

Testimony Summary of Scott Cleland, CEO of the Precursor Group[®]
“Conflicts of Interest Are Eroding the Market’s Integrity and Internal Controls”
Before the Senate Commerce Committee, December 18, 2001

I am Scott Cleland, founder and CEO of the Precursor Group[®], an independent research broker-dealer, which provides investment research to institutional investors. We have aligned our business interests with investors’ interests – actual and perceived. We do no investment banking for companies; do not manage money or trade for proprietary gain; and our researchers may not trade individual stocks.

The U.S. capital markets system clearly failed thousands of Enron investors, pension holders, creditors, employees and customers. I believe it is clear that the **system will continue to fail investors, until the root cause – rampant conflicts of interest throughout the system – are brought under control.**

Hopefully Congress and regulators will hear the Enron collapse and the tech bubble bursting as **wake up calls, alerting us that the market’s system of internal controls have broken down and are no longer effective.** The system’s internal controls are supposed to warn investors, auditors and regulators of financial problems, before they get out of hand and become an Enron.

Congress and regulators should be very concerned, because the **brehtakingly swift collapse of Enron is no isolated incident** that can be dismissed as unique, brushed under the rug and ignored. The Enrons and dot.com collapses will happen again and again until the integrity of the system’s internal controls is restored.

As the Baby Boomers age, our nation increasingly will depend on market-vulnerable 401ks and company pension plans to supplement Social Security and adequately fund Americans’ retirement. **Now more than ever, we need the internal controls capital markets rely on – auditors, research analysts, and boards of directors – to function with integrity to ensure the protection of investors’ financial security.**

Recommendations:

- 1. Official policy should discourage conflicts of interest that can undermine critical internal controls.**
- 2. Prohibit auditors from consulting for companies they audit and from conducting independent audits of their own internal audits.**
- 3. Strengthen the overall objectivity of the investment research system so investors get more unbiased research and are more aware of conflicts of interest.**
- 4. Discourage analysts from owning a financial stake in companies they cover.**
- 5. Increase awareness and vigilance of the press to stock manipulation, especially as it applies to “pro-forma” accounting and “Street expectations.”**

**Written Testimony of
Scott C. Cleland
Chairman and CEO
The Precursor Group®**

**“Conflicts of Interest Are Eroding the Market’s Integrity
and the Market’s System of Internal Controls:
Enron Is Not Unique, But Part of a Growing Pattern
of Missed Warning Signs”**

**Before the Senate Committee on Commerce,
Science and Transportation
Subcommittee on Consumer Affairs, Foreign Commerce and Tourism**

Hearing on

**“Enron Corporation and the Methods it Used to Market
its Shares to Unsophisticated Investors and Company Employees”**

Tuesday, December 18, 2001

I. Introduction

Mr. Chairman, thank you for the honor of testifying before your Subcommittee and for the Subcommittee's interest in the perspective of an *independent investment research broker-dealer*.

My testimony includes:

- An explanation of the Precursor Group® perspective;
- Our assessment of why the system was surprised by Enron's demise; and
- Our recommendations help prevent future Enrons from happening again.

II. Precursor Group® Perspective

I am Scott Cleland, founder and CEO of the Precursor Group®, an independent research broker-dealer, which provides investment research to institutional investors. A year and a half ago, my partner, Bill Whyman, and I founded the Precursor Group® very intentionally as an *independent* firm in order to better serve our investor clients' interests and not to serve companies' interests or investment banking interests. **We see a real market opportunity for pure investment research uncompromised by company conflicts of interest.** We also have learned that the investment research marketplace is thirsting for trust; and our business is trying to quench a part of that thirst.

Our business is simple. We work for institutional investors; they pay us research commissions on their trading to the extent that we help improve their investment performance.

- If our research helps investors identify opportunities or avoid pitfalls, we get paid in trading commissions.
- If our research does not help investors, we do not get paid.
- We have a market-driven, merit-based business model.

We are unusual in that we are a pure research firm in a business dominated by integrated full-service brokerage firms that bundle investment banking, trading and research. **We are exclusively an investors' broker-dealer**, akin to a buyer's broker in real estate. We are not the traditional sellers' or company broker-dealer, which tries to represent *both* companies' and investors' interests.

We have done our best to align our financial interests with investors' interests. We are very serious about avoiding conflicts of interest, actual and *perceived*, so we:

- Do no investment banking for companies;
- Do not manage money or own a stake in any companies;
- Do not allow Precursor Group® researchers to trade individual stocks – as a condition of employment (which exceeds NASD rules); and
- Do not trade securities for proprietary gain.

