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THE WATCHDOGS DIDN'T BARK: ENRON AND THE WALL STREET ANALYSTS

HEARING

BEFORE THE

COMMITTEE ON
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

FEBRUARY 27, 2002

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THE WATCHDOGS DIDN'T BARK: ENRON AND THE WALL STREET ANALYSTS

WEDNESDAY, FEBRUARY 27, 2002

U.S. SENATE,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The Committee met, pursuant to notice, at 9:33 a.m., in room SD–342, Dirksen Senate Office Building, Hon. Joseph I. Lieberman, Chairman of the Committee, presiding.

Present: Senators Lieberman, Levin, Torricelli, Thompson, Voinovich, Collins, Bunning, and Bennett.

OPENING STATEMENT OF CHAIRMAN LIEBERMAN

Chairman LIEBERMAN. This hearing will come to order. I thank you all for being here.

This hearing, which is called "The Watchdogs Didn't Bark: Enron and the Wall Street Analysts," is the third in a series of hearings that our Committee is holding on the largest bankruptcy in American history. It is part of our ongoing attempt to assess the damage, learn the lessons, and help craft the solutions to the problems that led to the fall of Enron and its many connected catastrophes.

Future hearings of the full Committee and our Permanent Subcommittee on Investigations will look at the role of other watchdogs, including Federal agencies, auditors, and the board of directors.

Today, we focus on the private analysts whose warnings could have, and many say should have, alerted investors to the fiscal fissures in Enron's foundation before everything crumbled, but who instead continued to urge investors to buy Enron stock even after the company began to crumble.

Why were the analysts blinded to the company's deceit and disintegration? And how can we prevent similar failures in the future?

Those are the crucial questions we are going to ask today, and they are crucial because the Enron earthquake has left millions of Americans worrying that their stocks are standing on shaky ground. According to a recent *Business Week/Ipsos-Reid* poll, 68 percent of investors said they have little or no faith that the stock market treats average investors fairly, and 54 percent of investors said they are concerned about the honesty and reliability of the investment information they receive. According to *Business Week,* "The worry is that thousands of companies have consistently and legally overstated earnings for the past few years." In other words, even when the Enron smoke clears, people are worried that there may be more accounting smoke and mirrors lurking. And this is

consequential. It is serious not only for those investors but for our economy.

The average investor today I am afraid feels like a swimmer who has seen a shark. He or she doesn't know how many more sharks are in the water and whether there are any lifeguards on duty who are doing their job.

Making sure those lifeguards are on the lookout is part of our purpose here, and it is a very important purpose because this is more than a crisis for a small slice of America's economy. It really hits at the heart of our recent prosperity.

Spreading 401(k) accounts and a rising market—or rising markets, really, have spurred a seismic shift in stock participation over the last 2 decades. From 1930 to 1980, the number of Americans investing in the markets hovered between 5 and 15 percent. By 1998, that had jumped to more than 50 percent.

It is these middle-class Americans, the new investor class, who are most shaken today. When equipped with trustworthy, up-to-date, and independent information on a company and its competitors, investors, whether professional or amateur, can choose stocks wisely. But without sound information or, even worse, with misleading information, they may as well go gambling.

Average investors I think don't expect Wall Street analysts to guarantee that they are going to get rich. But they do expect them and others to filter out the vast and potentially confusing flow of information about companies and markets to dissect and decipher the financials of companies, especially those with hard-to-understand business models, in a way that is meaningful not only to Wall Street insiders but to investors on Main Street.

Information, after all, is one of the most precious cargos in America's economy, and Wall Street analysts are expected to transport it with maximum care.

This, I think, is the unwritten agreement that has drawn middle-class investors into the market, and it is what they rely on as they enter the markets. They know that there is risk there, that not every stock they invest in will always make money. But they rely on the watchdogs, both private and public, to keep the stock markets fair and to give them accurate information to help them decide where to put their money and with it their hopes for economic advancement and retirement security.

The question we ask today is: Have the Wall Street analysts kept their part of the bargain? And I regret to say that, based on the investigation our Committee has done, my answer is no, they have not. Ten out of 15 analysts who follow Enron were still rating the stock as a "buy" or a "strong buy" as late as November 8. This chart [1]—the dark green being "strong buy," light green "buy," yellow "hold," and red "strong sell," pink "sell"—shows you that as of November 8, 10 of the 15 companies and analysts listed there were still recommending that Enron was a good buy. And that was 3 weeks after the initial report of the company's hidden losses appeared in the *Wall Street Journal* and about 2 weeks after the SEC announced an investigation of Enron, and literally months after the

[1] Chart entitled "Enron Stock Recommendations by Broker," referred to by Senator Lieberman appears in the Appendix on page 127.

challenging and provocative article by Bethany McLean that we have all learned so much about, and months after at least one independent analyst, who I will refer to in a moment, began to ring alarms about Enron.

Enron's ad campaign, or one of them, as some may remember, was: "Ask Why." It now seems clear that too many analysts failed to ask why before they said buy, and often when they did ask why but didn't get a straight answer from Enron's executives, they went right on touting the stock.

At least one analyst did no better. On May 6, 2001, the Off Wall Street Consulting Group issued a report calling Enron stock "extremely overvalued" and pointing out many of the problems that would later be revealed in full when the company collapsed. That was May 6 of last year. Among other things, the report questioned the fact that the company appeared to be using accounting tricks to pump up its revenue.

Regrettably, the analysts' performance with Enron that I have referred to is indicative of a broader problem. Let me quote David Becker, general counsel of the SEC, who said last August, "Let's be plain. Broker-dealers employ analysts because they help sell securities. There is nothing nefarious or dishonorable in that, but no one should be under any illusion that brokers employ analysts simply as a public service."

Well, I am afraid that a lot of average investors in the country are under that illusion, and Mr. Becker's statement is jarring news to them who have considered "strong buy" or "buy" or "hold" and "sell" recommendations to be honest investment advice.

I must say, in our Committee's investigation, one of the most stunning facts that has come to my attention is that, no matter what the market does, analysts seem to just keep saying "buy." According to Thomson Financial, two-thirds of all analysts' recommendations are "buy" and only 1 percent are "sell."

If you take a look at this chart,[1] this is over the last 2 years, and the dotted line is the S&P 500, which, we can see beginning at January 3, 2000, was up and down, down on February 3, 2002. This straight line is giving a numerical value to "strong sell," "sell," "hold," "buy," and "strong buy" of analysts' recommendations, coming out with an average, and it is really quite remarkable that the line remains almost exactly straight at a "buy" recommendation no matter what happens to the market, even as it went down.

Today we want to ask the analysts: How could that be? Of course, I fear—and I am not alone in this fear—that one of the reasons is that the majority of analysts work at Wall Street firms and banks that are doing business, particularly investment banking business, with the companies the analysts are analyzing. In fact, in a general sense, analysts' compensation is tied directly to their firm's success in attracting and holding investment banking business. And analysts usually develop close relationships with the companies they cover, relationships that are valuable to their firms and could be endangered by the release of a critical report or opinion.

[1] Chart entitled "S&P 500 Price Index Versus S&P 500 Consensus Recommendation," referred to by Senator Lieberman appears in the Appendix on page 128.

All of these influences I am afraid compromise analysts' objectivity and mean that average investors really ought to use analysts' recommendations with a great degree of caution.

There is a new set of proposed rules designed to improve analysts' independence crafted by the National Association of Securities Dealers, which were submitted to the SEC on February 7. I think these are a very valuable step forward. The rules would limit compensation that analysts can receive from investment banking activity, restrict analysts' trading of stocks they cover, ban them from reporting their firm's investment banking decisions, and prohibit them from promising favorable ratings to companies they cover.

In today's hearing, we are going to ask whether more should be done, and we are going to receive some recommendations, I believe, about more that could be done, even as we try to describe today the current system of investment analysis as a way to provide full disclosure and warning to investors, and hopefully to push Wall Street, on whose integrity and vitality so much of our economic strength relies, to clean up this part of its act.

In 1937, a long time ago, President Franklin Roosevelt said, "We have always known that heedless self-interest was bad morals. We now know that it is bad economics." Over the last few months, because of Enron, too many people individually and our economy as a whole have painfully discovered the wisdom of those words. Our job today is to make sure that from this point forward that wisdom spreads, not through more painful experiences but through enactment of new ethical and progressive policies.

I look forward to hearing from our witnesses today, who I hope and believe can help us do that job.

Senator Thompson.

OPENING STATEMENT OF SENATOR THOMPSON

Senator THOMPSON. Mr. Chairman, thank you very much. You have very completely addressed the issues that we are dealing with here today. I would ask that my statement be made part of the record and merely reiterate the fact that we are seeing a loss of investor confidence at a time when there is a remarkable surge in the number of Americans who invest in our stock markets. We have seen a growing lack of competence with regard to financial statements, accounting, and now we are having to deal with the reliability and objectivity of sell-side analysts' recommendations, which have also been called into question.

We have questions with regard to whether or not some of the things we have seen have been brought about by the obvious conflicts of interest that are in the system, whether or not those problems can be solved simply by disclosure. We have questions as to whether or not analysts really understand some of the data and the information that they are given, whether or not they were, in fact, misled.

On the other hand, as you point out, one study, at least, shows that "sell" recommendations account for just 1.4 percent of all analysts' recommendations. That raises the question as to whether or not there is something more systematic at issue here beyond Enron's confusing financials.

Of course, the question of analysts' independence is not a new one. It has had a renewed interest since Enron's collapse. I am looking forward to hearing the witnesses on our second panel about rule changes to address at least the perception of conflicts of so many of these analysts as well as to provide better ways of public disclosure.

