. Paul, and I believe that the interest rate has been kept too low and that we essentially financed a number of CLEC and Internet companies. We essentially misallocated capital in the Nation that will have a tragic cost to the country.

Currently, we are over-financing the financial sector. We are growing MZM at nearly a 20 percent rate over the last 6 months in an attempt to keep the bubble going. We believe that this bubble is not yet over.

There've been a number of comments as though the bubble has burst, the decline is over, we can get back to fun and games again. We don't believe that. The NASDAQ is still selling at nine times sales. The S&P 500 is still selling at 30 times earnings.

Mr. Glassman will of course disagree with me. He has a book out talking about the Dow 36,000. You know, we think that's absurd. Nobody will pay 100 times earnings for a company like Bank of America, as he's talked about in his book by assuming that the discount rate is going to be five-and-a-half percent.

We believe that there's still a great deal of danger in the economy going forward. It is due to excessive credit growth. If you look at some of the numbers recently, asset-backed securities growth is growing at 42 percent. Credit card securitization is growing at 70 percent. Home equity loans growing at 63 percent.

So I think it's important to understand that Wall Street is complicit in this credit growth and essentially seeking out asset inflation. And they sought out Internet companies and telecom companies in the first stage.

Now it's the financial companies, but we have an asset bubble and unfortunately there's more pain ahead.

Chairman **BAKER**. Mr. Paul, your time has expired. We'll come back for another round.

Mr. Capuano, why don't you be next by time of arrival, sir?

Mr. **CAPUANO**. Thank you, Mr. Chairman.

I too want to congratulate you for conducting this hearing. I think it takes a fair deal of courage to raise these issues in a public forum.

I'm not a big time investor. I don't really understand some of the things, the details of how all this works. But I try to draw analogies.

The analogy I draw is, I don't think there's a big conspiracy on the part of Wall Street to somehow control the world. There is certainly not one that I'm aware of in the Congress to over-regulate anybody. I don't do any of those things.

All I'm interested in really is transparency. We talk about it all the time when it comes to financial issues. We did it last year in the banking bill. We do it on international issues all the time.

Transparency is honesty and honesty is if you're making analysis of anything, tell them who you're working for, and then a reasonable person can make a decision.

Fair enough. I guess, though, I didn't get a chance to look it up, but a few months ago, I read a pretty interesting story about a young teenage boy who was dealing on the Internet on penny stocks, basically giving an analysis of the penny stocks to lots of people. They would drive up the market, and he would all of a sudden buy or sell or do whatever he was doing, and made billions of dollars as a young teenager.

He got caught. He got a slap on the wrist, but it was a lack of transparency. It has nothing to do with a teenage kid dealing with penny stocks who cares; that's good. But that's what I think is missing so far is all this concern about what's going on. I want honesty, that's all I want, so that investors can make honest decisions.

I guess I was going through a whole litany of examples, and I just wonder, what's the difference between what's going on and the old payola scandals of the radio days when people, allegedly independent DJs would be on the payroll of a record company, and all of a sudden, out of nowhere, this record was going to number one with a rocket. Why? Who knows why? Gee, it just so happens they're on the payroll of the record company.

What's the difference between this and the S&L scandal? Don't worry, this company, this investment is stable, it's got good credit, trust me. Oops. I didn't want to tell you that we have an investment in that. I didn't want to tell you that my cousin is the owner.

What's the difference between this and Michael Milken's situation? Trust me, we don't have any inside information, no one on Wall Street does that, that is wrong. What's the difference?

What's the difference between this and the cable oligopolies who tell me, as a

consumer, don't worry, everybody wants the 14 history channels, and in order to do that, we have to raise everybody's rates a buck-and-a-half. What's the difference. And gee, we didn't bother to tell you that we own all 14 of the history channels.

What's the difference between that and what's going on right now with our energy oligopolies? I'm not quite sure what they're doing just yet, but I know one thing. All of a sudden it is costing us a lot more money and it seems like it's all going to one group of people who keep telling me that there is only one problem; that they need to be able to drill.

All I see is a complete and utter—not by everybody—but, a significant lack of honesty and transparency. If someone is an analyst who works for somebody who pays them, and then there is money to be made, so be it. Just tell me what's so hard about that? What is so difficult about that? Why can't Wall Street just do it, as opposed to simply coming up with, and again I've only just gotten them today, but, you know, the best practices.

They sound awfully nice, but I don't see teeth in them, and I'm sure we'll have further discussions. I do want to talk to the SEC to see what's going on with it.

I don't believe there is any conspiracy, I really don't, but I do believe one thing; money makes people do crazy things. And I'm no different; we all do it.

And if there's money on the table to be made by someone who holds themselves out, either publicly or by innuendo, as an independent analyst, simply tell us the truth. Are they independent or are they not. And I would like to know what the difference is in any of your minds between any of the analogies that I just drew and what apparently is going on as apparently a relatively accepted practice on Wall Street that it's OK to try to burn both ends.

Mr. **TICE**. I'd like to respond, Congressman.

I agree with you completely that the system is broken. I do not see that much difference between what goes on commonplace on Wall Street versus what happened with this Internet 15-year-old boy. There's been a lot of discussion so far, as if we can fix this around the edges.

We think we have a broken system, and I would like to read you a couple of quotes from our written testimony. This is from a former research director at Lehman Brothers. He said an analyst is just a broker who writes reports.

Another gentleman, who was an analyst, said he explained his reasons for recommending a company. I put a buy on it because they paid for it. We launched coverage on this company because they bought it fair and square with two offerings.

Another case, an analyst at Morgan Stanley, who followed Cisco Systems, analyzed his rationale——

Chairman **BAKER**. Excuse me, Mr. Tice. I would like to have everybody have an opportunity and my time is running out. I apologize for interrupting.

Mr. **HYMOWITZ**. Congressman, I would add that disclosure is everything. You are absolutely correct. I think the problem, one of the problems with current disclosure today is often the disclosure statements are longer than the actual research pieces.

You get an early morning note from an investment bank, it'll be a paragraph long, and the disclosure statement is three pages long. Disclosure statements need to be, as I guess the SEC has tried to make prospectuses more in plain English, disclosure statements need to be more in plain English.

Furthermore, I think that if you really examine this issue, where the crux lies is that many investment banks, as is the nature of the business, are constantly trying to get more investment banking business. So people have grown skeptical of whether or not the analysts are trying to aid the investment bank in getting that business.

So one suggestion I have is possibly, as long as it doesn't interfere with the commercial practicabilities of the industries, for the investment banks, for issuer to disclose whether or not they are currently engaging in any publishing investment banks on them, or whether or not there is the potential that they are seeking investment banks.

Then you'll know really whether or not—or at least as to your point—the public will then be informed that possibly if Investment Bank X is issuing a positive report on Company Y, well maybe it's due to the fact that there is a beauty contest going on for capital markets transactions.

The disclosure needs to be more relevant, shorter, more succinct, and in plain English.

Mr. **GLASSMAN**. Congressman, I'm definitely in favor of transparency. I think the question is the role that this Congress should play. It seems to me that all industries, all businesses have a tremendous incentive to tell customers what they're doing, because customers will shun businesses that are either dishonest with them or opaque.

I also just want to say that I do take exception to a number of the things you said about energy oligopoly and some of your comments about Michael Miliken, but in general, I would also say that the S&L crisis had definitely presented a role for the Federal Government to play because of insurance.

This area I don't think there's a role for you to play except to have hearings like this and air these issues publicly. That's very important.

In general, I want to associate myself with your comments about the importance of transparency.

Mr. **LACKRITZ**. Congressman, I would also associate myself with those comments and with your comments about transparency. We have always favored transparency.

That's at the crux of the securities laws in this country.

Where I take issue is when you compare the situation to a number of other scandals in the past. I think if you take a longer perspective of what the securities industry has done over the last decade, the securities industry raised more capital in 10 years to build plants, to build schools, to create new jobs, to create new products and services than in the entire 200 years before that combined.

So we are very proud of what we've accomplished and the opportunities that we have created for millions and millions of investors who, if you look at over time, have done extremely well.

Last year, we had a terrible year. And we could have either said, well, it was just a bad year and we're going to get back on track, or we could say, look, let's see if we can fix some behavior here and assure that going forward, there will be no questions whatsoever about the independence and objectivity of analysis.

And that's what we've done with these best practices and transparency really is at the core of these best practices.

Chairman **BAKER**. Your time has expired, Mr. Capuano.

Mr. Castle, you'd be next.

Mr. **CASTLE**. Thank you, Mr. Chairman.

Let me thank you for holding these hearings. Let me encourage you, although I don't think you need encouragement, to continue this. This is big time business we're talking about. It's covered by a lot of national magazines, by national television every night, by a lot of financially focused magazines.

It involves the assets of most of America today, and these questions should be asked and we should get some answers. I'm not sure that we should legislate in this area, and I'm all for best practices, I think that's great.

I don't know how much good disclosures do unless somehow you all are regulating that. I started to get my privacy notices in the mail recently. I don't even understand what the heck they mean half the time. And I'm not convinced at all that either we, as average investors—and that's what I consider myself to be—would really, truly understand all disclosures anyhow.

And I would be the first to tell you that stocks are unpredictable and always will be. And when you get into the timing of the stock market, it becomes even more unpredictable, and when you get into the timing of particular sectors, such as the high tech sector, it becomes even less predictable yet.

Having said that, I am absolutely, totally convinced there are conflicts out there. I think

anyone who dismisses that out of hand is off base and I do agree with something Mr. Tice said, something along the lines of Wall Street has been the cheerleader for the bubble, and I think that is essentially correct. And I think it really needs to be looked at. I honestly believe it needs to be looked at, and hopefully you will all look at yourselves and tell us something so that we don't have to do something here.

I've been here for most of this hearing and I don't think I heard this; maybe I did. But I think Mr. Hymowitz, you said something to this effect, maybe you or Mr. Glassman can help me with this.

But you stated that many believe there are few sell recommendations on Wall Street. Maybe you question this fact, but how do you reconcile that statement with a study by First Call indicating that the ratio of buy-to-sell recommendations by brokerage analysts rose from 6-to-1 in the early 1990s to 100-to-1 in the year 2000.