- We get paid through agency trading commissions, which is the primary payment mechanism that institutional investors use to pay for investment research.
- Our contracted-out agency trading is not a conflict of interest because:
 - We do not act as an agent and never as a principal that has capital at risk – so our contracted-out agents execute stocks for others at their request, but we never actually own a stock of a company.
 - Our clients have complete freedom to choose which of our four contracted-out trading clearing firms they want to use.
 - Our institutional investor clients completely control whether and how we get paid with their shareholder or pension fund resources.
 - This arrangement eliminates any financial conflict.

We are a pure research firm because we do not believe one firm can well serve different masters at the same time: investors *and* companies. We strongly believe true independence yields better research.

III. **The Problem: Conflicts of Interest Erode the Integrity of Markets**

(a) **Systemic Conflicts of Interest**

The U.S. capital markets system is playing with fire – effectively ignoring rampant conflicts of interest – and investors are getting burned. The U.S. capital markets system clearly failed thousands of Enron investors, pension holders, creditors, employees and customers. I believe it is clear that the **system will continue to fail investors, until the root cause – rampant conflicts of interest throughout the system – are brought under control.**

Hopefully Congress and regulators will hear the Enron collapse and the tech bubble bursting as **wake up calls, alerting us that the market's system of internal controls have broken down and are no longer effective.** The system's internal controls are supposed to warn investors, auditors and regulators of financial problems, before they get out of hand and become an Enron.

Conflicts of interest abound where they should not:

- Companies routinely pay consulting fees to the audit companies that are supposed to keep the company honest.
- Auditors are increasingly doing the companies' inside audit work and the outside review of it – essentially grading their own papers or hearing their own appeal.
- Through the investment banking backdoor, companies effectively pay for most of the research departments, providing research on their company, of most all of the prominent brokerage firms that offer research to most Americans.
- It is common for analysts to have a financial interest in the companies they are expected to cover objectively.

- Credit agencies may have an indirect financial interest in the companies that they rate.
- Most payments for investment research is routinely commingled with more profitable and dominant banking and proprietary-trading commissions, effectively subordinating research for investors to the promotion of company interests.
- Analysts seeking investment banking are more susceptible to company pressure to emphasize the company's preferred pro-forma financial reporting.
- And companies routinely "beat the expectations" of a consensus of research analysts that seek their banking business.

Systemic conflicts of interest are more pervasive and corrosive than either Congress, regulators, investors or the press appreciate. Conflicts of interest are eroding the integrity and resilience of our capital markets, because they **undermine the objectivity, integrity and accountability of the "watch dogs" and the early warning systems that markets depend on** to prevent Enron-type situations from escalating to disasters.

Congress and regulators should be very concerned because the **breathhtakingly swift collapse of Enron is no isolated incident** that can be dismissed as unique, brushed under the rug and ignored. During the last two years, the bursting of the dot.com and tech bubble produced dozens of mini-Enron shareholder disasters (such as Excite@Home this past month) that cost investors hundreds of billions of dollars, while the capital markets routinely either ignored or missed the signals of their demise. Unless the integrity of the financial checks and balances in the system are restored, the Enrons and dot.com collapses will happen again and again.

Millions of trusting American investors have lost big in the markets in recent years in part because the system has become so conflict-ridden that the **system no longer effectively serves investor interests but primarily serves company interests**. It appears that the oversight mood has now shifted to an "investor beware" attitude from an "investor protection" attitude. An investor protection system keeps investors adequately informed; identifies problems early; protects investors from misrepresentation and fraud; and ensures fairness in information dissemination.

As the Baby Boomers age, our Nation increasingly will depend on market-vulnerable 401ks and company pension plans to supplement Social Security and adequately fund Americans' retirement. Now more than ever, we need the internal controls capital markets rely on – auditors, research analysts, and boards of directors – to function with integrity to ensure the protection of investors' financial security.

(b) A Pattern of Conflicts

The system failed investors at multiple levels because conflicts of interest have spread like a disease throughout the system of checks and balances, and undermined independent voices and public watchdogs.