I am also interested in hearing the explanations and opinions of the analysts testifying on our first panel. However, I would like for a moment to point out something concerning the first panel. The companies represented here today are not the only ones that covered Enron while also making other business relationships with the company. Merrill Lynch, Goldman Sachs, UBS Warburg also had investment banking relationships with Enron or invested in Enron partnerships, including LJM Partnerships, controlled by Andrew Fastow. So in a larger sense, there are other banks that may not have covered Enron that also engaged in this dual role with regard to other companies. So I sincerely hope that the investing public will not single out the particular banks represented here today simply because it is not feasible to call every bank that may have been similarly situated.

So, Mr. Chairman, I thank you for holding this hearing, and I believe it is a legitimate concern. At our first hearing we asked former SEC Chairman Arthur Levitt whether an American investor today can depend on Wall Street analysts, and his disturbing answer that Wall Street sell-side analysts have virtually lost all their credibility. And I hope today we can learn from our witnesses about the system so the Committee can contribute toward helping restore the faith of investors in our capital markets.

Thank you very much.

[The prepared statement of Senator Thompson follows:]

OPENING PREPARED STATEMENT OF SENATOR THOMPSON

Thank you Mr. Chairman. As we all know, one of the major fallouts of the Enron collapse has been the loss of investor confidence in our capital markets. Investment of capital is the lifeblood of our economy and we have seen a remarkable surge in the percentage of Americans that invest in our equities market over the last several years.

However, the collapse of Enron has shaken the confidence of investors in the transparency of the capital markets. It has also brought to the forefront the number of conflicts of interest that permeate different aspects of our system. Anyone seeking empirical evidence for the effect of these revelations need look no further than the recent volatility in the stock market and the constant references in the press to "Enronitis."

Unfortunately, reported problems with financial statements and accounting are not the only issues that have shaken investor confidence. The reliability and objectivity of sell-side analyst recommendations have also been called into question. Reports indicate that as of early October 2001, there were 16 analysts who covered Enron, and of them, 15 had a "buy" or "strong buy" rating, one had a "hold," and none had a "sell" or a "strong sell." Most of these analysts continued with "buy" or "strong buy" ratings even after the resignations of Enron CEO Jeff Skilling and CFO Andrew Fastow and after the restatement of earnings and reduction of shareholder equity.

I am sure that one of the reasons for these recommendations was the fact that analysts, like everyone else, were misled by Enron's financial statements and disclosure. On the other hand, I understand there is one study that found that sell recommendations account for just 1.4 percent of analysts' recommendations. That raises the question whether there is something more systemic at issue here beyond Enron's confusing financials.

The question of analyst independence is not a new one, but it has received renewed interest since Enron's collapse. I look forward to hearing from the witnesses on our second panel about rules changes to address at least the perception of a conflict for many of these analysts as well as to provide disclosures for the public.

I am also interested in hearing the explanations and opinions of the analysts testifying on our first panel. However, I would like to take a moment to make a point about that first panel. The companies represented today are not the only ones that covered Enron while also maintaining other business relationships with the company. Merrill Lynch, Goldman Sachs, and UBS Warburg also had investment banking relationships with Enron or invested in Enron's partnerships, including the LJM partnerships controlled by Andrew Fastow. And in a larger sense, there are other banks that may not have covered Enron that also engage in this dual role with regard to other companies. I sincerely hope that the investing public will not single out the particular banks represented here today simply because it is not feasible to call every bank that may be similarly situated.

Mr. Chairman, I thank you for holding this hearing. I believe it is a legitimate concern. At our first hearing, I asked former SEC Chairman Arthur Levitt whether an American investor today can depend on Wall Street analysts. His disturbing answer was that Wall Street sell-side analysis has lost virtually all credibility. I hope that today we can learn from our witnesses about the system so that the Committee may contribute toward restoring the faith of investors in our capital markets.

Chairman LIEBERMAN. Thank you, Senator Thompson. Thanks for an excellent statement. And you make a good point. The analysts that have been asked to come forward here were asked as a result of our staff's investigation because the staff judged them to be among the most prominent analysts who were covering and dealing with Enron. But you are quite right; there were a number of other firms, as the chart I held up showed, that also had analysts dealing with Enron and whose recommendations were really quite similar.

Senator Levin.

OPENING STATEMENT OF SENATOR LEVIN

Senator LEVIN. Mr. Chairman, first, thank you for convening this hearing. I think that most Americans who participate in the stock market—and that is most Americans—don't really think about or understand the role of the financial analyst in the investment banking world. We see the faces of analysts on TV. We read their comments in magazines and online and in newspapers. And I think most of us just see them as experts. But we don't think about their place in an investment banking enterprise and their dual role in facilitating investment banking deals as well as providing advice to investors. This hearing will help us hopefully explore that dual role and to address some of the inherent conflicts later on when we start legislating.

Most financial analysts wear two hats. One is the allegedly independent analyst of publicly traded companies providing us their educated and experienced insight on a company's future based on publicly available information. The other hat is that of the sophisticated insider investment banker analyst who helps his or her company attract and carry out investment banking business. Moreover, the analyst's compensation is often tied to the success of the investment banking business, as is the analyst's standing within the company. That is a problem, because as long as a company is a client of the analyst's investment banking firm, the analysts have incentives to promote the stock of that company.

Mr. Chairman, you have identified some of the suggestions of the National Association of Securities Dealers to address these in-

herent conflicts, and I think we should take a close look at those. Senator Fitzgerald and I have sponsored legislation to address the conflicts of interest problem with respect to analysts. It is in some respects similar to the NASD proposal. Our bill would require analysts, the investment banks for which they work, and persons or entities associated with the analysts to disclose any time the analysts' comments publicly, either in writing or orally, on a company that the analyst is covering on the following items: The fees the analyst or his employer received from the covered company in the last 3 years; the merger or acquisitions worked on by the analyst or his employer in the last 3 years relating to the covered company; and the amount and type of debt or stock owned by the analyst and his employer in the covered company. We would also have civil penalties and fines, depending on the gravity of the violation of those rules.

One out of every two Americans today have a stake in the stock market so addressing the problems uncovered under the Enron rock is not a choice but a necessity. And if we are going to maintain public confidence in our markets, as both you and Senator Thompson have indicated is such a necessity for us, we must act in these areas to address these inherent conflicts.

The role of the financial analyst is an important piece of the Enron puzzle. We know how dependent Enron was on its stock price, and that it provided significant business to the investment banking firms on Wall Street, initiating dozens of investment banking deals every year. So it is not hard perhaps to understand why the financial analysts waited so long to issue a "sell" recommendation when so much hung in the balance—indeed why most, perhaps the majority of analysts, never did issue a "sell" recommendation.

Thank you again, Mr. Chairman for convening this important hearing today.

Chairman LIEBERMAN. Thank you, Senator Levin. Senator Collins.

OPENING STATEMENT OF SENATOR COLLINS

Senator COLLINS. Thank you, Mr. Chairman. I want to thank you for continuing this important investigation.

I ask unanimous consent that my complete statement be included in the record, and I will just make a few comments.

Chairman LIEBERMAN. Without objection.

[The prepared statement of Senator Collins follows:]

PREPARED OPENING STATEMENT OF SENATOR COLLINS

Mr. Chairman, thank you for calling these hearings to focus on the role played, or, more accurately, not played by Wall Street analysts in the events leading up to Enron's bankruptcy.

Individual investors at times know little about the stocks they purchase. They tend to know what business the company is in and they might have some familiarity with its product. They may also know whether their broker's analysts rates the stock a "buy," a "strong buy" or something else. It's unlikely, however, that they will dig into a company's financial statements. As a consequence, there is a large reliance by individual investors on professionals whose job it is to look at one industry, or perhaps even one company, closely and make a recommendation on the purchase or sale of that company's stock.

Some financial analysts have pointed out that some of the information Enron gave them was inaccurate or incomplete. Analysts would ask questions but be brushed

off or even lied to. But, why didn't they press for answers or see the lack of information as warning signs?

After all, top Enron executives were selling substantial positions in the company. Bad investment after bad investment was being made by Enron. One analyst says that "Enron was a 'black box' company, where no one, not the analysts nor any of the institutional or individual investors, was really sure how the company made money." Another called a lack of transparency and disclosure an "Enron hallmark." Yet, he continued to keep it on his firm's recommended list, which connotes its highest ranking. A third noted that Enron's explanations were "an inadequate defense of the balance sheet." Yet he recommended its stock be "bought aggressively."

Analysts generally work for the same investment houses that seek to do business with the companies their analysts rate. As a consequence, do these "sell side" analysts, as they are known on Wall Street, come under pressure to base their conclusions on more than just the numbers? Many analysts believe that it is better to know the true picture of the company even if they can't reflect it in their recommendations because to do so would be lose their contact. As a result, a code develops. Analysts use terms like "hold." To many of us, Mr. Chairman, "hold" would mean that an investor should neither buy nor sell. Wall Street insiders understand that stocks rated "hold" should be gotten rid of quickly.

We need to determine whether it was such conflicts that led so many analysts to perform so poorly in their evaluations of Enron. Just weeks prior to Enron's declaration of bankruptcy, analysts from some of the best known firms on Wall Street were telling investors that concerns over Enron's finances were "very much exaggerated."

These analysts saw warning signs but ignored them. Common sense tells us that we should not recommend investments that we cannot understand. The analysts understood that there was something missing, something wrong with Enron. But the thing that was missing of *most* importance, Mr. Chairman, wasn't information. As one observer noted, what was missing most was skepticism and a willingness to delve for answers.