I don't even know what half these expressions mean. Out-perform, strong buy. I've never seen a sell recommendation on anything frankly. All I see are these recommendations of a buy nature, which is part of being the cheerleader for the bubble, as far as I'm concerned.

I'd be interested in your views on that. I think we have a problem out there and I think we need to admit that and determine how we're going to fix it.

But I get the idea that you don't necessarily agree that there is a problem; maybe you disagree with those facts or don't think it's relevant or something. I would like to hear from the two of you on that.

Mr. **HYMOWITZ**. Congressman, to answer your question, I'm not familiar with the First Call Survey. But we utilize First Call in my firm, and typically First Call covers mainly the well-known broker/dealers. That's only if, I believe, those companies submit their research and their analysts' estimates to First Call.

When I said there's plenty of sell recommendations——

Mr. **CASTLE**. I don't mean to interrupt you, I'm sorry, but let me go on. Maybe that's important. If Merrill Lynch is giving bad recommendations, if Dean Witter's giving bad recommendations, instead saying out of 100 securities firms, which are also analyzing stocks, so many of them gave us bad recommendations, I think we need to look at the number of people they are impacting and the total number of dollars they're impacting.

We might dismiss this on the basis of some three-man shop doing it incorrectly, but the big boys aren't.

Mr. **HYMOWITZ**. I understand that.

My point about the fact that there are as many sell recommendations on Wall Street as there are is the way I define Wall Street. As an institutional money manager, we have the

resources due to the fact that we do commission business all over the street.

To get private research, meaning companies like Mr. Tice's here and others who specialize in providing a counterbalance to the sell side research. There are different types of analysts on Wall Street.

In my written testimony, I define them. One is what we have mainly been talking about today, the sell side analyst that's mainly related to a large investment bank.

But there are numerous other kinds of analysts on what I call Wall Street, and many of them work at research houses only. And those analysts also provide buy recommendations and sell recommendations.

Although there has been the creation of a niche business recently where specifically research analysts look at accounting issues and sometimes just fundamental business issues, and recognize that certain companies are possibly candidates for shorting. So many of the institutional money managers who subscribe to these services, they tend to be very costly, you know. I think in the range of some of them cost roughly \$100,000 a year.

And we subscribe to these services and we use these services to counterbalance the sell side research. Just let me add one other thing, and I said this in my written testimony. The most important thing, though, is for the investor to do their own research.

How many people do we know that spend more time with the Consumer Reports magazine trying to determine what DVD player to buy. Then they do in time on due diligence of what stock they should buy, and ultimately——

Mr. **CASTLE**. Let me cut you off, because my time is running out. I don't know what you expect some of us, as investors, to do. I imagine most people you're dealing with have other jobs, have a heck of a lot to do and are dependent upon people who are supposed to be professionally trained in that job to do it, which are these analysts. If they're not getting good advice, they're in a degree of difficulty, and I don't disagree with you.

I wish I had the time to do it. I wouldn't probably be such a loser on the stock market.

Mr. **HYMOWITZ**. Could I touch on that one last point?

You have to remember the analysts are not buying the securities. You're right. Many of the individuals do not have the time to manage money. That is why I'm in business. Without the fact that you all don't have enough time, I'd be out of business. So that's why people are very wise to give money to mutual funds, money managers, hedge funds, index funds. That's why this business exists, because many people don't have the time, nor should they spend the time because you're right.

There are professional money managers out there who understand what sell-side research is all about.

Mr. **CASTLE**. Hopefully, individual investors could depend on those people who have the expertise, without conflict, to have their good advice.

Mr. Glassman.

Mr. **GLASSMAN**. I just wanted to comment on selling. There are 7,000 listed stocks in general. Analysts follow stocks that have good prospects, because it doesn't make a lot of sense for them to spend a lot of time on the others, and there are specialty firms that follow some of these other stocks if they think there might be a chance to short them.

I just also want to say that the idea that individual investors should be preoccupying themselves with selling, which is basically market timing that you talked about earlier I think is a mistake.

Generally, the way to be a good investor is to buy good companies and hold onto them for a long time. The paucity of sell recommendations, as I said earlier, is a reflection, in part, of what companies' analysts are following, and also the market itself, which, despite the year 2000, has gone from, if we just look at the Dow, from 777 in August 1982 to over 10,000 today.

So if you're spending a lot of your time selling, you weren't doing very well.

Mr. **CASTLE**. My final statement, Mr. Chairman, if I may. I don't disagree with what you've just stated and I don't mind buy-and-hold as a theory of investing, which I think makes a lot of sense.

But if you're getting a preponderance of buy recommendations, the ratio of 99 to one, and a lot of these are going down as much as 50-, 60-, 70-, or 80 percent of the course of a year or two, that's a problem as well for the poor devil who's trying to buy and hold it in that circumstance.

It's not just looking for sell recommendations, it's knowing what not to buy. And I don't think the average investor knows, looking at these reports, in many cases what not to buy.

You cited figures earlier. We can't go into them. I'm just not as optimistic about all those figures.

Chairman **BAKER**. Mr. Castle, if you will, it looks like we'll be able to do another round and we'll come back to you.

Mr. Kanjorski.

Mr. **KANJORSKI**. Thank you very much, Mr. Chairman.

I think the issue boils down to the fact of whether any of the alleged conflicts of interest are in real existence, and if they are, to what percentage they are.

I am sort of disappointed, looking at the analysts' problem, at a time when the stock market has not reacted well. Sometimes we get bad law out of responding in times like these. And, we ruin reputations and injure a lot of people who have been paid to make estimations that have not got any basis, other than a lot of their own intuitive senses, once they study a situation.

But I do think, from my own experience, something I would like to posit to the panel. Would any of you like to play on a professional football team where the referees' salaries were dependent on which team won the game? I think we would have a tendency to wonder whether every call of the referee was sound.

I will give you an example in Pennsylvania. Up until about 30 years ago, when we reformed our Constitution, the lowest judicial court in Pennsylvania was the Magistrate's Court. We saved a lot of money in Pennsylvania because we never paid magistrates. The way they got paid was by collecting the fees on the convictions.

It was amazing how many convictions there were in Magistrate Court, somewhere around 90 percent. When we changed the Constitution and directly paid Magistrates a set salary without a fee attachment, suddenly convictions fell precipitously.

I think in my analysis of this situation, it is somewhat similar to what happened in the late 1920s and the early 1930s in the boiler room operations.

There were a lot of people who said, "No, you do not have to pass the SEC legislation, we can self-regulate ourselves. I particularly look at the analysts that appear on the network or cable programs that are prognosticating 24 hours a day of how to get instantaneously wealthy.

Investors are 50 percent of the American population, and I think probably 95 percent of which do not have an MBA from Harvard or Wharton. So, in a way, they are responding to this guy in the Brooks Brothers suit, who looks smart, talks smart and works for a very prestigious named investment house. And they are relying that these analysts are honest people.

As I mentioned in my opening remarks, the point I want to make is that we should find whether or not there is any evidence of actual problems out there.

I would say if we do find literal abuse of position to gain personally, it is going to be in the smallest percentage of instances. I think in most instances, the failure to predict accurately what to do is the exuberance of the market. Who wants to call contrary to the trends of the market? That is probably what most analysts did.

This is not necessarily a bad time to raise this problem. I guess the question I would

like to have answered concerning the best practices as put out by the industry, which are nice, but are they not a little late and probably fortuitous in timing, because the hearing was coming up? That is my impression anyway.

But without any enforcement, do you four witnesses, any one or all of you, feel that the industry and the private sector itself cannot only put out standards and have best practices, but also develop an enforcing mechanism and a mechanism of disqualification, fines, penalties, and so forth, that will really work and take the unethical behavior out of the business, or is that beyond the private industry to do? Does this matter instead require SEC regulation or acts of Congress to accomplish that?

Mr. **LACKRITZ**. Could I address that first, Congressman? I think that these best practices that we've come up with are going to be very effective, and are going to work extremely well.

The reason for that is because they've been endorsed not only by the 14 largest firms representing 95 percent of the underwriting business, but all the CEOs of those firms down through the directors of research.

In addition, you've got an incredibly powerful and unforgiving enforcer in the marketplace. These practices are designed to help improve the quality of research.

To the extent that the quality of research doesn't improve for clients, they go other places. To the extent that competitors see that their competitors may not be following some of these rules, they're going to be quite aggressive.

Already you see a fair amount of competition in the marketplace.

Mr. **KANJORSKI**. Wait a second. I love the marketplace. I think it has a lot of regulation to it that is imposed by the natural forces, but I think to make the argument that the marketplace itself is going to take care of things is quite optimistic.

Let me give you an example. Just recently in a fraud case involving GSEs, as a matter of fact——

Chairman **BAKER**. I am shocked.

Mr. **KANJORSKI**. ——Perhaps thousands of mortgages were improperly sold at an inflated value. And, when you look at it, it is alleged that the perpetrators of the fraud were really two appraisers who were going in and appraising these homes over their real value.

And in the preliminary investigation, after identifying something has been maybe millions of dollars of potential fraud, these two appraisers were fined just \$10,000. Woowhee, big deal.

I mean, if you guys are going to self-regulate by fining somebody or slapping them on

the wrist, and shuffling them off to Buffalo, if you will, we will not receive any real reform. I have just met with the State regulators and they tell me that there are brokers selling intrastate that have been fined and convicted in three and four and five other states and the State regulators have no capacity to find out who these people are. They are just moving around the country, one State by one State, knocking it off.

And honestly, with the industry coming forward now and saying, wow, we have got to find a way to make sure this information gets out to all the regulators so that these investors are warned that there are these bad actors out there, it seems questionable.

Look, when you can make millions of dollars by perpetuating frauds like this one, and you only lose your license, or you get a penalty of \$10,000 on a multi-million dollar fraud, I do not know any con artists that are going to turn down that deal. That is a pretty good deal.