- **Auditors:** The integrity and functioning of the entire capital markets system depends on investors trusting publicly reported numbers. However, auditors now routinely work as consultants to the companies they are supposed to be objectively auditing for investors. This is analogous to expecting a judge to always be fair when judging someone who directly pays half of his or her salary.
- **Investment Banks' Research Analysts:** Research analysts of all types are supposed to be objective, have an expert understanding of the companies and identify material problems early. However, it is now the norm that equity and debt analysts' pay comes primarily from companies, not investors, through investment banking and proprietary trading. About 95% of the firms in the Wall Street Journal's "Best of the Street" research rankings have investment banking conflicts of interest. Conflicts of interest are pervasive on the Street. (See attached survey.) Analysts also routinely have another conflict in that they often have financial stakes in the companies they are covering. (This is analogous to the prohibited practice of an athlete betting on the outcome of the game they are playing in.)
- **Role of the Press:** The press exacerbates the corrosive effect of rampant conflicts of interest by tacitly and unwittingly condoning them. The press routinely headlines "pro-forma" or "spin" numbers that can't be relatively compared to anything else, rather than headlining Generally Accepted Accounting Principles or GAAP results that are readily compared to every other investment. In essence, regulators and the press are allowing companies to define their own success, and run from an accountable benchmark.

Further, the press routinely plays along with the Street's "expectations game," where the spin ignores actual performance and redirects focus to how the company still exceeded the "consensus expectations" of like-minded company cheerleaders. **The expectations game tends to decouple a company's stock performance from its actual financial performance.**

Ask the average American if it is wise to:

- Tempt auditors' objectivity by letting auditors moonlight for those they audit;
- Have companies pay for most of the investment research done on them; and
- Enable publicly-traded companies to make up their own accounting and decide what liabilities they have to disclose to investors.

Common sense suggests that conflicts of interest breed trouble. Other systems that depend on the public trust discourage conflicts of interest more strongly as the first line of defense against serious problems. Government policymakers must avoid conflicts of interest and our judicial system has very strict conflict of interest rules. The most obvious way to prevent more Americans from being financially devastated by Enron-like fiascos is to strengthen and improve the integrity of the early warning signals and the structural checks and balances in the system. Just like an ounce of prevention is worth a pound of cure, unsanitary conditions breed disease.

IV. Recommendations: Emphasize Trust – Discourage Conflicts of Interest

I believe that the focus of Congressional and regulatory oversight should be on how to improve the current system and prevent more Enrons from happening in the future. I recommend some common sense changes that can strengthen the integrity and functioning of U.S. capital markets, and protect the financial retirement security of all investing Americans.

(a) **Officially discourage conflicts of interest.**

Wherever possible, policies should encourage alignment of financial service provider interests with investor interests, or at a minimum, make it much more transparent when a person or an entity is not working primarily for investor interests. Investors must be better informed of the extent of the conflicts of interest. The Senate could pass a Sense of the Senate Resolution reaffirming the importance of protecting the integrity of capital markets by discouraging financial conflicts whenever possible.

I don't believe it is wise, necessary or practical to prohibit *all* conflicts of interest, but it sure is necessary to make it U.S. policy to discourage financial conflicts of interest and not create economic incentives that reward these conflicts through laws, regulations, structure or oversight processes.

Self-regulatory organizations can be effective, if combined with the strong discouragement of conflicts of interest in order to build checks and balances that can actually work as designed. Self-regulation combined with condoned conflicts of interest equals a recipe for more Enrons.

(b) **Prohibit auditors from consulting for companies they audit and from conducting independent audits of their own internal audits.**

Even better, encourage auditors to be only auditors. The public trust in the accuracy of public financial reporting is so critical it is not even worth the *perception* of a conflict of interest. Judges and U.S. government employees cannot moonlight for those that they have a public trust to police. Would it be a good idea for IRS divisions to do paid tax consulting for the companies they audit on the side? Mixing auditing and consulting is such a blatantly bad idea, it is amazing that it is officially tolerated. Moreover, auditors are increasingly conducting the outsourced internal audit function of the company, essentially acting as contract employees while also being responsible to investors for the outside audit to assure investors that all is well financially. The government is allowing organizations to essentially grade their own papers or handle their own appeals. There are probably **no more corrosive and counter-productive conflicts of interest** in the U.S. capital markets than these. The system is just asking for more Enrons to happen, because it appears that it is no longer in some auditor's primary interest to protect investors from fraud and misrepresentation.

(c) **Strengthen the overall objectivity of the investment research system.**

Discourage the bundling of banking, trading and research. The commingled nature of commissions without transparent and official separate accounting among trading, research and banking services has the practical effect of rewarding conflicts of interest and discouraging research objectivity. Investment funds go to great lengths, including third party evaluations and industry self-regulation, to get best trading execution for investors. Yet, there is surprisingly little systematic effort to get **“best research execution” for investors.** This could be encouraged through disclosure of what percent of trading commissions are spent on conflicted vs. non-conflicted research.

(d) **Discourage analysts owning a financial stake in companies they cover.**

Industry standards should be fostered and enforced so that analysts that present themselves to the investing public as **“objective research analysts”** should not have a financial interest in the company they are covering. Many in the industry condone the practice of analysts having “skin in the game” so they think like investors themselves. This is analogous to saying it is a good idea to condone athletes betting on the outcome of the games they play in. The extent to which analyst compensation is linked to investment banking should also be examined.

