Testimony of:

Adam Lashinsky
Silicon Valley columnist
TheStreet.com
(415) 733-8336
alashinsky@thestreet.com

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"Analyzing the Analysts II: Additional Perspectives"

I. Nobody explained the game to the new players.

When I first started covering financial news and set out to write about publicly traded companies, I was told to look for sources in the *Nelson's Directory of Investment Research*. All I knew about the "analysts" listed in Nelson's, the pre-Internet Bible on Wall Street coverage, was that the people listed followed the companies I was investigating. If I needed a quote on, say, Caterpillar, I'd flip to the Caterpillar page in Nelson's and start dialing, hoping to find an analyst who'd return my phone call and say something germane on the record. I knew nothing about the firm where the analyst worked, nothing about the investment-banking ties the analyst may or may not have had, nothing about the difference between a "sell-side" and "buy-side" analyst, and almost nothing about which analysts were better than others. (A star next to an analyst's name meant she was a member of the all-star research team chosen by *Institutional Investor* magazine, a distinction whose methodology I didn't understand.) All I knew was that an analyst who returned my phone call was more valuable than one who didn't. Nobody explained it to me in any greater detail.

It took me a few years to figure out the answers to these questions. But by the time the tech-stock boom began in the mid-1990s and I was covering tech stocks in Silicon Valley, I did understand. Unfortunately for the individual investor who plunged into the stock market around the same time, nobody bothered explaining these things to him. The average neophyte investor found himself with about the same level of understanding about how the Wall Street research game is played as I had when I was a cub reporter 10 years earlier.

Consider the ramifications. An investor seeing "an analyst" plugging a stock on CNBC or in the *San Jose Mercury News*, where I worked before joining *TheStreet.com*, had every reason to believe that the analyst in question was a credible source, an objective observer of a company's financial prospects and therefore of its stock-market value.

The entry of the confused investor into the stock market wasn't a trivial event, as we know now. Forrester Research estimated that total online brokerage accounts, a decent proxy for individual investors, will grow from 5.3 million accounts in 1998 to 14.3 million in 2002. Another analysis estimates that retail trading accounted for 35% of the total volume on the Nasdaq in 1990 and spiked to nearly 60% in 2000. For the first time in the history of the U.S. capital markets the amateur investor on Main Street was having as much an impact on share prices as the professional investor on Wall Street. Old-timers (anyone trained in financial analysis before roughly 1995) decried the lack of attention to fundamentals. But the amateurs, often listening to the respected "analysts" on the tube, made gobs of money as the Nasdaq composite index marched from less than 1,000 in 1995 to more than 5,000 in early 2000. For reference, the composite currently stands at about 2,000.

Individual investors were justifiably angry that the sources they trusted for their investment advice had served them so poorly. If it's any comfort, individuals didn't fare much worse than professionals, who also believed we had entered a new economy where fundamental value didn't matter.

So let's cover briefly what professional investors understood all along and what individuals, with the help of this committee and instruction from the Securities and Exchange Commission, have come to understand. In short, Wall Street analysts by and large are part of the investment-banking operation of their firms. They receive a chunk of their compensation based on the corporate finance and M&A advisory fees their colleagues collect. Their part of the bargain is to provide research that makes their firms and themselves prominent without embarrassing either their firms (with research that criticizes a banking client) or themselves (with research that predicts poorly which way stocks will go).

Based on my conversations with hundreds of research analysts and institutional investors, there is no doubt that the "game" has become more egregiously abused over time. Two factors have led to this. One is simply the huge uptick in investment-banking opportunities during the technology-stock bubble. At the same time, thanks to Big Bang reforms of the 1970s, trading commission fees earned by brokerages have become commoditized. The money isn't in trading when investors pay fractions of a penny to trade a share of stock. The money is in banking, and analysts are part of the banking process.