Mr. **LACKRITZ**. Congressman, I would take issue with that. Industry has no tolerance for bad actors. We want to do everything we can to get fraudsters out of the industry.

Mr. **KANJORSKI**. Why, under best practices, do you not have transparency, enforcement, and penalties that are just like the Bar Association?

If you have a bad lawyer, you can disbar him and throw him out.

Mr. **LACKRITZ**. We have transparency in these recommendations. There's mandatory clear language and mandatory disclosure of holdings of conflicts that go beyond these best practices, Congressman, go beyond the regulations that are on the books now.

They take the regulations on the books now and go beyond that. In fact, part of the reason it took us a while to come to release these was because it was a long process of negotiating among the firms.

The firms took it quite seriously because they realized in some cases they might have to change the way they did business in order to comply with this. They took it extremely seriously.

As a result, that's what held this process up a little bit, but from the standpoint of their effectiveness, I'm quite confident that they are going to be effective and I think time is going to be the test. The proof is going to be in the pudding.

Chairman **BAKER**. Mr. Lackritz, and Members, if I can, we would like to recognize Mr. Inslee for these questions. We are nearing the end of debate time on the next vote. I would like to get him in and perhaps conclude this panel before the vote starts. You probably would like that idea.

Mr. Inslee.

Mr. **INSLEE**. Thank you, Mr. Chair.

We don't have a rule that we just shoot the analysts here when the market goes down, if that's any relief to you, but I'm intrigued by a thought that Mr. Cole, who was an author, I assume you are familiar with, who has been critical of the industry in various ways.

Basically as I understand his approach, he believes that there's been such a radical change in the structure of the industry toward an investment banking oriented part of the industry that it's changed dramatically the problems that analysts have internally in their own structure.

For instance, he quotes a statistic. I don't know if it's accurate or not, that says that 60 percent of industry revenues before 1975 were trading commissions. Today, that's less than 16 percent.

As I understand his argument, he's basically saying that analysts now have this much greater incentive, if you will, to deal on the investment side, and that's what skewed judgments perhaps or at least created a concern in the public about that.

And I just want to read—and he's going to testify later—I want to read something I want to get your comments on, if I can.

He said, where the role of analysts has changed dramatically in the last 25 years, the regulatory environment has little changed from 1975 or even 1945.

Analysts have safe harbor under the law, even to the extent that they can tell their larger clients that a stock is really a dog, while keeping the buy signal on for the public. That is entirely legal.

It is even legal for an analyst to tell their trading departments that a buy signal will be out on the morrow. If the analyst is influential, the trading department can bulk up on the stock and then sell it to retail demand then generated by the buy signal all legal.

Brokerages call this, quote: "building inventory to satisfy demand, just serving our customers."

Others might call it a license to print money.

I read in your best practices. As I read it, it sounds like your best practices were designed somewhat to address some of the issues that he's raising here.

But I guess what I'd like you to do is if you could respond to his argument that the dominance of the investment side of the industry has become such that we now need to take another cut at looking at the regulatory aspects on analysts, particularly some of the

issues that he raised.

I'll leave this open to any of you.

Mr. **LACKRITZ**. I would just say, first of all, I disagree completely with some of the things that you read that he's written.

Clearly, an analyst that's giving some recommendations to one side of clients and not to others, that's not currently appropriate and obviously that's not a good business practice.

Second, the business is changing dramatically, but I suggest that it's changing from a transaction-based business that it's been historically, to an information and advisory business more and more and more. This means that the quality of our information is the most important product that we're offering.

The quality of our advice is the most important product that we're offering, which is why we put forward these best practices. We think these will help to continue to improve the quality of the advice that we are offering and in the long run, that's what's going to be successful for the business.

Mr. **HYMOWITZ**. Congressman, I would also add I would not be that concerned about the shift in fees investment banks earned from commissions to advisory fees. I will tell you things have changed once again back. One would have to wonder what investment bankers are doing these days. Even the fact that the capital markets are effectively shut down, there hasn't been, other than the Kraft IPO yesterday, I don't remember the last IPO.

It's a natural cycle in the business. When the markets are going up, the investors are looking for companies to take public. Therefore, the percentage of revenues in the investment banking department goes higher, the commission and management fees goes lower. But the cycle changes.

And today, if you took a snapshot of any investment bank, I'm sure commissions, asset management fees are gaining in the preponderance that they represent in the total revenues of the companies. And in investment banking fees, you can see it by Wall Street. Look at the layoffs that are occurring. They're not laying off asset managers, they're laying off investment bankers, because that portion of the business is suffering due to the fact that the capital markets are shut down.

Mr. **GLASSMAN**. Congressman, I'd like to respond to this issue of best practices and what the SIA has done. Also, this addresses something that Congressman Kanjorski asked.

I'm not so sanguine about it, because I think the way to solve this problem is by individual firms stepping up to the plate and saying that, at our firm, we have a real Chinese wall, and if we find anyone breaching it, that person is out. That's our rules at

this firm.

Now another firm will then compete and say "No, no, we can top that." We can have even more objectivity among analysts. There are good things about industry groups, but one of the problems is that they all get together and decide what the rule is going to be.

That's also the problem, by the way, with legislation. It takes away the competition, which really ends up giving you the best kind of rules and the best protections for consumers. That's what I worry about.

Mr. **INSLEE**. Let me tell you about a concern I have. Obviously what it sounds like, your best practices are designed to build a Chinese wall. My concern, however, is if you build a Chinese wall, but you leave it under the control of the Chinese about where the gates are going to be and how high the wall is going to be, I'm not sure it gives enough confidence to the people in this regard.

So let me just ask you this. In contrast to the legal profession or the accountancy profession, or the physicians' profession, is there any reason to have Americans trust the industry to be self-regulatory on this issue as to analysts where Americans demand some independent source, to some degree, to control the behavior of lawyers and doctors and accountants.

Mr. **LACKRITZ**. Can I address that?

I think, first of all, the quality of our professionals has never been higher. We in the securities industry have a mandatory continuing professional education requirement, as I understand that no other profession even has.

We have to have mandatory retesting your fifth year and tenth year after receiving a license. So that, in and of itself, makes it different and the quality has gone up considerably.

I also think that it is fairly easy for customers to see, because they get their statements every month how they are doing.

With other professions, sometimes it's not as clear; it's a much more subjective kind of judgment.

So we have a real bottom line I think that really serves as a very effective accountability mechanism, which is one of the reasons that the quality of the research is so important. Which is why our firms have an incentive to give out the best quality advice they possibly can to their investors.

Mr. **TICE**. Congressman, if I could just add that I do believe that you hit a hot button issue as far as the magnitude of dollars that are involved in the investment banking. And the fact is that people are people and money motivates people. And the structure of these firms is that the investment bankers are still too powerful within these firms, because

that's where money is made.

Now as Gregg said, the IPO and the investment banking revenues are down currently. However, paying 6 cents a share or 4 cents a share, which is what institutions are paying for research today, the profitability is much greater in investment banking, and therefore investment banking drives it.

We don't believe the industry can regulate this from within. The dollars are just too big.

Another problem is, the industry, in my opinion, has not even admitted that there's much of a problem. There's talk about there's a perception of a problem, rather than admitting that there is a problem.

Mr. **HYMOWITZ**. You're not arguing for higher commissions, are you?

Mr. **TICE**. I would pay higher commissions, sure.

Mr. **INSLEE**. Thank you, gentlemen.

Chairman **BAKER**. Your time has expired, Mr. Inslee. Thank you very much.

I want to pick up with a point that I failed to make accurately perhaps.

Mr. Hymowitz, in your answer to a prior question, talking about the demand in the market to get paper out, and that as a result perhaps some of the dot coms move to public offerings that weren't, in all circumstances, mature for that position. That is extremely troubling to me.

What is the role of the analyst? Maybe that's where there's a miscommunication. I want to take you to the days of LTC, and I'm not making a parallel, I'm not making accusations, merely to understand my level of concern.

We had 3 years of back-to-back trading without 2 days of concurrent loss. There were extraordinary levels of profitability. You had bankers, you had folks in the international community, literally throwing money at them.

You were told a million dollar minimum, 3 years. Don't pick up your phone and call me. I'll let you know what's happening. Extraordinary types of information, lack of exchange.

Now what drove that was the desire by the individual to get a piece of the action and make a quick buck. I understand that.

In my view of market responsibility, the single person who should have been in that room when the credit was being extended by the bank was the credit risk analyst. The little guy sitting in the corner with the glasses, reading the complicated sheets. Who says,

wait a minute, guys, there may be something wrong here.

If the management overrides him, I understand, but it's that analyst who should be the one to have the professional standard to stand in that door and say, no.

What you're telling me is, because the investor's demand to get in on the run up of the market, it was almost embarrassing to go to a cocktail party or a birthday party, or you're in the back row of the church, and people saying, man, have you seen my 401K lately, and if you weren't in it, there was something wrong with you.

So the public pressure was to get a piece of it, and within the firm, deciding what they were going to market and what they would not, because of the demand for paper.

Because the community was asking for it, the investor lowered his bar and said, let's put this out, because we've got to get something for people to buy and keep this moving.

Am I wrong?

Is it not the analysts' obligation to reach a professional opinion and express it, notwithstanding market conditions and consumer demand?

Isn't it a professional responsibility to say, no, now is not the time? People can disagree, but the board can override. But somewhere in the record, that analyst's view should be noted. Is that wrong?

Mr. **HYMOWITZ**. I don't think it's wrong, but I think the answer is very complicated. I'm sure we don't have enough time for it, but let me just make a couple of comments.

The capital markets changed dramatically when companies like Netscape and Yahoo were able to be taken public without profits.

Investment bankers realized, unlike years past, the investor was willing to take the chance, and risk, and look, that's what investing is about.

Chairman **BAKER**. But on that point, I hate to interrupt, but it's so critical and pivotal to the understanding.

The investor was willing to take the risk because the analyst was telling him it was a good risk to take. You're telling me the analyst was saying, don't invest in this? I didn't hear that.

Mr. **HYMOWITZ**. I didn't say the analysts, I'm not saying that. But I think it's more complicated than that. A company is taken public. We all recognize that the Internet was, a few years back, something completely new.