(e) **Increase awareness and vigilance of the press to stock manipulation.**

When the press headlines or gives prominence in a story to a company’s “pro-forma” financial results, the press tacitly lends credibility to a serious conflict of interest, because **public companies should not be making up their own accounting results or creating a public perception of their financial performance** that can’t be compared or checked objectively. The whole rationale behind GAAP is to create a transparent market, instilling investor confidence that reported earnings are actually earnings. Pro-forma reporting at its best is “spin” or partial truth; at its worst, it is misrepresentation. Pro-forma reporting has become more commonplace because the press has so frequently played along.

The press also perpetuates and lends credibility to conflicts of interest by being “spun” and playing along with the companies and the “Street” in the quarterly “expectations game.” The companies and their potential investment banking firms have an interest in the stock going up regardless of whether the financial performance warrants it. The quarterly “expectations game” is one of the subtlest manifestations of conflicts of interest. By headlining or leading a financial story with how a company “beat expectations,” the press lends objective credibility to the company sell-side cheerleading corps that has a strong financial interest in the stock going up. The press can limit the impact of this conflict of interest through an editorial policy of reporting “expectations” after actual earnings results are reported or by putting sell-side expectations in context with the consensus expectations of independent analysts.

V. Conclusion

To avert future Enron-type disasters and protect public confidence in the integrity and resilience of U.S. capital markets, Congress and regulators need a policy to reemphasize integrity and trust in U.S. capital markets. Congress can take a big step in that direction by officially discouraging conflicts of interest within the system of watchdog groups, auditors, analysts, and independent board members, which the system depends on to protect investors. Conflicts of interest are becoming so common and pervasive that they are becoming the norm not the exception. Sadly, this could mean that investor disasters like Enron could increasingly become the norm as well.

Thank you again Mr. Chairman for the honor and opportunity to testify on this important matter.

Attachments

Precursor Group[®] Survey Shows Conflicted Investment Research is Systemic and Pervasive, July 30, 2001

Precursor Group[®] White Paper: What Ails Investment Research? May 2001

For Immediate Release
July 30, 2001

Contact: Joy Howell (202) 828-7838
Cambridge Strategic Partners

Precursor Group[®] Survey Shows Conflicted Investment Research is Systemic and Pervasive

Washington, D.C. — A new survey by The Precursor Group, a Washington-based independent investment research firm, shows that almost all of the top investment research firms in the country have multiple structural conflicts of interest that undermine research credibility and investor confidence. In recent weeks, two top firms, have announced new policies that restrict their analysts from owning stock in the companies they cover. While analyst ownership of companies they cover is the most obvious conflict, the deeper, more important conflicts are investment banking and proprietary trading, according to Precursor.

“The problem of conflicted investment research is more systemic and pervasive than most investors appreciate,” said Scott Cleland, chief executive officer of Precursor, an independent research firm based in Washington. “Almost all of the top investment research firms have structural financial conflicts of interest that undermine research objectivity. At least 95% of *The Wall Street Journal’s* top 2001 stock picking firms and 100% of *Institutional Investor* magazine’s 2000 All-America Research firms have multiple conflicts of interest.”

Survey of Research Conflicts:

Precursor’s survey (attached) of top investment research firms shows that almost all have *structural financial conflicts of interest* that create actual and perceived research conflicts and undermine research objectivity: either through investment banking representation of companies or through direct ownership of a company through proprietary trading and money management.

- Ninety-five percent of the 82 firms ranked by *The Wall Street Journal* (June 26, 2001) as the “Best Stock Pickers on the Street” have line of business research conflicts: investment banking, proprietary trading and money management (<http://interactive.wsj.com/public/resources/documents/best2001-firms.htm>).
- And 100% of *Institutional Investor’s* 2000 top investment research firms have line of business research conflicts: investment banking, proprietary trading and money management (<http://www.iimagazine.com/activecontent/report.asp?rt=leaders&teamid=1&iyear=2000>).
- The survey builds upon the two of the most-widely respected and followed rankings of investment research quality. Each of these well-respected business publications publishes their rankings of investment research firms every year. Additional details can be obtained at the source/website address for each firm included in the survey results.

Precursor conducted the survey after Cleland testified before the House Subcommittee on Capital Markets. The Congressional Subcommittee’s interest in part was prompted by the deterioration in the capital markets over the last year. Many people questioned how U.S.

companies could plummet without more warning from investment research analysts who are charged with watching market trends and making investment decisions for their clients.