Senator COLLINS. Mr. Chairman, there is a large reliance by most individual investors on professionals whose job it is to examine closely an industry or perhaps even one company and make a recommendation on the purchase or sale of that company's stock.

Some financial analysts have pointed out to the Committee that information provided by Enron was incomplete or inaccurate. Analysts would ask questions but be brushed off or even lied to, and that raises the issue of why didn't these analysts press for answers or see the lack of cooperation and the lack of information as warning signs. After all, top Enron executives were selling substantial positions in the company. Bad investment after bad investment was being made by Enron. One analyst said that Enron was a black box company where no one—not the analysts nor any of the institutional and certainly not the individual investors—were really sure how the company made its money. Another called the lack of transparency in disclosure "an Enron hallmark," yet this analyst continued to keep it on its firm's recommended list, which connotes its highest ranking. A third analyst noted that Enron's explanations were "an inadequate defense of the balance sheet." Yet he, too, kept recommending the stock be bought aggressively.

Analysts generally work for the same investment houses that seek to do business with the companies their analysts rate. As a consequence, the question arises whether or not these sell-side analysts, as they are known on Wall Street, come under pressure, either direct or indirect, to base their conclusions on more than just numbers. Many analysts believe that it is better to know the true picture of the company, even if they can't reflect it in their recommendations, because to do so would jeopardize their contact. As a result, Mr. Chairman, a code develops. Analysts used terms like "hold." Now, to many of us, perhaps to the average investors "hold"

would mean that an investor should neither buy nor sell. But Wall Street insiders understand that stocks rated "hold" should be dumped quickly.

We need to determine whether it was such conflicts of interest that led so many analysts to perform poorly in their evaluations of Enron. Just weeks prior to Enron's declaration of bankruptcy, analysts from some of the best-known firms on Wall Street were telling investors that concerns over the company's finances were very much exaggerated. These analysts saw the warning signs but ignored them. Common sense tells us that we should not recommend investments that we do not understand. These analysts understood that there was something missing, something wrong with Enron. But the thing that was missing of most importance wasn't information. As one observer noted, what was missing most was skepticism and the willingness to delve for answers.

I look forward to hearing our witnesses today as we seek to ensure that there are improvements made in the system.

Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thank you very much, Senator Collins.

Senator Torricelli.

OPENING STATEMENT OF SENATOR TORRICELLI

Senator TORRICELLI. Thank you, Mr. Chairman, very much.

First, thank you very much for holding these hearings. I think it is an important contribution, and somewhere on Capitol Hill there should be some thoughtful analysis going on of this situation. There has been a great deal of commentary. There has been a good deal of cross-examination. But there is a need to have some venue that indeed is looking at some of the regulatory issues and the roles of the different institutions in depth, and I am proud that our Committee is doing so.

This is, of course, not entirely a new problem. The American people may be hearing about some of these issues for the first time, but it is not a new concern. There is very little happening here in the concern about the analysis being offered and the credibility of the profession that some were not asking during the dot-com fiasco. Companies with enormous multiples, involving tremendous risk, with conflicting information coming forward about their prospects, and, as my colleague noted, 1 percent were receiving "sell" recommendations.

There is a belief by most American investors, who may be unsophisticated but remain a critical part of the Nation's capital markets, that analysts are somehow on their side. That an analyst is your advocate. They are impartial. They are bringing you information as your advocate.

It may not be to the level of a lawyer or a doctor, but most clients do believe they are in a relationship with the person that is selling them stock and the analyst that person is relying upon has some degree of impartiality.

That, of course, was never the case, and perhaps there is some fault in people ever having been led to rely upon it. But it has been a reality in the marketplace.

An analyst for a firm who receives a bonus may be involved in IPOs, may own shares themselves, obviously has inherent conflicts

of all types. The question before the Congress, as we deal now with these twin fiascos—the dot-com meltdown and now the Enron problem, different in some respects but having some of the same core issues—is what we do about it.

As you are answering these questions today and making your presentations, remember that before this Committee is the issue of whether this is best dealt with in the marketplace. The best answer may just be that, based on the experiences of the technology sector and now Enron, some firms will have credibility and some will not. Some firms will find the means of restoring the confidence of their customers, and their customers will rely upon their analysis. You will provide to them descriptions of how you are avoiding conflicts, how you are restoring credibility, and you will succeed, and others firms that don't will fail. The marketplace may be the best answer. Or it may be that as a profession or within the industry, it is to be dealt with yourselves: Set standards as to what stakes analysts can own themselves, what conflicts will be tolerated, and what must be disclosed.

Or failing all that, is there a role for the government? Should we indeed place walls between analysts and brokers?

It is always the belief of most of us here that that is a role that is reserved for the most extraordinary of circumstances. But these are extraordinary circumstances. It may be that many of these people who lost their life savings were not sophisticated investors. Maybe some believe that is how the marketplace works.

But this country can't operate that way and maintain the success of the capital markets. In a society of a quarter of a billion people and a $10 trillion economy, our reliance upon average investors with their retirement savings, the little bit of money they can set aside is not a luxury in this economy. If it wasn't for our concern for their retirements or their security, it would still be important because it fuels our economic growth.

I hope you will remember all those questions. But I do want to place it in perspective. While I am as critical as any of my colleagues of how we got in the situation, I also remind my colleagues that for all the similarities to previous problems, Enron is distinguished in this: This is also outright fraud. It may be that all of your analysts should have been more inquisitive, should have pressed harder. But before you begin your own testimony, if you will indulge me, Mr. Chairman, I will quote just two sections from a transcript of Mr. Skilling and Mr. Lay on August 14 speaking to analysts, which may help us understand why they perhaps were not more inquisitive but, nevertheless, were misled:

> Mr. Lay: "In the second quarter, net income was up 40 percent, earnings per share about 32 percent, operation and physical volume of deliveries are up 60 percent. Again, if anything, in the last 5 years, we have had a 20 percent per year compound annual growth in earnings per share." Pretty good, pretty impressive—if true. Yes, analysts are to be faulted, but they do have to rely upon the information coming from executives as being truthful.
>
> Finally, Mr. Skilling: "One of the questions the analysts"—analysts, parenthetically, I am asking—"were ask-

> ing was on the new products. I think we have gotten really good traction from the new products. The numbers are looking good. I think in the last quarter, the second quarter, every one of those products, whether it was crude and crude products, metal, pulp, paper, coal, volumes had more than doubled. Every single one of them in the second quarter of 2001 or the second quarter of 2000 have all profited, which is a really good thing. So I am feeling very good, and I assume that we will continue on into next year. It looks like we are going to be succeeding very, very well in the wholesale businesses."

There is a lot of fault to go around all the way. I am not going to say that I am not faulting the analysts or the firms, but I will say if I had been in that conversation and I had listened to those numbers, frankly I wouldn't have been telling people to sell either. It was a fraud.

Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thank you, Senator Torricelli. Senator Voinovich.

OPENING STATEMENT OF SENATOR VOINOVICH

Senator VOINOVICH. Thank you, Mr. Chairman. I would like to express my appreciation to you for holding this hearing. As the Committee gathers information, I hope that it will allow us to develop real and productive changes, changes that can ideally prevent another Enron debacle from happening.

One of the things that is a little frustrating to me, Mr. Chairman, is some of the things that need to be done are not within the jurisdiction of this Committee.

Today's hearing focuses on the role of Wall Street's analysts in the financial markets through their "buy," "sell" and "hold" recommendations. We have already heard the important role that stock analysts play in terms of people relying on their advice. I suspect that there isn't anybody in this room that hasn't based a decision to buy or sell stock on what a group of analysts has said about a particular stock.

Unfortunately, in the Enron situation, in my State thousands of private investors lost as a result of the bad information they received. My State's pensions funds lost over $127 million as a result of the Enron debacle.

Overall, I have been pleased with the steps being taken by the industry to address some of the issues raised by the bankruptcy. Two weeks ago, the Securities and Exchange Commission proposed changes to the corporate disclosure rules that would require companies to expedite the release of annual and quarterly reports and require companies to immediately disclose trading by company executives. In addition, as was pointed out by one of the other Senators, the National Association of Securities Dealers announced new rules earlier this month that would increase the independence of Wall Street stock analysts, such as prohibiting stock analysts from owning stock in a company they review.

Investment banking firm Goldman Sachs recently announced that it is removing its research department from its investment banking operation and making it a separate independent division

of the firm. I expect that other firms are going to take similar actions in that regard.

Nevertheless, 40 different legislative proposals have been introduced to date in Congress in the wake of Enron's collapse. Each would in some way or another change our Nation's laws regarding pension plans, financial disclosure or auditor independence. Close to 30 Enron-related hearings have been held in the House and Senate since the company's bankruptcy less than 3 months ago. I think that before Congress acts to overhaul financial disclosure and accounting rules, we should proceed cautiously, take into account the non-legislative steps that have been taken, and make sure we all know all the facts before we act to overhaul laws governing the strongest financial markets in the world.

I think we also understand that the private checks and balances in this country are working as more and more individuals and entities are being sued for their fraud, dishonesty, negligence, and lack of due diligence. The Enron nightmare is going to be around for a long time, and many of the individuals involved will be taking that nightmare to their deathbed.

One final area of concern to me—and you won't be surprised, Mr. Chairman—regards the human capital resources of the Securities and Exchange Commission. The fact of the matter is that we have seen an increase of 660 percent in the amount of activity in the market over the past 10 years. During that same period of time, the Securities and Exchange Commission has not increased the people that are capable of dealing with it at all to put up with that increase in activity.