Let's remember, I see many Congressmen using their Blackberries. You weren't doing this 3 or 4 years ago. Without the capital markets financing these companies, we wouldn't

be able to do it.

So there's lots of tremendous positives that have come from this, thousands and thousands and hundreds of thousands.

Chairman **BAKER**. I agree with you. I think that's great.

What I'm saying to you is, the huge capital flows that appeared since '95 to the current day, come from less-than-sophisticated pension fund managers in some cases, you now, some school teachers' retirement fund, they are under critical pressure from their owners of that fund.

Wait a minute. Everybody else is getting 18, 21 percent, why aren't you? He goes further out on the risk profile. He is listening to his analyst.

My point, I want to be focused on, I'm not disputing that the capital markets don't perform a wonderful function. I am not a regulator. I don't think the Federal Government is the answer.

But I am suggesting very strongly in terms that I hope are clearly understood, I believe the sentiment's been expressed in this subcommittee today, if we don't get this fixed, probably some session of Congress is going to fix it in a manner the market won't like.

That's what we are about here, is trying to not have that occur. And if you're telling me the role of the analyst is not to be direct and forthright, and to tell people what they don't want to hear in an environment when it's not popular to say it, that's a very disturbing thing. We've got to find a way to fix that.

And I want to say to Mr. Lackritz and the SIA, I appreciate what you have done, but we have now recognized we have a problem. We have entered the 12-step process. We are step one, maybe two. We are all getting in a room together and comforting one another. We haven't really decided where we're going to wind up in a few weeks.

We're shaking it a little bit and we are a little bit worried, but there is a problem. And in my view, although I fault the media for hyping the stuff, I fault the investment bank for pushing the analysts, I fault the investor for not doing the due diligence that they ought to do.

At the end of the day when I get my call from a broker saying, boy, you don't want to miss this train, it's a sure bet, who am I to disagree?

I rely on their professional judgment to tell me when it's advisable. Should they be right a hundred percent of the time? Heck, no. I'd like them to be, you now, 51/49, but at some point we have to realize the standard of conduct which a reasonable man should expect from the Street has not been utilized, and the formulation of the best practice standard I think is evidence there was a recognition of a problem. And we're now about addressing it.

I don't think we need to skirt around it anymore. I think we've got to figure out what do we do. That's the last piece. I don't see a lot of recommendations beyond the best practice standard.

Mr. Tice, you had a few?

Mr. **TICE**. Yes. If I could respond briefly to Mr. Hymowitz' point, I don't think it is that complicated and you're exactly on target that the analysts should be objective. He should not be looking at what the customers demand for a product or an investment service.

That's the problem. The analyst most often serves as a sales person. He's looking at the customers out there and saying, what can I sell to them; therefore how can I promote this stock so that he will want to buy it, rather than being independent and saying, is this good for the customer.

That truly is the problem today.

Chairman **BAKER**. Let me give Mr. Hymowitz equal time, because we have a couple of more Members who want to come back with another question.

Mr. **HYMOWITZ**. First, I would say if the whole problem was just analysts had a lot of buy recommendations on stocks, and that was it then the railroad stocks would have gone to the moon, the drug stocks would have gone to the moon, the food stocks would have gone to the moon. That's not what happened.

What happened is the public at large, and I don't know who is to blame, and I'm not smart enough to figure it out, the public at large had a very short period of time, 12 months, maybe 18 months where they got completely enthused with the Internet and anything dot.com, and that's it.

You know what? Ultimately a lot of these companies will be good companies. Many companies will employ hundreds of thousands of people years from now.

The fact is, as I said earlier, for a moment, and I'm not necessarily saying this is a good thing or a bad thing, but for a moment, a short period of time, the capital markets that historically were mature markets, were funding what I have called and many other people have called "second stage venture capital businesses."

Chairman **BAKER**. I agree with you.

Mr. **HYMOWITZ**. There's nothing wrong with that.

Chairman **BAKER**. We don't have a dispute about that. My point is that there was no public discussion that we were into venture capital as opposed to long-term investments. When a dot.com only lost 6 cents instead of seven, they were rewarded. And when a

brick and mortar, who has a 50-year history of profitability, made 6 cents instead of 7 cents, they were hammered.

I can't explain that either.

My point is that the rational, calm voice in the midst of turmoil should be the analyst.

Mr. **HYMOWITZ**. Mr. Chairman, could I just comment on that last thing.

I actually respectfully disagree with you that we weren't warned. We were of course warned. Any investor should have just picked up the prospectus and read it, and all you had to do is look at the financial statements of these companies, and you would have seen the warnings.

You would have seen that these companies were profitless. There were plenty of warnings out there that these companies that were being funded were immature, often very young companies.

Chairman **BAKER**. I respectfully understand your disclaimer, but it would take someone fairly committed and fairly clever to read through the 86 pages of disclaimer. It's the only thing that I've seen that's more complicated than the first mortgage loan closing document package. That is not a reasonable man standard.

What I'm saying to you is the reasonable man, the working family was providing the capital for all this wonderful activity. The analysts comfort him and say, yes, I think in the long haul, you know, don't buy for today, buy for the long haul. It will be a wise investment. They did.

And when things go south, understandably, the investor is disturbed.

But if the analysts had done the job at the outset in saying, look, this is a ten percent shot. If you want to do it, I'll be happy to service your account, but I would strongly recommend you get over here with this long record. It'll be slower growth, it'll be more stable growth, less risk. And I don't think a lot of those conversations were held is my concern.

Mr. Castle, I'm sorry I've taken so much time.

Mr. **CASTLE**. I'll try to be brief too.

If this was asked, somebody cut me off because I had to be out of the room for a little bit.

But, Mr. Tice, you apparently in your testimony, according to our staff, cited the tremendous competitive disadvantages that independent research firms actually face.

I think a few of them, such as where is the revenue coming from and whatever, and I

can think of a few of them.* But if people who are investors believe that Wall Street firms are not giving good advice, then why don't the market forces send more people to the outside. Why don't the market forces sort of rise up and say, you're not giving us good advice. We have to look someplace else for it. And give the independent firms greater strength than they presently have. What's the marketing problem there. I don't follow the dynamics of all that.

Mr. **TICE**. One of the issues there, Congressman, is the fact that we believe that Wall Street research should be priced. Currently, Wall Street research is essentially being given away in order that the big investment managers could have access to their trading, to their IPOs, and so forth.

Therefore, it's very difficult for a small, independent firm, such as mine, to be able to garner fees and commissions in order to get paid. It's very easy to continue to get the First Boston, the Goldman Sachs, and Merrill Lynch research, because it's essentially free.

What we would like to see occur, and we've pointed this out in our solution to a very complicated issue that I can't get into today, is to have Wall Street price their research.

Mr. **HYMOWITZ**. Can I just make one comment?

Wall Street research is priced. You do not get Wall Street research if you're a client or an institutional money manager unless you have some relationship with the bank in the form of commissioned business. There's a price you pay for it.

Mr. **CASTLE**. Just a final comment. We are sitting here talking about analysts and Wall Street firms, and securities firms, and whatever. But the average person out there is usually dealing with a broker who is then handing them that information. They don't know who the analyst is. They don't even know if the firm that's handing them the information is the one who did the analysis or whatever it is.

There's sort of a disconnect here between what happens in public and what we're discussing.

Mr. **GLASSMAN**. Not only that, Congressman, they are dealing in many cases with mutual funds. Forty percent of Americans own mutual funds. Three trillion dollars are in equity funds, and these are professionals who are getting advice from lots of sources.

I don't think we need to have laws passed to protect these professionals.

And also let me just say, I really think it's important to put in perspective what has happened in the markets over the last few years.

Over the last 5 years, the stock market as a whole has gone up 120 percent despite what happened in the year 2000. The NASDAQ, which is the high tech index, has just about tripled over the last 10 years.

So the idea of passing legislation, which in fact, if it's the wrong kind of legislation, will have a devastating effect on the market itself, because of a problem that has occurred in stock prices over the last year, I think that may be going a little bit too far to say the very least.

Mr. **CASTLE**. I'll close with this. I don't disagree with you perhaps, at least at this point, in passing any kind of regulatory legislation or anything of that nature with respect to Wall Street research or whatever, but I remain adamantly convinced that you have not made the case that we have unbiased research on Wall Street.

I think a lot of the conflicts and problems that have been mentioned at this hearing do exist, and I think it is up to you all, meaning the broad securities industry as a whole, to really take a good look at this.

I think factually that can be demonstrated and I believe something has to be done, maybe away from Congress, but something should be done.

I yield back.

Chairman **BAKER**. Thank you, Mr. Castle.

For the record, Mr. Glassman, I don't think anyone today is suggesting further legislation on the matter. This is an opportunity to share thoughts and hopefully see some positive results without legislation.

Mr. Kanjorski.

Mr. **KANJORSKI**. Mr. Hymowitz, you made some interesting comments about reading the prospectus, the profit-and-loss statement, and the balance sheet of some of these corporations. You suggest that people are able to ascertain and make a judgment on their own.

Unlike Congressmen, you probably spend more time at the club than you do at the gas station. We are about to decide a public policy on whether or not Social Security should be invested in the stock market. The proposal would allow people to have the voluntary election to do that.

There are about 150 to 160 million workers covered by Social Security. If you know something about the statistics on level of education, I think it is more than 20 percent of the American population that is functionally illiterate. That would be 35-, 40-million adult Americans that cannot even read and understand what would be in a business prospectus.

I hope therefore, people are listening to this broadcast that are going to be deciding whether or not we should open up Social Security money to go into private accounts managed by private individuals for investments. In part of your testimony, I was under the impression that we were going to have a very high standard of professionalism. You

should have taken into account one out of four people's total incapacity to understand and comprehend these things. Without the professionals of Wall Street, they would not have to.

But you are telling me, you are saying to all Americans now: It is up to you to understand these things, to read these statements, and to comprehend these statements. So the Congress, under that argument, should say look, we know there is more than 20 percent of the population that is functionally illiterate, who cannot even read and fill out an employment form, much less read a prospectus.