“How could American shareholders and pension plan beneficiaries lose four trillion dollars in the NASDAQ when only 1% of analysts’ recommendations were ‘sell’?” Cleland asked. “One seldom-heard explanation is that the *entire brokerage system is structurally skewed* to put company interests before investor interests.”

In addition, Cleland pointed out that almost all of the largest and best known brokerage firms that most Americans rely on for their investment research have structural business conflicts of interest which discourage the production of research that could have a negative investment outlook for a company.

“More specifically, if a brokerage firm is either in the investment banking business or owns stocks through proprietary trading or money management, that firm has a financial interest in companies’ stocks going up, not down,” Cleland added.

Precursor conceived of the survey to measure conflicts of interest among investment research firms when it became obvious that conflicted research was more pervasive throughout the industry than most people realize.

“The real issue here is that the conflicted research problem is systemic,” Cleland said. “The primary and most profitable purpose of the brokerage industry is to raise capital and provide liquidity for companies. So the structure, economics, compensation, and regulation of the industry reinforce and perpetuate the purpose of selling companies to investors. In a bull market there may be better alignment of interests between companies and investors; in a bear market there is often a stark divergence of financial interests between companies and investors,” he concluded.

The Precursor Group[®] is an employee-owned and -controlled, independent research Broker-Dealer, which does no investment banking, money management, proprietary trading or stock picking. Precursor research[®] analysts, as a condition of employment, may not trade individual stocks; independent third parties must manage any Precursor analyst’s personal portfolio. Precursor products and services are designed for use by institutional investors and are also used by senior decision-makers from government, industry and other professional organizations.

The Precursor Group[®] is a Broker-Dealer registered with the Securities and Exchange Commission (SEC) and is a member of the National Association of Securities Dealers (NASD) and the Securities Investor Protection Corporation (SIPC). "Precursor Group," "Precursor Research," "Precursor Watch," "Investment Precursors," and "Helping Investors Anticipate Change" are registered trademarks.

###

**The Wall Street Journal's
 "Best on the Street" Stock Pickers
 "95% of These Top 82 Firms Have Research Conflicts"**

<i>Wall Street Journal Ranking June 26, 2001</i>	<i>Investment Banking</i>	<i>Proprietary Trading</i>	<i>Money Management</i>	<i>Source</i>
1. Salomon Smith Barney	X	X	X	www.salomonsmithbarney.com
2. Merrill Lynch	X	X	X	www.ml.com
3. Morgan Stanley	X	X	X	www.morganstanley.com
4. Lehman Brothers	X	X	X	www.lehman.com
5. Goldman Sachs	X	X	X	www.gs.com
6. A.G. Edwards	X	X	X	www.agedwards.com
7. Credit Suisse First Boston	X	X	X	www.csfb.com
8. J.P. Morgan Chase	X	X	X	www.jpmorgan.com
9. Bear Stearns	X	X	X	www.bearstearns.com
10. Banc Of America Sec's	X	X	X	www.bofasecurities.com
11. UBS Warburg	X	X	X	www.ubswarburg.com
12. Deutsche Banc Alex Brown	X	X	X	www.deutsche-bank.com
13. William Blair	X	X	X	www.wmblair.com
14. McDonald Investments	X	X	X	www.key.com
15. SG Cowen Securities	X	X	X	www.sgcowen.com
16. Prudential Securities	NO	X	X	www.prudential.com
17. ING Barings	X	X	X	www.ingbarings.com
18. First Union Securities	X	X	X	www.firstunionsec.com
19. CIBC World Markets	X	X	X	www.cibcwm.com
20. ABN Amro	X	X	X	www.abnamro.com
21. Robertson Stephens & Co	X	X	X	www.robertsonstephens.com
22. Needham & Co	X	X	X	www.needhamco.com
23. Dain Rauscher Wessels	X	X	X	www.dainrauscherwessels.com
24. Raymond James	X	X	X	www.raymondjames.com
25. BMO Nesbitt Burns	X	X	X	www.bmonesbittburns.com
26. Wit SoundView	X	X	X	www.witcapital.com
27. Wasserstein Perella	X	X	X	www.wassersteinperella.com
28. Morgan Keegan	X	X	X	www.morgankeegan.com
29. SunTrust Equitable Sec's	X	X	X	www.suntrust.com
30. Keefe, Bruyette & Woods	X	X	X	www.kbw.com
31. Ferris, Baker Watts	X	X	X	www.fbw.com
32. Buckingham Research	NO	X	X	New York ph# 212.922.5500
33. Tucker Anthony	X	X	X	www.tucker-anthony.com
34. Robinson-Humphrey	X	X	X	www.robinsonhumphrey.com
35. Barrington Research	X	X	X	www.brai.com
36. D.A. Davidson	X	X	X	www.dadco.com
37. Stifel Nicolaus	X	X	X	www.stifel.com
38. Fahnestock	X	X	X	www.fahnestock.com
39. Midwest Research	NO	X	NO	Sarah O'Connor-Compliance
40. First Analysis	X	X	X	www.firstanalysis.com
41. Thomas Weisel Partners	X	X	X	www.tweisel.com