In addition, I recently found out that one-third of the people at the Securities and Exchange Commission have left the Commission because the salary schedule there is not competitive with other regulatory agencies or with the private sector. And it seems to me that as we go through these hearings and receive testimony from witnesses in regard to various aspects of Enron, it is incumbent on this Committee to make sure that the Federal agencies that have the responsibility for oversight have the personnel and the competent people to get the job done. And as I have observed over the years, too often we have hearings and lots of TV and newspaper publicity and the rest of it, but after it is all over with, what have we done to make the situation better? I think our responsibility in this Committee is to make darn sure, as part of our oversight, that those agencies that have responsibility for these markets have the adequate personnel and the expertise to get the job done to protect the American people.

Thank you.

Chairman LIEBERMAN. Thank you, Senator Voinovich. Someday somebody is going to give you the award you deserve for reminding us constantly about the importance of investing in the human capital, the people who operate and run our government.

There is a vote that is going off on the floor. What I would like to propose is that we go to Senator Bunning and Senator Bennett. I am going to leave, go and vote, try to get back real quickly so we don't interrupt the flow of the hearing. If I am not back, I would ask that the last Senator standing—or sitting, as it were—just recess the hearing for a few moments.

Senator Bunning.

OPENING STATEMENT OF SENATOR BUNNING

Senator BUNNING. Thank you, Mr. Chairman.

The Enron collapse and that of Global Crossing is troubling, to say the least, and has shown many weaknesses that need to be fixed. I was in your business for 25 years prior to coming to the Congress, so I know how inherent some conflicts can be, particularly those firms that have an investing, an equity, an underwriting, and also an advising position.

If you take a position in a stock, an equity position in an underwriting, and then you become an analyst and are not independent of that firm, you have a direct conflict of interest.

I hope at the end of the day all these hearings are not in vain and that Congress can make some necessary changes, especially to our pension laws. Today's hearing will focus on why some analysts continued to recommend stocks to investors even as the companies were restating its financial earnings and those stocks were in free fall. Investors' confidence in our markets without a doubt has been shaken, and many may be more hesitant—and I see that presently in the market—to trust the information they receive about a company before investing in it. I hope that is the case.

As a couple of our witnesses will testify today, there can be some very direct conflicts of interest and pressures that analysts face as they rate and recommend stocks. These conflicts need to be looked at and dealt with as they come up.

However, it is important to remember analysts are only as good as the information they receive. Any changes that are made will not make a bit of difference if the companies they are dealing with are not honest about their financial situations.

The representatives from the National Association of Securities Dealers and the Association for Investment Management and Research have some suggestions for us about how the system can be improved. If you all remember, there used to be a column in the *Wall Street Journal* called "Heard on the Hill." And you know what happened there. The person who was writing "Heard on the Hill" was investing and taking a position on the stock and then writing columns about how good this stock was going to be. And on the swing up, they would unload the stock and make a profit.

Now, you know about that as well as I do if you have been around the investing business very long. That kind of conflict of interest is in direct contradiction in what we want to see.

I am looking forward to the hearing today, and the other witnesses that are going to appear, and I thank you, Mr. Chairman, for allowing me the time.

Now, Senator Bennett, you are up.

OPENING STATEMENT OF SENATOR BENNETT

Senator BENNETT. OK. I get to be the Chairman.

Simply for the record and for the information of the witnesses that are waiting to testify when we get back from voting, I want to note that I think the hearings are useful. I think an airing of this issue in a forum as public as this one is a salutary thing. But I recognize that human beings being human beings, we are not

going to come to a clear solution that will pass into law and bring us into the promised land.

I have been involved in IPOs. I have been involved in presentations to security analysts. I have been the CEO of publicly traded corporations and have gone through the experiences. I know about road shows. I know about "buy" and "sell" recommendations and all the rest of it. I wish my colleagues were here that I could share with them, but we will share with the witnesses the experience of seeing analysts make "buy" recommendations for the funds that they represent and seeing the funds purchase stocks that then dropped off the cliff in the face of which experience the analysts kept saying, This is a great buy opportunity at the lower price, keep buying. And they were playing with their own money, that is, their own firm's money. They were absolutely convinced that their analysis was correct, and they ended up losing the firm that they worked for huge sums because they were wrong.

There is no way that the Congress or any other legislative body in the world can prevent people from being wrong. You don't have to be dishonest. You don't have to be engaged in fraud. You can make a mistake. And all of us, all of us have, and all of us will continue to do that in the future.

I wonder if at some point in your testimony you gentlemen could address what I would call the Stockholm effect. Those of you who don't know that term, the Stockholm effect refers to someone who is taken hostage—I don't know why it happened in Stockholm or why the term is applied to it, but someone who is taken hostage and then at the end of his or her incarceration has fallen in love with or embraced his captors and is more on the side of the captors than the liberators.

Maybe Patty Hearst is an example of that when she was kidnapped and ended up, at least for a brief period of time, joining her kidnappers.

I have seen analysts who have come in very glinty-eyed, very skeptical, as analytical and as objective as they can possibly be, examined the company's books, examined the company's business, fallen in love with what they found, and then blindly continued to support that first decision and urge people to buy stock in that company even as the business has turned. They have become so enamored of the management, which they thought they were viewing very objectively, so enamored of the market, which they thought they were looking at in very glinty-eyed terms, that they really did believe that everything was going to turn out all right after all. And they continued to recommend the stock out of complete conviction, no conflict of interest pushing them, complete conviction that this was the right thing to do, and they simply made a mistake. They were simply wrong.

So while it is good for us to air all of these things, I think these hearings are a wonderful thing to be doing. I think it is a very good exercise for everybody to go through periodically. I would just underscore the fact that when it is all over, we should not kid ourselves into believing that a set of congressional hearings are going to render every analyst completely objective and completely wise. And the ability to make a mistake is programmed into the DNA, and it is still going to be there for human beings when we are over.

With that, I now have to go save the Republic, so I will declare this hearing temporarily postponed until the return of the Chairman.

[Recess.]

Chairman LIEBERMAN. I thank the witnesses and all in attendance for your understanding. We are just completing a vote on the Senate floor.

I now go to our first panel. As is the custom of the Committee, I would like to ask the members of the panel to stand and please raise your right hands. Thank you. Do you solemnly swear that the testimony you are about to give this Committee today is the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. FEYGIN. I do.

Mr. GROSS. I do.

Mr. LAUNER. I do.

Mr. NILES. I do.

Mr. SCHILIT. I do.

Chairman LIEBERMAN. Thank you. Please be seated and let the record show that all of the witnesses answered in the affirmative.

I thank you for being here. I want to say for the record—although perhaps this doesn't have to be said, but it hasn't been the case in other committees—that all of the witnesses are here at their own decision and judgment and did not require a subpoena to ensure their presence. I appreciate that very much.

We will begin. Obviously you have heard our concerns, which are deep, and we want to hear you now and then have the opportunity to question you. We are going to hear first from Anatol Feygin, senior analyst and vice president at J.P. Morgan Securities, Incorporated. Mr. Feygin.

TESTIMONY OF ANATOL FEYGIN,[1] SENIOR ANALYST AND VICE PRESIDENT, J.P. MORGAN SECURITIES, INC.

Mr. FEYGIN. Good morning, and thank you, Mr. Chairman.

Mr. Chairman, Members of the Committee, my name is Anatol Feygin. I am a senior analyst and vice president of the U.S. Equity Research Department of J.P. Morgan Securities. My area of coverage is the domestic natural gas industry, and I am pleased to have the opportunity before you today to discuss my work as an analyst on Enron Corporation.

At the outset, Mr. Chairman, I would like to make four important points. As you mentioned in your opening remarks, absolute integrity is essential in our line of work. Second, I do not own any stock of the companies I cover and never owned stock in Enron Corporation; neither has my family at any point in my tenure at J.P. Morgan. Third, I have complete freedom with respect to the recommendations that I issue on the companies that I cover, and my compensation is not tied in any way to those recommendations. Finally, I have never received any compensation in any form from any company that I analyze, including Enron.

Consistent with J.P. Morgan's policies of analyst independence, in analyzing the companies I follow, I rely on publicly available information. My sources of information include the audited financial

[1] The prepared statement of Mr. Feygin appears in the Appendix on page 67.

statements of the companies, their filings with the Securities and Exchange Commission and other regulatory bodies, annual reports, and presentations to analysts. The accuracy of this publicly available information, as Senators Torricelli and Bunning pointed out, is absolutely essential to the accuracy of the resulting recommendation.

Let me now turn, as the Committee has requested, to my work with respect to Enron. I began following Enron in June 1999, and prior to issuing my report and my initial "buy" recommendation on the stock, I conducted extensive research for nearly a year, tapping all publicly available sources of information. I also met with senior management at Enron and other personnel, and I believed that Enron's innovative business model could be successfully applied in other industries to generate stable and growing earnings while assuming minimal risk.

In 2000 and in the 7 months leading up to August 2001, we saw for the most part very positive developments as they related to Enron that justified our "buy" rating. Enron's revenue grew from $40 billion to $101 billion in 2000, and its business model accounted for dramatic successes in various industries. Enron's outlook did become a little less certain with the sudden resignation in August of the past year of Mr. Skilling. We did view that as a negative event. But this did not lead to a downgrade because one of the things that Enron brought to the table, in our opinion, was a very deep and very talented management team and a successful business model.

By mid-October, the picture had deteriorated somewhat, but still not to the point where we believed that a downgrade was justified. On October 16, Enron did report a third quarter loss of $618 million and took a $1.2 billion charge to shareholder equity I should say. However, at the same time they reported a 35 percent increase in its core business, and even though this release was made in the morning, the stock closed the day up 2 percent.