Should we not protect them and say that is the craziest issue in the world? Are you not one of the greatest witnesses against privatizing Social Security?

Mr. **HYMOWITZ**. Congressman, let me answer the question. What I was responding to was Chairman Baker's question about why wasn't the public informed when the capital markets switched, in some respects, to start funding secondary venture capital companies, young, immature enterprises.

And my answer was that prospectuses that this Government requires companies to file hopefully are meant to be read. And the individual who does not want to spend time and the effort to read the prospectus then should do what millions and millions of Americans do every day, and that is give their hard-earned investments to mutual fund companies to index funds, to brokers, to money managers to hedge funds.

Look, I don't know anything about automobiles, so if I go in and I attempt to figure out what car to buy, I'm going to get some expert advice on what kind of car I should buy.

Mr. **KANJORSKI**. The average American does not do that. He does not hire an engineer to evaluate an automobile. I do not know where the heck you are living, but you are not going to the gas station to which I go to pump my gas. I talk with people every day.

I want to give you an anecdote. In a coffee shop 2 weeks ago, I saw a friend of mine, injured seriously on his job, and who settled out his Workman's Compensation case at \$250,000 about 3 years ago. He got caught up in the hysteria of the stock market, and made some investments in early IPOs. These stocks really ran up at first.

He thought Christmas had now arrived 365 days a year. That \$250,000 is, however, now worth less than \$19,000. When he told me what he was doing, I could not believe it. I recommended against it. I said, "Don't you ever play this game with this money. This is your livelihood." But he could not resist that temptation. Everybody else was doing it.

Mr. Baker made the point. Having all my 401(k) in Government securities, I have to say over these last 5 years, sometimes I have kicked myself when I look at that bottom line, and I look at my neighbor's bottom line. But knowing that I neither have the time nor the expertise, I just cannot. I may also have a conflict of interest, so I just stay out of it.

But there are an awful lot of American people who are not capable of doing that. We try to open up hope and opportunity to everyone, and there is not any question, as I said in my opening statement, that the American capital markets are the envy of the world. We are not trying to cast aspersions on all analysts, even the majority of analysts, and certainly not on all investments.

I know these people. They are mostly exceptionally talented, bright, and highly ethical. Do they police everything or are mistakes made? Yes. But our problem is that we have to respond and try to protect in some way, even the foolish and the functionally illiterate. What I think we are asking this panel to do, and the industry to do, is put your heads together and come up internally within your industry with standards that are acceptable, and enforcement that is acceptable. We need standards that leave us with the belief that the markets are being handled by people that are credible with integrity, and not to the disadvantage of the average person.

And if we cannot do that, I agree with my colleagues: there will be a time when either the regulator, or this Congress, will act precipitously if conditions continue.

Chairman **BAKER**. Thank you, Mr. Kanjorski.

If no other Member wishes to ask a question of this panel.

Congressman Shays.

Mr. **SHAYS**. Mr. Chairman, I consider this a very important hearing and I was chairing the National Securities Subcommittee and I just apologize for missing what I was told was an outstanding dialogue with this panel and the Members and I look forward to the next panel.

Thank you.

Chairman **BAKER**. Thank you, Congressman Shays.

I want to thank each of you for your perspectives. I assure you, the subcommittee will move very slowly. We are, hopefully, not being viewed as demagoguing an important issue. We want to understand it. We want to know how markets function, the role of the analyst and all participants.

We would welcome your further comment pursuant to your appearance here today. If you have answers responsive to any Members' questions, we would welcome them.

I specifically would like further analysis on if we are to proceed with the best practices model, in whatever form that finally is contemplated, I feel it appropriate to have some confirmation of compliance, whether that is by the Congress, the regulator or some other activity by contract. But we need to have some assurances that the standards that are

being held up, as in all other professions, there's some level of accountability for assuring those practices are being followed.

I don't sense, from the Members of the subcommittee here today, that we feel like we're near resolution, but that we can reach an understanding with professional leadership from the investment community that I think can be acceptable to all parties, and most importantly, we all fully understand that the huge growth in our economic ability and our quality of life in America has been very positively effected by the activities over this past decade.

We wish to do nothing to impair the efficient flow of capital markets, but we also have a new political responsibility. People who are working families that had no access to the markets to speak of are now on-line, as we hold this hearing, making investments because they want to have part of this dynamic growth and that is creating a new level of responsibility.

As I quoted earlier in the week, I said it may be one thing for one shark to eat another; it is quite a different matter for the shark to eat the minnows, and we're about making sure that everyone who's in the tank has equal access to opportunity, a free flow of information that's unbiased, that will result in the restoration of unquestioned truth and faith in our capital market system.

That really is our purpose and I really do appreciate your participation. It was not easy to get folks to come and talk about this and frankly it wasn't easy to call the hearing, but I think we served an important purpose and I thank you for it.

At this time, I'd like to call our second panel, please. I'm told, just as an update, we're getting to a point in debate on the floor where we're expecting a vote within a few minutes. I'd like to go ahead and proceed. If need be, we will temporarily suspend. I think it may be only one vote and I can run over quickly and be back just to give you an advisory.

We will start first with welcoming Mr. Benjamin Mark Cole, Financial Journalist, author of the "Pied Pipers of Wall Street: How Analysts Sell You Down the River."

Thank you, Mr. Cole.

STATEMENT OF BENJAMIN M. COLE, FINANCIAL JOURNALIST

Mr. **COLE**. Thank you, Mr. Chairman, for receiving my testimony today. With the NASDAQ cut in half from 2000 and Internet stocks trading for pennies on the dollar, many Americans are asking themselves what happened.

How come no major securities house predicted you might lose half your dough on the NASDAQ in less than a year, or lose almost all your money on an E-toys price line, or an I-Village.

It reminds me of that old joke of the 1970s, made fresh again by recent events. "How do you end up with a million bucks on Wall Street? Start off with two million."

What the public doesn't realize yet, though it is catching on, is that Wall Street research has become hopelessly corrupt. Today's so-called analysts are more akin to lawyers in court. They regard their job as one of advocacy to make the best case why a stock is a terrific buy.

Ask an analyst if what they are doing is dishonest, and they will answer that you don't understand their job description.

What happened to analysis? Why does a sell signal make up less than one percent of analysts' recommendations?

The answer lies in the way Wall Street makes money today compared with 1975. Twenty-five years ago, Wall Street made money in ordinary retail trading commissions which were fixed by regulation. That environment, something of a cross between Shangri-La and Fat City, made Wall Street a clubby place of almost assured profits. The prized customer was a wealthy individual or family that liked to trade stocks and the prized employee was a stockbroker with a good book of business.

But the SEC erased fixed trading rates in 1975, an action then fought tooth and nail by the industry, which wanted no part of free enterprise and competition.

In the years since, if inflation is taken into account, retail trading commissions have fallen to a penny on the dollar.

If you look at a thrifty investor using a discount on long brokerage for securities firms, the downward plummet of trading rates raised a serious problem.

How do we make lots of money like we all came to Wall Street for?

Wall Street, after 1975, had to come up with a new way to make lots of money and they found it, happily for them in their own corporate finance departments, also known as investment banking.

Investment banking is the business of underwriting initial public offerings of stock, secondary offerings, bond underwriting, or advising companies on mergers and acquisitions.

Increasingly, brokerages have moved upstream in the financing cycle of companies, often providing private equity, also called venture capital, to a company before they take it public.

This activity can be extremely lucrative. CIBC Oppenheimer, now CIBC World Markets, invested \$30 million in private equity into Global Crossing Limited, the Telecom giant. After the company went public and the stock surged, that stake became

worth \$4.3 billion.

Goldman Sachs invested \$36 million private equity or stock in Storage Networks, Inc., pre IPO. That stock became worth \$1.6 billion after Goldman took Storage Networks public.

Some quick numbers illustrate the changed nature of Wall Street. In 1974, the U.S. securities industry underwrote \$42 billion worth of stocks and bonds. In 1999, the industry underwrote \$2.24 trillion of stocks and bonds, more than 50 times the pre-1975 level.

Trading commissions today made up 60 percent of industry revenues before 1975, but today make up less than 16 percent.

The simple story is this: Wall Street makes its money on investment banking, not retail trading commissions. With this change, came a change in who held power within the brokerage.

In days of yore, as quaint as it may seem today, the stockbroker with his book of business was the power employee within the brokerage. Sometimes they were referred to as customers' men.

When an analyst wrote a report, he looked over his shoulder at the customers' men who would hold him accountable.

Today, things have changed. Today, analysts look over their shoulders at investment banking and trading departments, the new profit centers.

The results of this switch in loyalty are obvious to all within the industry, so much so that brokerage analysts are referred to often dismissively as sell-side analysts. Perhaps not surprisingly, numerous industry and academic studies have found that analysts' recommendations as a group under perform the market.

Investors would be better off tossing darts at the Wall Street Journal than following analysts' recommendations.

Although the role of analysts has changed dramatically in the last 25 years, their regulatory environment is little changed from 1975 or even 1945. Analysts have safe harbor under the law even to the extent that they can tell their larger clients that a stock is really a dog while keeping the buy signal on for the public. That is entirely legal.

It is even legal for analysts to tell their trading departments that a buy signal will be out on the morrow. If the analyst is influential, the trading department can bulk up on the stock, and then sell into the retail demand generated by the buy signal, all legal.

Brokerages call this "building inventory to satisfy demand." Just servicing our customers. Others might call that a license to print money.

What is disturbing in the last 25 years is to see that many practices once limited to regional and one-branch brokerage shops, the so-called schlock shops have become commonplace in Wall Street proper.

In particular, when a brokerage finances a company before an IPO and then has an analyst issue a buy recommendation, it is mimicking practice commonplace off Wall Street for generations.

Some quick stabs at solutions here.

One, I would increase the budget of the SEC for enforcement actions and beef up the U.S. Attorneys Office for securities industry prosecutions.

Two. I would require the brokerages to create a uniform standard for rating the accuracy of analysts' recommendations and that analysts' batting averages, if you will, be constantly published on an industry website maintained by the National Association of Securities Dealers.