<i>Wall Street Journal Ranking June 26, 2001</i>	<i>Investment Banking</i>	<i>Proprietary Trading</i>	<i>Money Management</i>	<i>Source</i>
42. Janney Montgomery Scott	X	X	X	www.janneys.com
43. First Albany	X	X	X	www.fac.com
44. Adams, Harkness & Hill	X	X	X	www.ahh.com
45. Jefferies	X	X	X	www.jefco.com
46. Ryan Beck	X	X	X	www.rbeck.com
47. U.S. Bancorp Piper Jaffray	X	X	X	www.piperjaffray.com
48. Sidoti	NO	NO	X	John Zolidis-Sidoti
49. BB&T Capital Markets	X	X	X	www.bbandt.com
50. Pacific Growth Equities	X	X	X	www.pacgrow.com
51. Hibernia Southcoast Capital	X	X	X	www.hibernia.com
52. Argus Research	NO	NO	NO	www.argusresearch.com
53. Davenport & Co, LLC	X	X	X	www.davenportllc.com
54. Friedman,Billings,Ramsey	X	X	X	www.fbr.com
55. H.C. Wainwright	X	X	X	www.hcwainwright.com
56. Gerard Klauer Mattison	X	X	X	www.gkm.com
57. Robert W. Baird	X	X	X	www.rwbaird.com
58. Legg Mason	X	X	X	www.leggmasoncapgmt.com
59. Brean Murray	X	X	X	www.bmur.com
60. Griffiths McBurney	X	X	X	www.gmponline.com
61. Hoak Breedlove Wesneski	X	X	X	www.hbwco.com
62. LJR Great Lakes Review	NO	NO	NO	www.ljr.com
63. RBC Dominion Securities	X	X	X	www.rbcds.com
64. Gruntal	X	X	X	www.gruntal.com
65. Lazard Asset Mgmt	X	X	X	www.lazardnet.com
66. Wedbush Morgan Sec's	X	X	X	www.wedbush.com
67. Credit Lyonnais	X	X	X	www.creditlyonnais.com
68. Hilliard Lyons	X	X	X	www.hilliard.com
69. Advest Group	X	X	X	www.advest.com
70. Sandler O'Neill	X	X	X	www.sandleroneill.com
71. Stephens Capital Mgmt	X	X	X	www.stephens.com
72. Fox-Pitt, Kelton	X	X	X	www.foxpitt.com
73. Miller Johnson	X	X	X	www.stockwalk.com
74. Josephthal	X	X	X	www.josephthal.com
75. Simmons	X	X	X	www.simmonsco-intl.com
76. WR Hambrecht	X	X	X	www.wrhambrecht.com
77. Frost Securities	X	X	X	www.frostsecurities.com
78. Johnson Rice	X	X	X	New Orleans 504.525.3767
79. Kaufman Brothers	X	X	X	www.kbro.com
80. Wells Fargo Van Kasper	X	X	X	www.fsvk.com
81. Pacific Crest Securities	X	X	X	www.pacific-crest.com
82. Southwest Securities	X	X	X	www.swst.com
Totals	76/82=93%	79/82=96%	79/82=96%	

Institutional Investor Magazine's
"2000 All-America Research Team"
100% of These Top 16 Firms Have Research Conflicts

<i>Institutional Investor Magazine Ranking</i>	<i>Investment Banking</i>	<i>Proprietary Trading</i>	<i>Money Management</i>	<i>Source</i>
1) Merrill Lynch	X	X	X	www.ml.com
2) Morgan Stanley	X	X	X	www.morganstanley.com
3) Salomon Smith Barney	X	X	X	www.salomonsmithbarney.com
4) Credit Suisse First Boston	X	X	X	www.csfb.com
5) Donaldson Lufkin Jenrette	X	X	X	www.dlj.com
6) Goldman Sachs & Co	X	X	X	www.gs.com
7) Bear Stearns & Co	X	X	X	www.bearstearns.com
8) Lehman Brothers	X	X	X	www.lehman.com
9) PaineWebber	X	X	X	www.painewebber.com
10) J.P. Morgan Securities	X	X	X	www.jpmorgan.com
11) Prudential Securities	NO	X	X	www.prudential.com
12) Sanford C. Bernstein & Co	NO	X	X	www.bernstein.com
13) Banc of America Securities	X	X	X	www.bofasecurities.com
14) Deutsche Banc Alex. Brown	X	X	X	www.deutsche-bank.com
15) ISI Group	NO	NO	X	www.morningstar.com
16) Robertson Stephens	X	X	X	www.robertsonstephens.com
Totals	13/16=81%	15/16=94%	16/16=100%	