Nevertheless, during the next week, we saw a developing crisis of confidence. It was fueled by negative press coverage, Enron's disclosure that the SEC had launched an informal inquiry, and Enron's failure to address the resulting investor concerns head-on.

On October 24, I downgraded Enron's rating from a "buy" to a "long-term buy" and removed it from our company's focus list. Let me just clarify this point. A "long-term buy" does not mean that the stock would be a good investment in the near term. Instead, the rating tells my institutional clients that the company is facing near-term challenges that, once resolved, should allow the stock to outperform its peers.

On November 8, Enron filed documents with the SEC revising its financial statements for the past 5 years to account for $586 million previously unrecognized losses. I did not believe that a second downgrade was justified because Enron's results for the first three quarters of 2001 were not materially impacted by this restatement.

On November 9, a proposed merger was publicly announced between Enron and Dynegy. As the Committee may be aware, J.P. Morgan was one of the advisers to Enron with respect to this merger. I, however, was not involved in the transaction and was only informed of it a few hours before it was publicly announced. Other-

wise, I was not privy to any non-public information with respect to Enron, Dynegy, or the proposed transaction. I viewed the proposed merger as a positive event and believed that if the merger was consummated, the combined entity would go on to outperform its peers.

The merger was abandoned on November 28 following Enron's downgrade to below investment grade. And immediately following, on November 29, we suspended coverage of Enron. As everybody knows, Enron filed for bankruptcy protection on December 2.

Thank you, Mr. Chairman, and I would be pleased to respond to any questions that you or other members of the Committee may have.

Chairman LIEBERMAN. Thank you, Mr. Feygin.

Now we go to Richard Gross, who is an analyst at the Equity Research Division of Lehman Brothers, Incorporated.

TESTIMONY OF RICHARD GROSS,[1] ANALYST, EQUITY RESEARCH DIVISION, LEHMAN BROTHERS, INC.

Mr. GROSS. Good morning, Mr. Chairman and Members of the Committee. My name is Rick Gross. As indicated, I am an analyst in the Equity Research Division at Lehman Brothers. Lehman Brothers is a global investment bank and securities firm that provides research, investment banking, brokerage and other services to corporations, institutions, governments, and high-net-worth investors.

I have been an equity analyst covering the energy industry for 27 years. I have been an analyst at Lehman since 1991. Prior to Lehman, I worked as an analyst at other firms for 16 years. I have a B.S. and M.S. in finance from the University of Illinois.

At Lehman Brothers, I cover a sector called "United States Energy/Power, Natural Gas." One of the companies in my universe of coverage is Enron. As an analyst, I analyze the publicly available information about a company and its industry. This information can include: Information made available to me through SEC filings that the company makes; press releases and company presentations; materials from the rating agencies; information about competitors that I can glean in the marketplace, trade journals, seminars; general information about the industry as well as whatever public information is available that I can reasonably obtain. I compile all of this in a framework for my analysis.

My analysis includes relative valuations arrived at by reviewing historical and current industry trends, reviewing market valuations, comparing the company being analyzed to its peers. Based on this analysis, I develop opinions and make recommendations, and the factors on which they are based are reflected in my reports. These reports are available to clients of Lehman Brothers, which in general are primarily institutional in nature, although we also serve a high-net-worth individual group.

I appreciate the opportunity to answer questions before the Committee.

[1] The prepared statement of Mr. Gross appears in the Appendix on page 72.

Chairman LIEBERMAN. Thank you, Mr. Gross. Maybe one of those shorter opening statements we have had in the history of the Committee. We will be back to you for questions.

Next, Curt Launer, Managing Director, Equity Research Group, Credit Suisse First Boston.

TESTIMONY OF CURT N. LAUNER,[1] MANAGING DIRECTOR, GLOBAL UTILITIES RESEARCH GROUP, CREDIT SUISSE FIRST BOSTON

Mr. LAUNER. Good morning, Mr. Chairman. My name is Curt Launer, and I am a Managing Director at Credit Suisse First Boston. I head the Global Utilities Research Group of CSFB that comprises 28 professionals. My specific research coverage is the natural gas and power sector, and as a research analyst for the past 18 years, I have followed Enron and its predecessor companies. I would like to make four main points today.

First, the role of an analyst is to make informed judgment about companies based on publicly available information. We depend on senior corporate officials and independent accountants to ensure the accuracy of public disclosures. Without accurate and complete financial reporting from a company, I simply do not have the proper tools to do my job.

CSFB's client base is largely comprised of sophisticated, institutional investors, not individual retail customers. My clients have their own research staffs. They look to me for quality information and projections and challenge the information and analysis that I provide to form their investment decisions.

My second point is that inaccuracies and lack of information in Enron's financial reporting affected my conclusions and ratings on Enron. Each day there are new allegations in the media concerning Enron about which I was previously unaware.

Third, I performed my analysis independently and objectively, and I never felt pressure from Enron or any investment banker or other employee of my firm to reach any conclusions other than my own. Not only have I done my work independently, but, in addition, my firm has strict rules that prevent me from even having access to the kind of confidential, non-public information that investment bankers often have. CSFB has also adopted rules banning stock ownership by analysts in the companies we cover.

In this regard, I would like to note that before that ban, my sons each owned 100 shares of Enron that were sold in December 2001 to comply with new CSFB rules. My family's only current investments related to Enron are $18,000 I invested in the NewPower Company and an Enron bond held by my mother, which is now in default.

Finally, I applaud any effort to craft thoughtful responses to improve the overall quality of public company disclosures and restore confidence in our markets. To protect the integrity of our research, CSFB consistently and without exception follows Chinese wall procedures. To maintain our independence and ensure that our research is not influenced improperly, the Research Group is physically separated from the Investment Banking Department. We

[1] The prepared statement of Mr. Launer appears in the Appendix on page 73.

have no access to the confidential files or data of any other unit of the firm.

In addition, CSFB not only complies with the Securities Industry Association's best practices for security analysts, but also has worked with the SEC, the NYSE, and the NASD to create new rules for analysts and investment banks which, after months of work, were recently announced.

Enron was unique in its use of off-balance-sheet financings, off-balance-sheet partnerships, fair value accounting, and other techniques and vehicles. Any one of these would not be problematic in and of itself. Many fine companies use these techniques. However, Enron used all of them in ways that apparently were not fully disclosed and that we are just beginning to understand.

It now appears that some critical information on which I relied for my analysis of Enron was inaccurate or incomplete. For example, in January 1998, I attended an analyst meeting at Enron with over 100 analysts. During this meeting we toured a trading floor of Enron Energy Services. In viewing the activity in the trading room, I was impressed at the progress Enron had made in developing this new business. It has now been alleged in press reports that Enron staged the activity on that trading floor, and if this allegation is true, the progress of the business unit was illusory.

In addition, during the August 15, 2001, analyst conference call following Jeff Skilling's resignation, I specifically asked him whether his departure suggested that there were likely to be further disclosures with respect to Enron's finances. Mr. Skilling responded that there was nothing to disclose and that the company was in great shape. Furthermore, Enron never publicly disclosed the alleged use of the Raptor investment vehicles. It now appears that these entities may have engaged in trades with Enron simply to establish artificially higher asset values. Had I known any or all of these items, the information would have significantly affected my analyses and recommendations.

I believed as of late November of last year that Enron could have survived if it had taken the appropriate steps. These steps would have been a substantial capital infusion combined at complete disclosure of off-balance-sheet liabilities and debt levels, plus a decision to slow growth, all of which could have, in my opinion, resulted in Enron's survival. Essentially, these are the elements that could have been provided by the Dynegy merger. Indeed, it appears that Chevron-Texaco and Dynegy had much the same view of Enron as I did. Chevron-Texaco was willing to commit $2.5 billion in cash to its view of Enron, and Dynegy was willing to issue $8.5 billion of additional shares to acquire Enron.

In sum, hindsight allows a view that I as an analyst never had. I based my views and ratings on the information that was available every step of the way.

In 2000, the SEC adopted regulation FD in order to promote equal access by preventing the selective disclosure of information to some individuals, but not the public at large. As laudable as that goal is, the regulation can be used as an excuse by company officials, as it was by Enron, to duck tough questions from analysts and, thus, thwart full disclosure. The point, of course, is that these

tough questions should be answered and the answers made available not just to the questioners but to the public.

The focus of any policy changes should be more complete, more timely, and more understandable disclosure. We should consider full disclosure of off-balance-sheet financings and related-party transactions, more accelerated disclosure of insider transactions and corporate reports, and enhanced disclosure of stock option programs. Greater scrutiny of accountants and other professionals and additional resources for regulatory agencies like the SEC may be necessary as well.

Thank you again for the opportunity to appear today, and I look forward to answering any of your questions.

Chairman LIEBERMAN. Thank you, Mr. Launer.

Now we go to Raymond C. Niles, senior analyst, Citigroup Salomon Smith Barney.

TESTIMONY OF RAYMOND C. NILES,[1] SENIOR ANALYST, CITIGROUP SALOMON SMITH BARNEY

Mr. NILES. Thank you, Mr. Chairman and Members of the Committee.

Since March 2000, I have been the senior analyst at Salomon Smith Barney for the integrated power and natural gas sector. Before that, and since 1997, I was the senior analyst for the integrated power and natural gas sector at Schroder. I covered Enron at both Schroder and at Salomon Smith Barney.

As an analyst, my job is to report to investors about business and market developments in my industry sector. I also develop and communicate timely and detailed recommendations about particular companies in that sector.

In order to do this job, I work with publicly available information to develop financial models, earnings estimates, and price targets for the stocks of the companies that I follow. I also follow and analyze industry trends, such as power prices, spark spreads, generating capacities, the trend toward deregulation, and similar items. Part of my job also is to forecast the impact on individual stock prices of the supply and demand for electricity and natural gas, the overall health of the national economy, and even such variables as the weather. In performing these analyses, I make use of computer modelings techniques, economic theory, and other tools.