The key to understanding the so-called scandal this committee seeks to investigate is that the game has been well understood for years. Institutional investors -- analysts and portfolio managers who work for pension funds, mutual funds and sophisticated hedge funds -- long ago stopped relying on equity analysts to help them make buy-sell decisions. These investors know about -- and generally are unbothered by -- the blatant conflicts of interest that exist on Wall Street. When three investment banks underwrite the IPO of a small technology company and 26 days later -- surprise, surprise -- analysts for those three, and only those three, brokerages initiative coverage on the stock, it is obvious to careful observers that a connection exists. This situation doesn't alarm the experienced investor. But nobody told the amateurs who were new to the game.

II. The role of the financial news media.

As I began to understand how Wall Street works, I made it a standard practice in my reporting to point out these conflicts. Just because an analyst worked for the investment bank that took public a company I was covering didn't mean I wouldn't talk to the analyst about the stock. I just wanted to be sure my readers understood the pros and cons of this analyst's perspective. After all, while the analyst might be predisposed to be positive about his client, he also tended to know the company better than an analyst who didn't have extensive access. These are trade-offs.

TheStreet.com started in late 1996 with the same principles I already was using. From the beginning it was standard operating procedure to mention any investment-banking conflicts any time an analyst commented on a stock. The goal, according to Dave Kansas, former editor in chief of *TheStreet.com*, was to make sure the reader understood that an analyst was "not some disinterested professor pontificating from the ivory tower" about a stock. That didn't make the person a bad source, just one colored by their experiences, as are we all.

TheStreet.com didn't get everything right. We shined a bright light on analysts. But at the same time we did our share to hype the momentum stocks of the era. We created the Red Hot Index -- notice that it hasn't been mentioned much lately -- which tracked the performance of the sizzling technology stocks of the late 1990s. And we wrote favorably about IPOs on the assumption that new offerings would continue doubling, tripling and quadrupling upon their introduction. Our own shares rose nearly four-fold on their first day of trading in May, 1999, so we benefited from the phenomenon we were covering.

Other financial-news outlets also pointed out analyst conflicts, but none with the formulaic and purposeful attention of *TheStreet.com*. Most financial news media quoted stock analysts the same way I did when I first started covering business in the late 1980s: Analysts who returned phone calls were the most valuable.

The diligence or oversights of print or online journalists, however, paled in comparison to the influence of broadcast journalism, especially CNBC. For years, CNBC acted as if conflicts of interest simply didn't exist. Analysts weren't questioned on their conflicts, fund managers weren't asked their positions in stocks they discussed. Yes, CNBC humorously pilloried flip-flopping analysts by comparing them to penguins. But no institution, in my opinion, did more to sell hyped-up stocks to poorly informed individual investors than CNBC during the late 1990s. By the way, there is undoubtedly a correlation between bullish hype and ratings. It always was in CNBC's interests to hype stocks because rising stocks meant greater viewership.

In sum, the media in general failed the investing public by failing to provide skeptical analysis about the stock market. After all, an investment bank's job is to sell. The media are supposed to scrutinize. If the financial media had been as critical of Wall Street as political reporters are of Congress, it's possible, though unlikely, that the bubble wouldn't have become as inflated as it did. Many skeptical journalists have much to be proud of for their work during the bubble era. But many should be ashamed of strapping on their pom-poms and simply cheerleading along with the salesmen.

III. The pressures analysts face.

This committee is better off hearing from analysts about the pressures analysts face. But I talk to analysts and their clients every day, and I can give you some insight. One prominent analyst I know once described his job as having to be willing to come into work each day and get clobbered repeatedly by a two-by-four. Who's delivering the punishment? By turns: Retail brokerage clients unhappy with a recommendation that didn't work out, companies bothered by unfavorable commentary, institutional brokerage clients displeased at not getting the early word, investment banking colleagues peeved that some report hurt a deal. And so on.

This isn't to make you feel sorry for analysts. It's just that one begins to understand how a profession so badly conflicted could try so hard to please so many and end up pleasing so few.

