EXCHANGE

Subcommittee on Capital Markets

Richard H. Baker, Chairman

Securities, Insurance, Government-Sponsored Enterprises

The News from U.S. Rep. Richard H. Baker
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Opening Statement
The Honorable Richard H. Baker, Chairman
House Financial Services Committee Subcommittee on
Capital Markets, Insurance and Government Sponsored Enterprises
Hearing, July 31, 2001
"Analyzing the analysts II: Sources and ramifications of analyst conflicts of interest"

Like the Copernican revolution before it, Quantum physics has had its impact as much for its scientific discoveries as for how it transformed the way we perceive the world. When scientists found that the very act of perceiving a particle of light altered the outcome of experiments to discern the nature of light waves, it challenged traditional notions of the scientist as passive observer of events and further blurred the lines between reality and our perception of it. At that moment in history, it is said, the scientist emerged from behind the curtain to become an active participant in and as influential a factor as all others in the outcome of experiments.

Over the last few years we've witnessed a similar emergence of market analysts from behind the scenes and out of the traditional cloister that protected their painstaking objective research. Not surprisingly, the markets, as I imagine occurs with all speculative bubbles, entered a phase that conflated perception with reality, or as one analyst put it, "Stocks don't go up or down because they have a specific 'value.' They go up or down because investors decide to buy or sell." In the "quantum marketplace," reality – whether the price of a company's stock will go up or down – depended less on any inherent factors of "proper" value than on an analyst's saying it would.

During the same period we also witnessed an explosion in financial media coverage and its powerful impact on events. In fact, I would hazard that in no other area of journalism do reporters and commentators, like the scientist altering the experiment while conducting it, shape reality in the very act of reporting and commenting on it. In other words, while a journalist reporting on a possible plane crash has no effect on whether it actually will, the same cannot be said about a journalist reporting on the possibility of a company's stock doing the same. In today's marketplace, analysts and journalists are players, not passive observers.

While this new situation has resulted in positive increases in the amount of information accessible to investors, it has also brought new responsibilities and, we now know, new dangers. Perhaps not coincidentally, the new high profile union of financial analysts and journalists coincided with a breakdown in the traditional Chinese wall shielding analysts from the investment banking side of their firm's business. While the market went up and up, it was understandable that analysts were unanimously bullish on nearly every stock. Only when the market turned downward and the unanimous "buys" and "strong buys" remained did questions begin to arise about analysts' conflicts of interest and their ability to remain objective within the new market structure.

We have begun a process to understand the problem, and we will not cease until we have helped to find an adequate solution. In our first hearing on this matter in June we saw that conflict-of-interest problems exist and are pervasive. Second, the existing industry association best-practices proposal doesn't go far enough to address the problems, nor, I might add, do subsequent actions taken by individual firms. And third, while self-regulatory reform is preferred, future legislative or regulatory solutions may be required.

For the sake of insuring that the growing number of $200 investors receives the same care as the $200,000 investor, we are proceeding on the careful task of discovering the extent to which the Chinese wall has eroded and whether strong steps need to be taken to reconstruct it.

Ranking Member, Rep. Paul Kanjorski, D-Pa., and I have established a review board to provide the subcommittee "expert guidance" in examining industry association proposals for analyst standards and practices. Consisting of pertinent regulators, noted academics, market professionals and representatives of other organizations, the review board's members were asked to submit separate and independent written reports to the subcommittee by August 21st, with recommendations for sufficiently remedying the problem of biased and unclear investment research.

However, before this process moves toward receiving those proposed remedies, it's essential that we understand the full scope of the problem. This problem didn't begin with the analysts, and its harmful implications don't end with them, either.

Accordingly, while today's hearing will further explore the connection between investment-banking pressure in inflating stock recommendations and the impact on an individual's investments, I hope witnesses will also address additional sources and ramifications of analyst conflicts, including:

1. Pressures placed on analysts from institutional investors who may be highly staked in a particular stock;
2. Pressure from companies that may select an investment bank based on the prospect of rosy coverage from the firm's analysts; and
3. The responsibility of financial journalists, when citing an analyst who may have conflicts of interest, not only to discover but to fully disclose the potential conflicts, and the ramifications when they don't.

As events and public disputes last week indicated, the stakes are high here. By as early as next year this Congress may be asked to take up the controversial issue of Social Security reform. We have the prospect of addressing what is, in my view, one of the boldest policy initiatives in generations, to give every American, not just a select elite, the opportunity to participate in real wealth creation. This subcommittee has an obligation, therefore, to help erase the controversy by that time, and dispel all doubt in responding affirmatively to the question: "Are the markets ready for the challenge and responsibility?"

I thank all of our witnesses for appearing today and look forward to their testimony.

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