At the heart of my work are the financial statements of the companies that I follow. I review and analyze a company's financial statements, press releases, and public filings before I make a recommendation. I also go beyond the paper record and participate in regular conference calls held for analysts by senior and financial management of the companies that I cover. I visit the companies and call on company personnel in order to obtain clarification and context regarding the company's finances and business prospects.

Although I collect and analyze a great deal of information, I must stress that all of the information I use is and must be public information. Under Securities and Exchange Commission rules, a company cannot make selective disclosure of confidential information only to certain analysts.

[1] The prepared statement of Mr. Niles appears in the Appendix on page 82.

Also, investment banks that trade securities establish information barriers—you have heard those referred to as the Chinese wall—so that confidential information that may be known to a company's bankers does not reach the analysts and salespeople who may be recommending or trading that company's stock. Therefore, when I issue a report on a company on behalf of Salomon Smith Barney, I am prevented by rules and regulations, as well as by the firm's policy, from asking my banking colleagues about their non-public dealings with the company that is the subject of my report.

If an analyst is ever brought "over the Chinese wall" to receive non-public information, he is not permitted to make recommendations with respect to the particular company until the information learned by the analyst becomes stale or has been disclosed publicly.

With this background, I would like to summarize for the Committee my reports concerning Enron.

I initiated coverage of Enron in January 1998, when I worked at Schroder. I developed my own methodology for forecasting the company's earnings, and based on my analysis of the company's reported financial results and business prospects, I placed Enron on the firm's "recommended list."

It was my professional opinion that Enron was well positioned to take advantage of the deregulation of the electricity industry. By that time, Enron had already built an impressive reputation and had achieved dominance in the competitive natural gas industry, which deregulated about a decade before.

It was also my professional opinion that Enron's core merchant energy business model was sound. Under that model, economies of scale, innovative marketing, and risk management could allow Enron to offer cheaper and more customized energy-related services than those provided by its competitors. I believed that Enron's objective—using risk management products and long-term contracts to address the needs of wholesale energy customers in the volatile commodity markets—was a successful paradigm. The strength of Enron's reported results appeared to confirm the correctness of this objective and Enron's success in achieving it.

While I was at Schroder's, Enron's performance in the gas and electricity commodity markets was impressive. I believed that Enron's core platform could be applied to other inefficient markets for commodities that were delivered over a network, such as bandwidth.

In March 2000, just before our firms merged, I joined Salomon Smith Barney as a senior analyst. I issued my first report on Enron at Salomon Smith Barney in April 2000. At that time I rated Enron as a 1H, which means a "buy" recommendation, with high risk attached to it. The high-risk notation refers to the business risk given that Enron was a first mover in new markets.

I continued to recommend Enron during the rest of 2000 and into 2001.

In a report dated August 14, 2001, shortly following an announcement that Jeff Skilling had resigned, I noted that although he was an architect of the company's energy merchant strategy, I believed in the soundness of their business model, and even though it was a negative factor, barring any further disclosures from the company, we still felt positive about the company.

Beginning in October, Enron began to make public disclosure of the transactions and financial restatements and writeoffs that eventually led to its bankruptcy. I made timely reports as the significant facts were announced.

On October 16, I noted Enron's decision to take $2.2 billion in charges, but reported that the charges, as described by Enron, did not relate to its core merchant energy business. Accordingly, I continued to rate the company a "buy" with a "high risk" rating.

On October 19, when the stock was still trading at over $32 per share, I issued a report which noted that the company's "complex off-balance-sheet vehicles have raised concern," and that there could be further writeoffs, and I was also concerned that Moody's had put the debt on review for a possible downgrade, but that we were still evaluating these issues at that time. Later that day I issued another report, again raising concern about their off-balance-sheet financing, and again about the uncertainty and magnitude of potential writeoffs of the company.

I downgraded my rating to 1S, or "buy, speculative," on October 25, and lowered it again to "neutral, speculative," a 3S rating, the next day. In my report that day, I noted that management had to address issues related to credit and liquidity, particularly the use of off-balance-sheet vehicles.

Given everything that has happened since late October, I think it is appropriate to ask why the analyst community, at least the vast majority of its members, missed the mark on Enron.

The short answer, Mr. Chairman, is that we now know that we were not provided with accurate and complete information.

A company's public certified financial statements are the bedrock of any analysis of the value or the prospects of a company's stock.

It is now common knowledge that Enron's financial statements, which had been certified by its independent auditor, did not represent the company's true financial condition. The analyst community relied on these financial statements, which were restated. The company restated 3 years' worth of its earnings in November.

When analysts look at certified financial statements, we assume that they are accurate and that they fairly and completely represent the company's financial condition. In Enron's case, that assumption turned out to be invalid.

As analysts, our reputation and ultimately our livelihood depends on our making timely and correct calls. I did not want to get this wrong in terms of Enron. I recommended Enron's stock because I believed in the company's core business model, and I trusted the integrity of the company's certified financial statements and the representations of the company's management. At all times, I exercised and communicated to investors my best professional judgments based on the information that was available to me.

Thank you, Mr. Chairman and members of the Committee.

Chairman LIEBERMAN. Thank you, Mr. Niles.

The last witness on this panel, Dr. Howard Schilit, president and founder of the Center for Financial Research and Analysis.

TESTIMONY OF HOWARD M. SCHILIT, PH.D., CPA,[1] PRESIDENT AND FOUNDER, CENTER FOR FINANCIAL RESEARCH AND ANALYSIS, INC.

Mr. SCHILIT. Thank you very much, Senator. I do have a prepared statement, but I just wanted to interject before I got into that, at the conclusion of that if you would like me to comment on what I just heard and also my analysis on Enron that came out of the public records, I have some interesting findings in front of me.

Chairman LIEBERMAN. Fine. Let me ask that you go ahead and do the opening statement, and during the question and answer then we will give you an opportunity to offer your reactions.

Mr. SCHILIT. Senator Lieberman and esteemed colleagues, I am pleased to appear before this Committee to describe my role as an independent financial analyst and some of the important differences between Wall Street research and our independent boutique.

Before proceeding, I want to emphasize that my comments are based solely upon personal observations over the last decade rather than on a comprehensive study of Wall Street or other independent research boutiques.

My name is Howard Schilit. I am founder and president of the Center for Financial Research and Analysis, or CFRA, based in Rockville, Maryland. Prior to that, I was employed for 17 years as an accounting professor at American University. I also authored a book called "Financial Shenanigans: How to Detect Accounting Gimmicks and Fraud in Financial Reports."

My organization has been writing research reports since 1994, warning institutional investors about companies experiencing operational deterioration or using unusual accounting practices. Our reports are published daily and distributed over our website.

We use a variety of quantitative and qualitative screens to initially select companies for review. Then an analyst reviews the financial reports and other public documents to search for any problems. If any are found, we interview company management to discuss these issues. If concerns remain, we publish a report on our website. We make no buy or sell recommendations; rather, we simply discuss the issues of concern.

Our clients are mainly institutional investors who purchase the research on a subscription basis. We are paid a fixed fee based on the number of actual users at the firm, similar to a license fee on software. Subscribers receive an E-mail each morning with a notification of the companies profiled, and the reports are posted on our website at 9 a.m.

All CFRA subscribers receive the information in the same way and at the same time. In addition, all subscribers have equal access to discuss issues with our analysts.

CFRA has a variety of strict editorial policies and ethical guidelines that protect clients' interests and ensure CFRA employees receive no remuneration based on stock price performance of companies they profile. I have attached those policies with my formal statement.

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[1] The prepared statement of Mr. Schilit with attachments appears in the Appendix on page 86.

In short, we have no brokerage, investment banking, or money management operation. We have no conflicts of interest. We have one client class: Those who make economic decisions based on financial disclosures. And we have one overarching goal: To help them make the best decisions.

In contrast, Wall Street research is fraught with real and potential conflicts of interest.

Wall Street brokerage firms have at least two major client groups: Those that purchase investment banking services and institutional investors. Typically, a company needing funding will hire a brokerage firm to underwrite securities in a public offering. The brokerage firm receives a fee, generally 6 percent or higher, for this investment banking service. Shortly thereafter, the successful analyst at the brokerage firm will begin coverage on this new client with a positive research report. Generally, future research reports on this investment banking client will remain positive. Future investment banking fees on stock or bond offerings depend on a close relationship with the corporate client.

If CFRA or another critic raises concerns to investors, the brokerage firm often publishes a rebuttal to show support for the investment banking client, and in some cases with disastrous results.

This shows the inherent conflict of interest; the brokerage firm serves both the underwriting client—the subject of the report—and the investor, who must be informed when problems arise.

The method of paying for research also differs substantially at Wall Street firms. Whereas we receive a cash payment for selling subscriptions, brokerage firms are paid by investors in commission dollars. The trading volume affects the amount, the timeliness of the information, and access to speak to research professionals. That is, the bigger clients typically get the first call from institutional brokers and salesmen, while smaller clients have lesser access.

Moreover, non-institutional investors who generate no commissions often have no or very limited access to such research. CFRA, for example, was not permitted to purchase brokerage research through First Call—the distributor of brokerage research—because we generate no commission. They refused our offer to purchase the research for cash.

I have outlined in a chart ten important differences between the work of our independent boutique and Wall Street firms, and I will leave that for you to go over, perhaps during the question and answer period.