As an aside, I find it somewhat amusing that we know Marc McGuire's batting average day-by-day, how many home runs he's hit, but we don't know what the analysts' batting average is day-by-day, yet we are investing based upon their recommendations.

In the 1930s, the SEC examined whether brokerages should even have underwriting and retailing operations under one roof. It may be time to reexamine that situation.

In care and feeding of short traders, in a nut shell, allow short traders to have contracts specifying terms for returning borrowed shares. Short traders can be a tonic on the market.

Lastly, better mandatory disclosure of analysts' conflicts of interest in both broadcast and print media.

Thank you very much, Mr. Chairman.

Chairman **BAKER**. Thank you very much, Mr. Cole.

The next witness is Mr. Scott Cleland, Chief Executive Officer of the Precursor Group.

Welcome, Mr. Cleland.

STATEMENT OF SCOTT C. CLELAND, CHAIRMAN AND CEO, PRECURSOR GROUP

Mr. **CLELAND**. Thank you, Mr. Chairman, for the honor of testifying. I'm Scott Cleland, Founder and CEO of the Precursor Group.

We provide investment research to institutional investors. We've aligned our business interests solely with investor interests so we've avoided the common financial conflicts of interest. We do no investment banking. We don't manage money. We trade stocks but we never own them.

And all Precursor researchers may not own individual stocks. We are a pure research firm because we believe that a company cannot serve two masters well at the same time. You can't serve investors and companies together.

We think conflicts undermine research. We think independence improves research.

We saw a real market opportunity to be a pure research company.

Our interest in testifying is clear. We are worried that the powerful investment banking and trading interests that have suffocated independence within a firm are at work within the industry at large, and can suffocate the independent research views at large.

That's because the firms that have conflicts control well over 90 percent of the market for research commissions, according to our best estimate.

So what we're calling for is more competition to conflicted research, not less. The less regulation of pure research and more disclosure and regulatory oversight of conflicts of interest, the freest and the most competitive flow of information is what best serves investors and helps the markets operate efficiently.

A system that's 90 percent or more dominated by companies that have inherent conflicts of interest profoundly distorts the type of information that the market receives. We think that more competitive research is the answer.

Recently, American shareholders and pension plan beneficiaries lost over \$4 trillion when the NASDAQ fell, and at that time, there were only one percent of analysts recommending a sell.

I'm not saying that the problem is the analysts. I think they are being made the scapegoat.

The problem is the regulatory system that is favoring companies over investors. The analysts and the firms work primarily for companies, so it's unrealistic to expect that they are going to bite the hand that feeds them.

So what are our recommendations for you? We have four.

The first recommendation is, encourage fuller and more practical useful disclosures of financial conflicts of interest. Who does a researcher work for? Is it the companies or is it the investor.

My second recommendation is encourage the alignment of interests, encourage research that is aligned with investment and with investor interests.

Let me tell you a little fable in a sense. This is a classic case of the fox in the hen house. Today, the investment research assumes that the investor hens will be just fine in the same hen house with the investment banking fox as long as the regulator, the farmer, makes sure there's enough chicken wire to keep the fox away from the hens.

My question to you is: Why not encourage more hens seeking out hens and why does the system always encourage that a hen must deal with a fox? It makes no sense, but that's what the system encourages.

It encourages the hens to live right next to the fox all the time.

Now what's my third recommendation? Reduce regulatory barriers to people who want to do pure investment research like we do. Do you realize that in order to become an independent research broker/dealer, we had to be licensed and regulated and audited to do investment banking and all the trading.

There are over 900 pages of regulations that we are subjected to and only ten apply to research. We essentially in the regulatory system, why you have so little independent research is the regulatory system powerfully discourages it. We have to take a regulatory exam called a Series 24. We took it and we passed it.

However, it was a very difficult exam. We spent over 150 hours studying for that in order to pass it. And there were very few questions, a very small percent that applied to what we are trying to do in our business, which is to provide investment research to improve investors' performance.

So we think you can do a little bit of deregulating. The last recommendation I have is ensure a full and diverse competition for ideas and information in the marketplace.

More specifically, watch the institutional commission lists, because right now the folks that have 90 percent share of those research commission lists are trying to get 100 percent. That's the reason why we're testifying here today. If you want to have more independent research, if you want to fix the solution, allow the marketplace to compete with conflicted research.

Thank you for the opportunity to testify today.

Chairman **BAKER**. Thank you very much, sir. We appreciate your appearance.

Our next witness is Mr. Thomas Bowman, CFA, President, Chief Executive Officer, Association for Investment Management and Research. Welcome, Mr. Bowman.

STATEMENT OF THOMAS A. BOWMAN, CFA, PRESIDENT AND CEO, THE ASSOCIATION FOR INVESTMENT MANAGEMENT AND RESEARCH

Mr. **BOWMAN**. Good afternoon, Mr. Chairman, and other Members of your subcommittee. My name is Thomas Bowman, President and Chief Executive Officer of the Association for Investment Management and Research, a non-profit organization with the mission of advancing the interests of the global investment community by establishing and maintaining the highest standards of professional excellence and integrity.

Thank you for the opportunity to and privilege to speak on behalf of more than 150,000 investment professionals worldwide who are members of AIMR or who are candidates for AIMR's Chartered Financial Analyst designation.

For more than 30 years, CFA charterholders, candidates and other individuals who are AIMR members have adhered to a standard of practice that requires them, among other things, to achieve and maintain independence and objectivity in making investment recommendations and to always place their clients' interests before their own.

Although AIMR members are individuals, not firms, AIMR has succeeded in developing other ethical and professional standards that require firmwide compliance and have been globally adopted. Based on our experience, ethical and professional standards are most effective when voluntarily embraced rather than externally imposed.

To provide analysts with an environment free of undue or excessive pressures to bias their work, we must understand that these pressures come from many sources, not simply investment banking activities, and not all of them internal to their firms. None of these pressures is new, but their impact has escalated in an environment where penny changes in earnings per share forecasts make dramatic short-term changes in share price, where profits from investment banking activities outpace profits from brokerage and research, and where investment research and recommendations are now prime time news, or as some would say, entertainment.

Let me elaborate a bit on some of these pressures. Analysts need to work with their investment banking colleagues to evaluate prospective clients. Although we do not believe that this relationship is inherently unethical, firms must have procedures in place that minimize, effectively manage and adequately disclose the conflicts to investors.

Firms should foster a corporate culture that supports independence and objectivity.

They should establish or enforce separate and distinct reporting structures so that investment banking can never influence a research report or investment recommendations.

They should have clear policies for analysts' personal investment and trading.

They should implement compensation arrangements that do not link analysts' compensation to work on investment banking assignments; and

Make prominent and specific, rather than marginal and boilerplate, disclosure of

conflicts.

Analysts also have been pressured by companies to issue favorable recommendations. Companies have been known to take punitive action against analysts and their firms for negative coverage.

Some institutional clients also support ratings inflation. Portfolio managers' compensation may be adversely affected by a rating downgrade of a security in their portfolio. Consequently, they may retaliate by shifting brokerage to another firm.

These and other conflicts are discussed at length in a position paper that AIMR will soon issue for public comment. This paper will form the basis for the development of AIMR's Research Objectivity Standards, which will be specific and measurable practices addressing each conflict.

Finally, we must address how research recommendations are communicated. Increasingly, private investors get research recommendations through brokers, the media and the Internet. Typical research reports are lengthy, but are often condensed to earnings forecasts or buy, hold or sell recommendations when communicated to the investing public. This makes a good sound bite, but investors should know that headline ratings do not provide sufficient information for buying or selling a security.

Investors or their investment managers should study the entire research report to assess the suitability of the investment to their own situation, their own investment objectives, and their constraints.

Although the analysts we are addressing are a small fraction of AIMR members, and the investment profession at large for that matter, I would like to impress upon the subcommittee that AIMR and its members appreciate the seriousness and also the complexity of this problem. We recognize that the reputation of the entire investment profession has been called into question. But a precipitous solution is not the answer.

AIMR is committed to work with the profession to develop effective, long-term solutions. I'll be happy to answer any questions you may have. And again, Mr. Chair, thank you very much.

Chairman **BAKER**. Thank you, Mr. Bowman.

Our final witness today is Mr. Damon Silvers, Associate General Counsel, AFL-CIO. Welcome, Mr. Silvers.

STATEMENT OF DAMON A. SILVERS, ASSOCIATE GENERAL COUNSEL,
AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL
ORGANIZATIONS (AFL-CIO)

Mr. **SILVERS**. Thank you, Mr. Chairman. The AFL-CIO and its member unions—there are 13 million members—believes today's hearings on investment analyst

independence is of vital importance to working families and their pension funds.

We would like to thank the Subcommittee for its efforts in this area. In particular, Mr. Chairman, let me express our appreciation to you for your concern for the interests of working families as investors.

Defined benefit pension funds that provide benefits to the AFL-CIO's 13 million members have approximately \$5 trillion in assets. Through 401(k) plans, ESOPs, and union members' personal savings accounts, there are further extensive investments in equity markets by America's working families and union members.

Most of our members and the trustees of our pension funds rely on a variety of professionals for their information about the equity markets. America's working families have an enormous stake in the accuracy of this investment analysis.

In addition, many of the largest pension funds, whose beneficiaries account for hundreds of thousands of working families, have placed the majority of their equity investments in index funds. This decision is driven by index funds' lower fees and the difficulty of obtaining consistent above-market returns in active trading.

However, the funds who invest in indexes are placing their trust in the transparency and honesty of our markets and have no defense against systematic distortions such as those created by conflicted analysis.

In that context, what are we to make of the data that's been cited here frequently today that in December of 2000, 71 percent of all analysts' recommendations were buys and only 2.1 percent were sell?

In the remainder of my testimony, I would like to suggest that what has happened here is the collapse of what used to be called the Chinese Wall between investment banking and analysis, and that only regulatory action can rebuild it.