And it's important to point out here, again, who's complaining about rotten research and who isn't. The primary audience for Wall Street research is the institutional investors who are trading clients of the firm -- the ones who understand best what the research is worth. They aren't typically disappointed by the quality of the work, at least not enough to complain about it. If they are disappointed, they hire their own researchers to investigate companies. All the best investors conduct their own research and use the sell side to supplement their data and test their conclusions. Who's left? The individual, who typically is not paying for the research but is reacting to things he or she heard on television. Let me state that a different way: The people complaining loudest about the quality of Wall Street research generally are the people who aren't paying for it.

IV. Solutions.

This committee seems to be taking the approach that its best role is to use its bully pulpit to get the market's participants to clean up their act rather than to propose structural reform. As a columnist and observer of the capital markets, I support that approach. Analysts should be encouraged to disclose their conflicts of interest. Reporters should be urged to be critical. Investors should be admonished to do their homework before buying securities. Investment banks should be embarrassed at the way they have misled the general public.

But there are other, more radical, approaches Congress, together with the SEC, could take.

A. **Split investment banks from brokerages.** This step flies in the face of the last decade of financial services reforms intended to allow consolidation of the industry. But if the government feels that the public is being hurt by the system as it exists today, take apart the system. Brokerages that didn't have investment-banking arms no longer would be conflicted by investment-banking pressures. Investment banks could distribute research to whomever they liked, but it would be clearer whose interests they serve. Brokerages, of course, would find it difficult to make money under such a scenario. Conversely, perhaps all that's needed is a semantic shift. Perhaps if investment banks somehow were more honest about the fact that their research arms already lack independence then the charade would be over and everyone would be happier.

B. **Allow fixed-rate minimum commissions**. When Congress threatened the exchanges with price-fixing charges, it began the end to institutional investors paying for research. If trading isn't profitable, the brokerages will find other ways to make money. But if they could charge some clients more, those clients likely would be willing to pay for the privilege of receiving independent research. Research, after all, isn't public information the way the public filings of listed companies are. The way the system works today, however, brokerages don't try to make money on research, essentially because they are not allowed to.

C. **Require greater disclosure.** This process is underway, led by a series of best practices suggested by the Securities Industry Association. These are guaranteed to be little more than palliatives. It will help a paying client to know the conflicts of an author of a report, but only so much. Similarly, firms restricting stock ownership by analysts will have little impact. The big money is in investment banking, not trading for one's personal account. These are matters properly addressed by a firm's own compliance department, not Congress.

D. **Support Regulation FD.** The job of being a research analyst has become more difficult since Oct. 2000, when the SEC promulgated Regulation FD, for "fair disclosure." Because public companies must disclose all material information simultaneously, analysts with good social skills or financial muscle with senior management no longer have an edge. This is a good thing. In order to be effective, analysts must analyze again. An analyst recently wrote me an e-mail complaining that companies had to be allowed to supply him with a financial model. Otherwise, how could investors know what to expect? I reminded him that it is his job to build a model based on his research. Good modelers will make good money for their clients; bad ones will not. A dangerous move is afoot by the securities industry and some elements within the SEC to weaken FD. If Congress wants to do right by the individual investor and force analysts to analyze, it should throw its support behind Reg FD.

V. Conclusions.

Wall Street research during and after the stock-market bubble has become something of a joke. Analysts went from unknowns to superstars to goats in the span of five years. Fortunately, the market has a wonderful self-correcting mechanism. To restore its credibility, Wall Street is trying to promote the appearance of objectivity and independence in its research departments. Individual analysts are struggling to keep up in a Reg FD world and one where most of the participants now have the fabled decoder ring that lets them understand what analysts mean when they say buy, accumulate and hold, but rarely sell. As well, my sense is that the financial news media generally is embarrassed by its role and is correcting the situation by embracing its natural skepticism again.

For the time being, the investment-banking conflict will diminish because there is so little investment banking being committed. The key for this committee is to determine what regulatory oversight will be needed, if any, when the investment-banking machine cranks itself up again.