In conclusion, as a result of the conflicts of interest and internal policies, Wall Street research has regularly failed to warn investors, so not just Enron but regularly failed to warn investors about problems at companies. I would be happy to answer any questions at this time.

Chairman LIEBERMAN. Thanks very much, Dr. Schilit.

To the four analysts here, obviously, Dr. Schilit has laid down a challenge and raised concerns and issued charges that are very much on the minds of all of us, and I want to ask you a series of questions, as other Members of the Committee will, to respond to those.

To one extent or the other, the four analysts who are here from the firms this morning have defended the fact that jumps out at

us, that you were continuing to recommend Enron long after it appears that there were warning signs. Some did it quite specifically, others of you quite generally.

The concern obviously is whether you were influenced in those favorable recommendations that now seem so wrong by the fact that your firms were doing business with Enron or perhaps just because you had become too close to Enron. We have a syndrome that they sometimes talk about in diplomacy where the Ambassador we send to a foreign country becomes the advocate for the foreign country as opposed to the advocate for the United States. And I wonder about that as I listen to you.

But let me cite the Bethany McLean article in *Fortune Magazine* in March 2001, very direct, strong questions about Enron's viability. At least one analyst, Mark Roberts, of Off Wall Street Consulting Group, May 2001, which is an independent research firm, diagnosed the problems with Enron in a research report that was printed on the Web and talked about shrinking profit margins, raised questions about Enron's related party transactions, even identified one dark fiber transaction as being used to exceed earnings expectations for two quarters in 2000. In additional reports in July and August of last year, he raised concerns that Enron was relying even more heavily on related-party transactions and that Enron's cash flow from recurring operations and return on capital was poor as compared to its competitors. Finally, he noted that insiders at Enron were selling like crazy, then put together the growing media concern during last fall about Enron with some specific allegations being made in articles and places like the Wall Street, and the beginning of the SEC investigation. And yet the four of you—and, in fact, by our calculation, about two-thirds of the analysts on Wall Street who were really focused on Enron continued to recommend a "buy," to say the other obvious fact which I haven't mentioned, the stock price was dropping significantly over the period of time.

So the obvious question is: Why? And why shouldn't we or average investors feel that you were not really doing independent analysis but that you were affected by the fact that—by either of the factors I mentioned: One, that you got too close to Enron; or, two, that your firms were benefiting from ongoing business relationships with Enron? Mr. Feygin.

Mr. FEYGIN. Thank you, Mr. Chairman. Again, I would like to go back to something you said in that integrity is absolutely essential in this line of work, and we focus on the core operations, the business model, and the publicly available information.

In the releases from Enron and the conference calls they had and the financials that were published, the core operations were doing exceptionally well; as I mentioned, even in the third quarter with the charge, they were up 35 percent. And as you mentioned, the stock kept sliding while I believed that the core operations were continuing to do well. I thought that the deterioration and all of the issues that were raised were more than factored into the stock price, and, again, my outlook, which is what my recommendation is based on, pointed to a solid core business, the rapid move by Enron to rid itself of some of these distractions that you mentioned, and I firmly believed that the stock would go on to outperform

until fundamental issues arose and we downgraded it on October 24 pending the resolution of those issues.

Chairman LIEBERMAN. Let me ask you more specifically, isn't there a natural way in which the public's growing skepticism about the independence of analysts working for firms, as you do, is justified? In other words, I understand one of you—perhaps it was you, Mr. Feygin—said you didn't receive any compensation from Enron. I understand that is true. But I gather that the income that you make, including bonuses at the end of the year, is affected by your firm's overall performance during the year, including its investment banking and other businesses, which Enron was significantly contributing to.

So weren't there implicit or explicit pressures on you to continue to recommend a buy for Enron as it slowly collapsed?

Mr. FEYGIN. The answer to the last part of your question is no, there were no pressures on me to maintain the rating.

Chairman LIEBERMAN. Mr. Gross, why don't you answer that question? I understand the defense, notwithstanding the evidence I have presented, that you are all saying you made a judgment call. But why should average investors feel that you and the other analysts working for the firms that were doing business with Enron were not affected by that, since your advice seemed to be so counterintuitive? As the stock price slid, the insiders were selling like crazy, and there were all sorts of growing—not just speculation but accusations that something was very rotten at Enron.

Mr. GROSS. Well, I think we have all reiterated in one way or another that the core business, the basic business model, we believed was very strong, was growing rapidly, was portable into other commodities, and that this was the strength of Enron. It materialized when the stock went from $45 to $90, and we believed that that franchise was portable into broadband in a context where there was a lot of enthusiasm in general about broadband.

As the stock fell, it became evident that the broadband business was not going to pan out as rapidly as most observers had viewed it. We were back to an energy company. The energy company still, as we were reporting, they were reporting record quarters. They were reporting very strong volumes. We could see the confirmation of the business model in the other companies that we followed that were also doing very, very well. And so the core business all along, I think each and every one of us believed was very, very strong.

As we got toward the end and we got incremental pieces of information—we would get a piece of information saying that management was selling stock. The early sales of stocks were from individuals that in my belief were on their way out of Enron or retiring. The stock sales of many of the other senior managers we believed were normal sales. They were programmed sales. They were very regular.

When it came down to Jeff Skilling quitting, once again, all of us in our own way interpreted that. My own reports indicated that this is an issue, but at the end of the day, the bench is very deep. We had two instances in the 1990's where senior executives at Jeff's level had quit abruptly, early in 1992–93, an individual named Mick Seidel and an individual named Rich Kinder. The bench took over and the stock continued to do well.

It was only toward the very end that it became evident that the core business, because of lack of management credibility, because of some rating issues, was going to deteriorate, possibly to the point where we had significant problems with that core business. And I think that was the essence of how we were able to recommend the stock as it——

Chairman LIEBERMAN. We try to keep each of the Senators, including the Chairman, on a time allotment. I have gone over mine. I just want to ask, not for a defense of what you did because you gave it in your opening statement, Mr. Launer and Mr. Niles, but how do you explain why you missed the signs that Mr. Roberts of Off Wall Street Consulting Group saw?

Mr. LAUNER. As an analyst, I worked very hard on Enron, on all of the publicly available information. I have made it a practice throughout my career not to use other research reports written by anybody. I was aware of the Roberts report because some of the claims in it were brought to my attention by the institutional investors that I serve.

The questions that came up at that time were relatively easy to answer analytically through our own work. One of the main comments in that report dealt with Enron being overvalued because it was simply a trading business. The analysis that we have done of the merchant energy business that Enron and other companies take part in is that the business has substantial barriers to entry, needs a lot of capital, and has a utility function to serve and, therefore, justifies a higher multiple than a trading business.

From the standpoint of the other concerns about dark fiber sales that you mentioned, we had seen that from Enron and other companies, and those issues were disclosed and part of our analysis in terms of the company having included dark fiber sales in their earnings reports in the year 2000.

In terms of related-party transactions, there simply was incomplete disclosure, as we now know, of the related-party transactions. And in terms of the return on capital employed having come down, that was consistent with Enron's business and strategy of investing heavily in new start-up businesses that weren't counted on to provide earnings or returns for the first couple or 3 years of their existence.

So, overall, from the standpoint of hindsight allowing a view that we simply did not have, we relied on the information that was available at the time.

Chairman LIEBERMAN. Mr. Niles, I am going to let my colleagues question you because time is up. I want to leave you with a quote, and maybe some of you will respond to it. James Chanos, a short seller who gained recognition for doubting Enron's value fairly early on, testified before the House Energy and Commerce Committee on February 6 that he met sometime early in 2001 with the analysts covering Enron from CS First Boston and Salomon Smith Barney. I trust that was the two of you? Do you remember meeting with Mr. Chanos?

Mr. LAUNER. Yes, I do.

Mr. NILES. Yes.

Chairman LIEBERMAN. Anyway, he testified that, "They saw some troubling signs. They saw some of the same troubling signs

we saw. A year ago, management had very glib answers for why certain things looked troubling and why one shouldn't be bothered by them. Basically, that is what we heard from the sell-side analysts. They sort of shrugged their shoulders. One analyst said, 'Look, this is a trust-me story.'"

I would like to hear as this morning goes on your response to that recollection of his to those conversation.

Senator Thompson.

Senator THOMPSON. Thank you, Mr. Chairman.

Mr. Gross, what did you consider to be Enron's core business, as you referred to it? You thought the core business remained strong?

Mr. GROSS. Yes, its wholesale energy markets and trading business.

Senator THOMPSON. All right. But they were doing quite a few other things in addition to that, weren't they? They were trading other things besides——

Mr. GROSS. Yes, as they began to migrate the business model to other commodities, we thought that it would be successful in the context of the success they had already had and experienced in natural gas, the experience and success they had in energy, and the numbers that they were reporting in the way of volumes.

Senator THOMPSON. Is it fair to say that they made quite a bit of money with their energy trading but they lost a lot of money with regard to other trading areas, broadband and a lot of other things, in addition to losing money on most of their foreign investments, their base business, their bricks-and-mortar business or pipeline business and all that? They were making money in a very speculative area and losing money in other areas. That is a great generalization, but is that not a fair generalization?

Mr. GROSS. I would say it is a partial characterization. In general, Enron had invested in international infrastructure, and a good portion of that historical portfolio, beginning with some of the investments in the early 1990's, did not generate high returns.

Senator THOMPSON. Well, none of it generated a profit, did it?

Mr. GROSS. The way it was reported to us in the audited statements, it showed that it was making money.

Senator THOMPSON. Well, we know now that some of the profits they were showing, if not most of the profits they were showing, was because they were utilizing these 3,000 or so partnerships, the Raptors and so forth, and disguising or not reporting some of the losses and taking credit for some of the gains generated from self-dealing and all that. We know that now. The question, I guess, is what did we know back in the fall?