Source: The Precursor Group
July 26, 2001

What Ails Investment Research? The Precursor Group® May 2001

Introduction

Why is there so much market volatility? Why are investors so often surprised by companies? In large part because the “sell-side” investment research system is so biased toward the company view. The Wall Street firms that produce most “investment research” are rife with potential financial conflicts of interest. There is precious little quality, independent investment research that serves as a source of new ideas or as a check and balance on the “Street/Company” spin.

What Ails Investment Research?

Bundled Services: Most investment research is not sold separately, but as part of a bundle of services including access to investment banking and trading liquidity. As part of a financial bundle, research functions largely as advertising for other more profitable lines of business — banking and proprietary trading. Without separate pricing, low quality research is concealed in the bundle of services. Consequently, there is little accountability or measure of research value in the marketplace, and little incentive to improve the quality and objectivity of research. This suggests the current research system simply does not value research much.

Conflicts of Interest: Investment research is compromised by financial dependence on other lines of business with very different masters than investors. Investment banking and proprietary trading heavily subsidize Wall Street research, creating both real and perceived financial conflicts of interest. Since a research analyst’s compensation is often largely driven by investment banking deals, there exists a stark conflict between the analyst’s responsibility to investors and responsibility to the firm’s corporate finance clients. The evidence of this conflict of interest is powerful: according to First Call, of the 28,000 U.S. stock recommendations, only ~1% are “sells.” This suggests it is not in the interest of most investment research to warn investors in advance of problems.

Expedient to Depend on Company Information: Companies are the easiest source of information, and are also highly sophisticated in managing their investment “story” through investor-public relations and lobbying firms. Because original research is difficult, time-consuming, costly and risky, it is simply easier to adopt the company’s worldview and version of the facts. Securities & Exchange Commission (SEC) fair disclosure regulations also give companies wide latitude to manage information flow tightly — as long as they are equally stingy to all parties. This suggests the investment research system implicitly re-enforces the incorrect assumption that companies know all, see all and share all.

Rehash Rather than Research: Since an underlying purpose of most investment research is to sell companies to investors, Wall Street markets the positive and does not fully research the negative. The large conflict between company and investor interests tends to produce a superficial rehash of public company information or benign commentary on industry developments. The result is a Wall Street system focusing more on “re” than “search” — more backward-looking reporting and reformatting, and not much forward-looking searching for what is new and original in the market, the core value of research to investors. This suggests most investment research has become an echo chamber for the company line.

Conclusion

Former SEC Chairman, Arthur Levitt calls the problem with investment research a “web of dysfunctional relationships.” The result of a dysfunctional research system is biased and poor investment research. This increases market volatility and surprises that blindside investors, skews the market toward investment banking at the expense of investor interests, and doesn’t fully help investors anticipate change, capture opportunities and avoid risk.

Quotes from the Industry & Academics

What Ails Investment Research?

The Precursor Group® May 2001

Bundled Services

“Research analysts have become integral members of the investment banking units....[t]heir compensation is tied importantly to the fee revenue that they generate for the investment-banking unit.”

Samuel Hayes, professor emeritus at Harvard Business School, June 20, 2000, Wall Street Journal

“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.” Stefan D. Abrams, Chief Investment Officer for Asset Allocation, Trust Company of the West, December 31, 2000, New York Times

“[Y]ou can’t get paid for research anymore, because the commissions have been whittled down; you have to look elsewhere for money....Today, it’s investment banking – looking for deals to do.”

Chuck Hill, Research Director, First Call Thompson Financial, August 14, 2000, Interactive Week

Conflicts of Interest

“I see... a web of dysfunctional relationships – where...the analyst attempts to walk the tightrope of fairly assessing a company’s performance without upsetting his firm’s investment banking relationships.”

Arthur Levitt, Former SEC Chairman, April 6, 2000, Remarks at the Economic Club of Washington

“Analysts must bring in deals, and there is an inherent conflict of interest....Quality becomes a function of the deal calendar. It’s only natural that the credibility of sell-side research falls as banking steps up.”