There is substantial statistical evidence that analysts' decisions whether or not to recommend that investors buy a stock are influenced by whether their firm is an underwriter for that issuer or considering becoming one.

CFO Magazine reported last year that analysts who worked for full service investment banks have 6 percent higher earnings forecasts and close to 25 percent more buy recommendations than analysts at firms without such ties.

And in the last few months, analysts have been quoted by name in the financial press saying such things as, quote: "a hold does not mean it's OK to hold the stock". And, quote: "the day you put a sell on a stock is the day you become a pariah."

This data is not surprising given the relationships that have developed between analysts and the investment banking side of the full service securities firms. It has become a common practice for analysts to accompany teams from their corporate finance

departments on underwriting roadshows, and most importantly, analyst compensation has become tied at many firms to analyst's effectiveness at drawing underwriting business.

In addition, the consolidation of the financial services industry puts issuers in a position to withhold business from the firms of critical analysts across a wide array of markets, including commercial loans and commercial banking services, pension fund and Treasury money management and insurance contracts.

For example, the same CFO Magazine article reported last year that First Union cut off all bond trading business with Bear Stearns in response to negative comments by Bear Stearns' analyst, and Bear Stearns then ordered the analyst to be more positive.

Just yesterday morning there was an account of how an analyst report critical of the Kraft offering that was mentioned here today was effectively suppressed by Goldman Sachs. They had their reasons, they reported in the press. The fact is, the report was suppressed.

On the eve of this hearing, the Securities Industry Association announced a voluntary set of principles governing analysts at their member firms. We would urge the subcommittee to look closely at this code to see if it leaves room for continued linkage of analyst compensation to investment banking activity or continued participation by analysts in marketing securities underwritten by the analysts' firms.

The problem of conflicted analysts is driven by extremely powerful financial pressures, and it will not be halted or reversed by either general statements of a desire to be honest or subtly crafted principles that on closer examination leave room for a continuation of business as usual.

Rather, we think Congress ought to assist the Securities and Exchange Commission, the NASD and the national exchanges in continuing the course toward greater market transparency and integrity promoted by the SEC's recent regulatory initiatives.

Already in Regulation FD on selective disclosure, the subcommittee has taken an important step toward combatting conflicting analysts' reports. The disclosure targeted by Reg FD gave issuers power to punish and reward analysts with information that warped the behavior of those analysts who actually got the selective disclosure.

Unfortunately, despite the improvements wrought by FD, we believe that there is a need amply demonstrated by this morning's hearing for this Subcommittee to work with the regulatory agencies, including the industry itself, in the NASD and the SROs to develop new regulatory approaches.

Some measures this subcommittee ought to consider and raise with the Commission should include bars on any form of linkage between analyst compensation and investment banking performance. And in addition, bars on analyst participation in marketing activities by their firms, most importantly, underwriting roadshows.

The subcommittee should also consider whether in view of the pressures at work here a more comprehensive ban on analysts from issuing reports to the public on companies which their firms are underwriters for should be appropriate. One thing that has not come out in this discussion very much this morning is that analysts and broker-dealers are fiduciaries for their clients here. And they owe a duty to those people under law currently. Unfortunately, it seems to be somewhat unenforceable.

Working with the Commission on these new initiatives, however, will take time. In the meantime, we think this subcommittee would do a great deal to protect investors and the analyst community if at a minimum it used its influence with the SEC to protect Regulation FD and ensure it continues in its place in current form.

In conclusion, the AFL-CIO believes the question of analyst independence is vital for the retirement security of America's working families. We thank this subcommittee for its work in this area, and we look forward to working with you in the future.

Chairman **BAKER**. Thank you, Mr. Silvers.

Mr. Bowman, I'd like to start my questions with you, sir. In your capacity representing AIMR and secondarily as to the content of your statement, I found it most helpful. You centered on a number of concerns that I have had, and I express my great interest in the release of the paper, which I assume will address all of those issues raised.

Have you had occasion to review yet the Best Practices standard of the SIA?

Mr. **BOWMAN**. Very briefly, sir. I think they came out earlier this week. And I had not had any advance—I had not discussed that with the SIA prior to their coming out with it. So I'm vaguely familiar with them, but I have not read them in depth.

Chairman **BAKER**. And you're not in a position to make a comment today?

Mr. **BOWMAN**. Well, I found one thing very interesting. As I read through those, in fact I had an e-mail from one of our members who had seen it, and if you read through those Best Practices, while we agree with them all, it's very interesting to see that most of what was included in that report has been in our Standards of Practice handbook for 35 years—analyst independence, clients first, you know, conflicts.

Chairman **BAKER**. I was expecting that looking at that manual for 35 years of practice it would appear to me on first blush from a distance of about 40 feet, it contains a bit more than the Best Practices Standard recommended by the SIA. Is that a fact?

Mr. **BOWMAN**. Well, in fairness it does, but there's case studies in here too. So this is not all the standards.

Chairman **BAKER**. Are there significant elements of its content which you would deem advisable for the subcommittee to consider in the application to the Best Practices of the SIA?

Mr. **BOWMAN**. Very much, sir.

Chairman **BAKER**. What I will suggest, since I have a suspicion this will get inordinately complex very quickly, is to request—and I'll follow up in writing—your organization's review of those Best Practices as recommended, and particularly a contrast between your Manual of Best Practice and that which is proposed to help the subcommittee better understand where deficiencies might exist or where we find something of value in the SIA's proposal.

At least my view, and I think the view of most Members of the subcommittee is there is not a desire to legislate in this matter, but we certainly want to encourage the best possible standard to be self-implemented, but to view the best way to confirm, as Mr. Silvers had pointed out, a way to ensure that the conformity with the standards is in place. Is there such an audit or enforcement provision with regard to the AIMR standards?

Mr. **BOWMAN**. Again, sir, as I mentioned in my testimony, we are an organization of individual professionals. We do not have corporate membership, and therefore no authority over some of the firms that we're talking about here this morning.

So we do have enforcement mechanisms over our members.

Chairman **BAKER**. Right. In other words, if you find somebody not complying with your rules, they're out?

Mr. **BOWMAN**. They're out.

Chairman **BAKER**. But my point is that there's accountability at least within the organization, and where there is evidence of inappropriate conduct, there are consequences?

Mr. **BOWMAN**. Absolutely.

Chairman **BAKER**. Well, see, that's something that's lacking I think in the SIA proposal. There's not even the beginning suggestion of a consequence for your failure to act appropriately.

Mr. Cleland, did you want to jump in there?

Mr. **CLELAND**. Yes, if I could. It's always important to put things into context. And the SIA Best Practices, everyone should support. I just would like to put it into context that there's nothing really new here; that this is boilerplate.

If you look at the National Association of Security Dealers self-regulatory manual that was first published in the 1950s, this language would be very similar to what the preamble was there.

Chairman **BAKER**. So you would characterize this as not a particularly bold step, in other words?

Mr. **CLELAND**. This is probably a needed refresher course. But it's been the standard for 45 years.

Chairman **BAKER**. And by the way, just for the record, it was stated earlier that perhaps the organization was one of the few that had continuing education. I can confirm from my own personal experience there. Annual education requirements for most professional affiliations with annual testing. And I can speak to that from only the real estate perspective. But it is not an abnormal activity for a professional organization to require continuing education and examination, and I think that's highly appropriate.

Did you wish to jump in, Mr. Silvers?

Mr. **SILVERS**. Yes, Mr. Chairman. I think that you have a way of avoiding the dichotomy that I think you wish to avoid between purely voluntary self-policing of the sort that the SIA code suggests, and legislation. Congress is fortunate that in its wisdom it created the structures of the self-regulatory organizations and the NASD, which are industry structures, controlled by the leaders of the securities industry who have the authority to enact structures of accountability in this area.

It's our view that the proper role for this subcommittee here is to work with those bodies and encourage them to use the authority they have to address this problem and create the kinds of accountability, Mr. Chairman, that you are concerned about.

Chairman **BAKER**. Thank you. I'm going to jump to Mr. Bentsen. I don't know how soon we'll get to a vote, but I'd like to try to at least get Mr. Bentsen and Mr. Shays' questions in before then. Mr. Bentsen?

Mr. **BENTSEN**. Thank you, Mr. Chairman. let me just restate and make sure it's clear what my opinion is on this so no one is confused. I think there is some move here to try and treat financial analysts in the same way that we treat auditors and to link their positions. And I just continue to believe that those are two different professions and we ought to be cautious in our approach.

And in a couple of the testimonies that were given, there seems to be an extrapolation of not just fiduciary responsibility—and I agree that analysts, because they have contact with investors, are required to take their Series 7 and I don't know whatever series tests they have to take through the SROs.

But no one yet has shown me in the law where analysts' reports fall under the same guidelines that offering documents for securities do in terms of providing objective disclosure. And second of all, no one has yet fully provided for me some widespread pattern of manipulation of the market on the part of the analyst corps that creates some real and present problem that needs to be addressed through regulation or legislative action.

Now at the same time, as I said to the earlier panel, and maybe I'll try and be less subtle, that it comes as no great surprise to me that analysts who work for investment banking firms or brokerage firms may well be, particularly on the sell side, may well be trying to add in the pitch of the sale. And I think there is a risk to the brokerage firms that they be cautious in how subjective they want to be, because they are trading ultimately on trust. And then if they cross that line into what is manipulation through false disclosure, even though they are not under the Security Act or other disclosure laws.

I mean, can anybody here give me a pattern that has occurred? And the other thing I would just add, and I'd ask Mr. Cole, you talk about the fact that the NASDAQ has been cut in half from 2000, but this is not the first time we've seen market corrections in the 20th century. I mean, you had in 1900, in the 1920s, in the 1950s. You had a brief correction in the 1980s.

And if there's a correlation between analysts saying sell versus hold versus buy, is it to say—I mean, how did you get that 50 percent correction in the first place? Had they all said "sell," would it have been a 100 percent correction in the market? Or does the market move on information other than what analysts provide to them?

And finally, I'd just say, in many respects I think there is a herd mentality that occurs in the market, and I think the excess capacity of media outlets amplifying what analysts are saying, which heretofore used to be a subscription-type business sort of amplifies what their real worth is.

But basically, I'd like to know where is the pattern? Where is the empirical evidence? Because I don't think that case has been made today.

Mr. **CLELAND**. If I could jump in, I wouldn't necessarily say that—I wouldn't try and answer it that way. What I would say is the entire structure, the economics, the structure, the regulation, the compensation structures, are all mutually reinforcing that put company interests ahead of investor interests.

The SIA's Best Practices said the investor interest comes first. Well, if you look through the regulation, the structure, the economics of the industry and the compensation, it all rewards companies over investors.

Mr. **BENTSEN**. Now Mr. Cleland, do you support Reg FD?

Mr. **CLELAND**. I think that Reg FD is OK. I think what it means is that most research has to happen in a stadium, and that generally isn't how research is done. Research is done day by day, tough, you know, digging and getting different nuggets at different times.

Mr. **BENTSEN**. But wouldn't it, if we had a Reg FD, isn't there a school—I think there's a school of thought if we had Reg FD that when a company tells an analyst that they have a cozy relationship with they also have to disclose to the rest of the world. I

mean, isn't that what you want to see happen?

Mr. **CLELAND**. I have no problem with that.

Mr. **BENTSEN**. Isn't that what we're saying in part here today?

Mr. **CLELAND**. Yes. And I don't think there's any—I'm not quibbling with FD.

Mr. **BENTSEN**. We had a hearing a week ago, or 2 weeks ago, where some were trashing Reg FD and saying that it was going to lead to less disclosure and contort the market and all other sorts of things.

Mr. **CLELAND**. And I'm not quibbling with FD. I'm trying to tell you that there is a systemic bias toward representing company interests over investor interests throughout the system. And you will get biased research, because that's what the system is geared to do.

Mr. **BENTSEN**. In the laws governing offering documents, I mean, issues you raise about companies taking positions, the brokerage houses taking positions in companies that they're also writing research for, when they are actually pitching a stock through an offering document is a material item that has to be disclosed in the document.

And I think what you are arguing is perhaps we need to apply disclosure standards, legal disclosure standards to research, which is a pretty far step to take.

Mr. **CLELAND**. No, I'm not saying that. I think the rules as I know them that research reports are classified as sales material. So at least that's what the current rules do say. They treat research as—they call it sales material.

Chairman **BAKER**. If I can, Mr. Bentsen, I'm going to jump to Mr. Shays, and hopefully we can release our witness panel. Mr. Shays?

Mr. **SHAYS**. Thank you. I'm intrigued with all your testimony. Mr. Cole, you start out very clearly and say Wall Street has become hopelessly corrupt. And I'm interested in you trying to give me the two or three best examples of why you think it's hopelessly corrupt, and then I'd like a response by the rest of the panel.

Mr. **COLE**. Well, when you look at a Planet Hollywood underwriting or Playboy secondary offering and you see the quality of research which was released in either of those companies. Planet Hollywood went bankrupt shortly after it went public. Or if you consider the role of analysts at a brokerage where the brokerage actually provides venture capital to a company, helps create the company, then takes it to an initial public offering and the company does go public, the brokerage itself has a stake in the company worth from hundreds of millions to billions of dollars.

What analyst is going to come out with a sell recommendation when the brokerage itself owns billions of dollars of stock in that company? If the analyst's sell

recommendation only knocked 10 percent off the value of that stock, it could hurt the brokerage to the tune of hundreds of millions of dollars.

Mr. **SHAYS**. I'm struck by the fact, though, I don't know how a brokerage firm does well if its analysts are constantly telling people to do something that's not in their best interest. I see the built-in bias, but in the end, it seems to me that analysts——

Mr. **COLE**. The day of reckoning may come, as I said in my statement. I think the public is catching on. And if you want to be a little bit dramatic, what happens when the public does catch on and loses faith in Wall Street?

Mr. **SHAYS**. What about all the other analysts who work for other companies who will express an opinion about a particular area where one company has a vested interest in? In other words, doesn't the fact there are so many analysts out there ultimately modify, provide additional information? So one brokerage firm says buy and another one says sell.

Mr. **COLE**. I wish that it did modify it, but it seems to magnify it since as we've heard, 99 percent of recommendations are buy, it seems to have a reinforcing effect rather than a moderating effect.

Mr. **SHAYS**. I guess my question is, other firms that don't have a vested interest in it. Therefore, I don't see where their bias is.

Mr. **COLE**. They may seek business in the future. They may be owned by a commercial bank which has a commercial banking relationship with the company in question. It never pays to make enemies.

Mr. **SHAYS**. Let me just hear the response of others. Mr. Cleland, I want to just say, the way you organize your statement tells me it's based on your training as an analyst. I'd love to show my staff how clearly you organize your statement. It's intriguing.

Mr. **CLELAND**. Thank you.

Mr. **SHAYS**. But I'd love you all to just respond to Mr. Cole's comments.

Mr. **CLELAND**. Well, I think I wouldn't use the word "corrupt". I would use the word "conflicted". I mean, there's nothing wrong with representing companies. The problem in the system is, is people think the system represents investors. And the structure, the economics, the compensation and the regulation is all biased toward helping company interests subordinate investor interests. That's the system. That's the problem is that it's not transparent that the system is so skewed.

Mr. **SHAYS**. Mr. Bowman?

Mr. **BOWMAN**. With all due respect, I categorically disagree with Mr. Cole's statement. As I think Mr. Glassman and the earlier panel indicated, life has conflicts, as

does any business.

As I mentioned, I represent an organization of 150,000 investment professionals and I deal with thousands of investment professionals every day, and I can tell you that in 99.99 percent of the cases, all they want is for the investing public and for us to be able to demonstrate that these people are honest, forthright and are putting their clients first.

In fact, since this whole issue arose several months ago, I have probably never been inundated with e-mail, mail and fax from members about the concern that they have and the black eye that they're receiving over what is really an isolated set of conflicts. And that is a relatively few number of sell-side firms who have these potential conflicts.

So I can tell you that over 30 years of investment practice, all the investment professionals that I've ever run into and at least those who are members of our organization, are honest, forthright and only interested in serving their clients.

Mr. **SHAYS**. Thank you.

Chairman **BAKER**. Thank you, Mr. Shays.

Mr. Royce.

Mr. **ROYCE**. Thank you, Mr. Chairman. I missed a little bit of the testimony here, because the Investor and Capital Market Relief Act is on the floor and I was speaking to that bill. But I caught some of the earlier testimony.

And I have yesterday's Wall Street Journal with me here. And I just want to read for the panel here a comment made in yesterday's Journal: "Investors increasingly are blaming analysts for helping to pump up the dot.com bubble by issuing favorable research reports in recent years on companies handing out fat investment banking fees and not warning investors of the problems at these companies until long after the bubble burst."

And what the Journal does is just give a short example here, which I'd like you to comment on. It says: "A week ago Credit Suisse First Boston was appointed lead underwriter on a new stock deal for GoTo.com, a Pasadena, California Internet search engine. And Credit Suisse First Boston beat out Merrill Lynch and Company for the lucrative position. A few hours later, Merrill's high profile technology stock analyst, Henry Blodgett, who had been bullish on GoTo.com shares, did a turnaround on the stock. He downgraded the stock to a neutral from accumulate." And the Wall Street Journal asks the question, a coincidence? And that's the question I want to ask you. Is that a coincidence?

Chairman **BAKER**. If I may suggest, gentlemen, respond very quickly, and here's the incentive. If we get through this round of questions in time, we will adjourn our hearing. If not, we'll come back. It's your choice.

[Laughter.]

Mr. **ROYCE**. Those types of examples. Are they a coincidence?

Mr. **SILVERS**. Congressman, I think that if you look at the academic studies in this area which were cited extensively in my written testimony, you'll see that not only is that not a coincidence, but that it preceded the bubble. That those people at the leading business schools of this country who have taken a look at the relationship between whether or not an analyst's firm has an investment banking relationship with the company that analyst is looking at has an effect on their reports, the answer time and time again has been yes in the 1990s.

It's a matter I think of statistical proof. And in addition to the academic studies that were done all through the 1990s that are in my testimony, the Journal had reports yesterday on a study that showed someone who followed the recommendations of conflicted analysts would have had a 50 percent greater loss than one who did not. And furthermore, there was a study in CFO Magazine that I mentioned earlier. And there is to my knowledge no contradicting studies.

I think that there is ample data for the proposition that you're asserting here and that regulators' inaction, frankly, at this point is inexplicable to me.

Chairman **BAKER**. If I may suggest, we're down to probably a couple of minutes left, Mr. Royce on the vote.

Mr. **ROYCE**. Thank you, Mr. Chairman.

Chairman **BAKER**. Thank you very much. I would enter into the record, Mr. Silvers, the document you were referring to is the Investars.com study in which 53.34 percent—investors lost an average of 53.34 percent when they followed analysts employed by firms as opposed to independent analysts lost 4.24. Now both were losing. I mean, there's nothing to brag about in this message. But the point is that it seems to have been exacerbated by the affiliation.

To that end, I think the testimony given here today has been very helpful.

I'm sorry, Mr. Bentsen. Very quickly.

Mr. **BENTSEN**. If I could clarify very quickly, on a point Mr. Cleland made, talking to counsel, the 33 Act for disclosure purposes does not cover analysts' reports. And I think we're again being very confused here that analysts' reports are not offering documents. And at the end of the day, people who are buying stocks and bonds should read the offering document where the disclosure is in and we are now extrapolating that, expanding that to cover analysts reports. And I think we need to think long and hard before we make that assumption.

Chairman **BAKER**. We're down to a minute, Mr. Bentsen. And I don't dispute your

point. Investors should have some responsibility. But this complicated matter, I hate to close our hearing in this fashion, but I must. We will address the remaining issues in hearings that are yet to come. I would welcome your written comments and suggestions, and certainly Mr. Bowman, I eagerly await the findings of the paper and look forward to working with each of you toward appropriate resolution.

Our hearing is adjourned.

[Whereupon, at 1:25 p.m., the hearing was adjourned.]