Andrew Barth, U.S. Research Director, Capital Guardian Trust Co., October 1, 2000, Institutional Investor

“[A]nalysts affiliated with the lead underwriter of an offering tend to issue more optimistic growth forecasts than unaffiliated analysts....[T]he magnitude of the affiliated analysts’ growth forecasts is positively related to fee basis paid to lead underwriters.” Patricia Dechow & Richard Sloan, University of Michigan; and Amy Hutton, Harvard Business School, June 1999, Research Paper: “The Relation Between Analysts’ Forecasts of Long-Term Earnings Growth and Stock Performance Following Equity Offerings.”

“[T]he way an analyst can get fired is to damage an existing investment banking relationship with a company or sour a future investment banking relationship.”

Mitch Zacks, Vice President of Zacks Investment Research, December 31, 2000, New York Times

Expedient to Depend on Company Information

“They (analysts) get spoon-fed the information by investor relations officers and they have a very strong tendency to put a positive swing or twist on everything....And like sheep they follow.”

Hugh Johnson, Chief Investment Officer, First Albany Corporation, September 24, 2000, Reuters

With the SEC Fair Disclosure regulations, “nobody’s going to have the inside dope. Analysts now will distinguish themselves more on scholarship and analytical ability rather than connections and relationships.” Ted Pincus, CEO, Financial Relations Board, October 1, 2000, Institutional Investor

Rehash Rather Than Research

“[W]e find there’s a lack of initiative; they rarely really aggressively question what the company is telling them. What we get instead of research is reporting.”

Gary Langbaum, Fund Manager, Kemper Total Return Fund, December 11, 1997, Wall Street Journal

“Our findings....[suggest] that analysts mostly react to changes in market values rather than cause them.” Eli Amir, Tel Aviv University; Baruch Lev, New York University and Theodore Sougiannis, University of Illinois, September 2000, Research Paper: “What Value Analysts?”

References
What Ails Investment Research?
The Precursor Group® May 2001

Periodicals

- Editorial Comment. "Shoot All The Analysts." Financial Times, March 19, 2001. www.ft.com
- Fuerbringer, Jonathan. "When Being Wrong Won't Hurt: Economists' Ideas Are Valued More Than Their Forecasts." New York Times, October 15, 1999. www.nytimes.com
- Guglielmo, Connie, Cantwell, Rebecca, and Mulqueen, John. "Special Report: Analyze This." Interactive Week, August 14, 2000. www.zdnet.com
- Hill, Miriam. "Even Research Comes With Spin." The Philadelphia Inquirer, August 1, 2000. www.phillynews.com
- Kawamoto, Dawn, and Kanellos, Michael. "Stock Analysts Roll With The Punches." CNET News, January 18, 2000. www.cnet.com
- Levitt, Arthur. Remarks at the Economic Club of Washington, April 6, 2000. www.sec.gov
- Maremont, Mark. "As Wall Street Seeks Pre-IPO Investments, Conflicts May Arise." Wall Street Journal, July 24, 2000. www.wsj.com
- McGee, Suzanne. "After Oracle Misfire, Wall Street's Research Is Blasted." Wall Street Journal, December 11, 1997. www.wsj.com
- Morgenson, Gretchen. "How Did So Many Get It So Wrong?" New York Times, December 31, 2000. www.nytimes.com
- Pulliam, Susan. "Goldman Raises Eyebrows With E-Commerce List." Wall Street Journal, June 20, 2000. www.wsj.com
- Roberts, Kristin. "Wall Street Analysts Miss The Ball." Reuters, September 24, 2000. www.reuters.com
- Rynecki, David. "The Price Of Being Right." Fortune, February 5, 2001. www.fortune.com
- Sargent, Carolyn and Kenney, Jane. "The 2000 All-American Research Team." Institutional Investor, October 1, 2000. www.iimagazine.com
- Vickers, Marcia. "The Fall of the Net Analyst." Business Week, December 11, 2000. www.businessweek.com

Academic Research

- Amir, Eli (Tel Aviv University), Lev, Baruch (New York University), and Sougiannis, Theodore (University of Illinois). Research Paper: "What Value Analysts?" September 2000.
- Dechow, Patricia, Sloan, Richard (University of Michigan), and Hutton, Amy (Harvard Business School). Research Paper: "The Relation Between Analysts' Forecasts Of Long-Term Earnings Growth and Stock Performance Following Equity Offerings." June 1999.
- Michaely, Roni (Cornell University & Tel-Aviv University), and Kent Womack (Dartmouth College). Research Paper: "Conflict of Interest and the Credibility of Underwriter Analyst Recommendations." February 1999.