I don't think we will ever be able to really second-guess your analysis about what you were thinking at the time. To me, just because a stock is going down, that doesn't necessarily mean that you ought to sell it, for sure. Some of the richest people in the world, most successful people in the world, don't do that. So we have got to look at it from an objective standpoint, and the question is: What are the American people going to think, what is the average investor that our economy is so dependent upon now going to think?

On the one hand, you have the objective factors that everybody looks at that have been described here. Mr. Skilling leaves under

questionable circumstances. By September the stock had lost 60 percent of its value from its high. All these other things were going on. And then analysts had a conference call on October 22, in which you were basically told, "Don't bother me, I'm busy." And then the next day Lehman Brothers came out and said Enron's conference call began as a methodical review of current liquidity and deteriorated into an inadequate defense of the balance sheet; despite this, we affirm our strong buy recommendation.

So when the public looks at all these objective factors and then they look at what we now know is a system that is complete with conflicts of interest where your interests and your firm's interest is in the stock going up, they have to balance that over against what you say was basically a reliance on corporate executives. As I see it, they were telling you everything was going to be all right.

Let me ask you, in a general sense, I would assume that that would be a situation you would run into a lot, that a lot of corporate executives would try to be optimistic with regard to their own firm. Accounting principles is another issue. But do you normally rely on just what the public record has got out there that anybody could look at, plus what the corporate executives are telling you? Even in light of all these objective factors and the inherent conflicts of interest with regard to your job, does the former outweigh the latter?

Mr. GROSS. Each of us in our own way go about determining management credibility in their statements, in that context where we would be able to confirm or not confirm how Enron was doing if they are in a market with other competitors. It has been mentioned earlier that Enron in aggregate generated a rather poor return on capital. You could see competitors trading in the marketplace with financials that basically represented that core business that were earning very high returns. You could check out the statements of management with their competitors. Is the market good? Is it bad? Is it deteriorating? Is it improving?

So there are all kinds of cross-checks at the end of the day that we have to perform, instead of just taking statements at face value from the individual companies.

Senator THOMPSON. Well, I understand that. But let me give you a cross-check on the other side of the ledger. Mr. Feygin, I was looking here at a clip from the *London Times,* March 21, 2001, where it says J.P. Morgan reins in analysts. It says that the independence of J.P. Morgan's stock research is being questioned after analysts at the U.S. investment bank were instructed to seek approval from corporate clients before publishing recommendations on those stocks. In a memorandum circulated to J.P. Morgan analysts last week, Peter Houghton, head of Equity Research, said that he must personally sign off on all changes in stock recommendations. In addition, the memo further sets out rules described as mandatory, requiring analysts to seek out comments from both the companies concerned and the relevant investment banker, J.P. Morgan, prior to publishing the research.

He says, "If the company requests changes to the research note, the analyst has a responsibility to incorporate the changes requested or communicate clearly why the changes cannot be made."

So it looks to me like J.P. Morgan is telling their analysts that they have got to get a sign-off from the company they are analyzing and the mortgage banking side of the operation before they can make any changes.

As I say, nobody can get in anybody's head and dispute the fact that there are some factors out there that might lead one to go in another direction. But over here, you have not only all of the objective things that were going on out there in the marketplace that anybody could see, plus the mortgage banking houses basically letting the companies they are analyzing, it looks like, call the shots.

What kind of investor confidence comes out of a situation like that?

Mr. FEYGIN. Thank you for the question, Senator Thompson. I have to say that I learned of this memo from the press. Peter Houghton is the head of our research franchise in London, and those rules did not apply to my actions. Until the rules were changed recently, senior analysts were not required to seek approval for ratings changes, period.

In the initiation process for the companies that we are about to pick up coverage on, we do send part of the report to the company, what we call the back of the report, which factually describes the businesses for fact checking. But after that point, the recommendations, the evaluation, and our opinions are not second-guessed by outside or inside people.

Senator THOMPSON. So this only applies to new businesses as opposed to companies that you are already doing business with? Is that——

Mr. FEYGIN. To my best understanding—and, frankly, since it didn't apply to me, I didn't study it in great detail, but that applied to the London research—the department in London, and it did apply to rating changes broadly, not just to new initiations.

Senator THOMPSON. And is it still applicable?

Mr. FEYGIN. I don't know the answer to that for the London franchise.

Senator THOMPSON. My time is up, Mr. Chairman. Thank you.

Chairman LIEBERMAN. Thanks, Senator Thompson. Senator Levin.

Senator LEVIN. Thank you, Mr. Chairman.

The Powers Report says, "There is some evidence that Enron employees agreed in undocumented side deals to ensure the LJM partnerships against loss in three transactions." Now, one of the documents that we have identified in the materials that we have been reviewing at the Permanent Subcommittee on Investigations confirms this with respect to several deals that were called the ENA CLO Trust. Enron North America agreed to buy back accounts receivables that it sold to LJM if these receivables could not be collected.

Now, three of you, representing Credit Suisse, J.P. Morgan, and Salomon Smith Barney, were limited partners in LJM. So it is logical to conclude, I would ask you, that they knew about these guarantees. And those guarantees were apparently not reported on Enron's financial statements because that would have defeated the purpose of the transaction in the first place. So any of the three of you representing the companies that I have mentioned, did any

of you work on any of the deals related to LJM or any decisions relating to the LJM partnership? Let me start with you, Mr. Feygin.

Mr. FEYGIN. Absolutely not.

Senator LEVIN. OK. Mr. Launer.

Mr. LAUNER. I was not over the wall for any of the LJM activity of our firms.

Senator LEVIN. Thank you. Mr. Niles.

Mr. NILES. No.

Senator LEVIN. OK. Now, if you had known about the guarantees, I assume that you would have considered those guarantees a liability to Enron, lessening to some degree, at least, Enron's financial standing. Is that correct?

Mr. FEYGIN. That is absolutely right.

Senator LEVIN. Mr. Launer.

Mr. LAUNER. The same answer would apply here.

Senator LEVIN. Mr. Niles.

Mr. NILES. I believe so. I might just add, though, if this was material non-public information, I would have to go to my attorney, and I wouldn't be able to comment on Enron because of the Chinese wall restriction.

Senator LEVIN. But I am asking if that information were known to you, if it had pierced the wall, it would have affected Enron's value.

Mr. NILES. Yes.

Senator LEVIN. OK. Now, the value of the partnership depends to some extent on the Enron guarantee. The partnership's value, which is being assessed, touted, sold by the other part of your firm, depends to some extent on that guarantee. So should the fact of the guarantee be known to the analyst since guarantees are significant liabilities? In other words, you said that it would have affected your judgment had you known. Part of your firm knew. You didn't because of the wall.

Should you have that information available to you before you begin telling the public that this is good stock to buy since someone else in your firm knows, hey, there is something that is not appearing on that balance sheet which would affect that analyst's judgment? Mr. Feygin.

Mr. FEYGIN. Again, if the question is if this information is material, it is absolutely incumbent upon the company to issue and disclose that in its financial statements, at which point it becomes public information for me——

Senator LEVIN. It was not in its financial statements, according to the document.

Mr. FEYGIN. Correct.

Senator LEVIN. Now, someone in your company knows something that is not in the financial statement, because there is evidence that those guarantees were issued without being publicly disclosed. Now, does that not create an inherent problem for your company and for you? Because someone in your company knows something which affects the value of a stock that you are analyzing and that you do not know that would affect that analysis.

Mr. FEYGIN. The issue of the Chinese wall has been brought up often in these hearings, and I am sure there is a lot of information

that is on the other side of the wall, the non-public information that resides within our institution that I am not privy to. That is not my role, and, regrettably, that is not something I can incorporate into my analysis.

Senator LEVIN. So the information that I have just described, you don't think should be available to the analyst?

Mr. FEYGIN. If it is material, it should be made available to me by the company itself.

Senator LEVIN. All right. And if it is not disclosed by the company but kept private on the other side of the wall, but it affects your recommendation, then what?

Mr. FEYGIN. As the laws are structured today, obviously that information cannot flow to me from the other side of the wall.

If inadvertently it did, I would have to report that to our Compliance Department and action would be taken after that.

Senator LEVIN. Therefore, on the other side of the wall, they know that you are giving an analysis which is based on incomplete information which affects what they are doing because the more that Enron stock is held to be valuable because it is not known that that guarantee exists which would reduce its value, the greater is the partnership interest that it is selling, the more valuable it is. There is an inherent conflict right there. How do we solve it?

Mr. FEYGIN. If it is a material issue, again, the forces at play should make the company disclose that information openly and publicly.

Senator LEVIN. Or your company should itself insist that that information, that guarantee, be made available on the financial statement, should it not?

Mr. FEYGIN. In this case, the company being Enron? Absolutely.

Senator LEVIN. No. The company being your company.

Mr. FEYGIN. Should insist that Enron disclose that information?

Senator LEVIN. Yes, that it be on the financial statements.

Mr. FEYGIN. I can't speak to that call being made on the other side of the bank.

Senator LEVIN. Anyone else, just with the three companies, have a comment on this?

Mr. LAUNER. The only comment I would make is it is not our job to disclose material non-public information. It is the responsibility of the company, meaning Enron, their accountants and their lawyers.

Senator LEVIN. Why is it not the responsibility of your company, on the investment side of your company, to make sure that something which should be disclosed in that financial statement which would have an effect on the stock be disclosed?

Mr. LAUNER. Material non-public information. We are not over the Chinese wall and do not have possession of that information.

Senator LEVIN. By not insisting that it be disclosed, it is leading the other side of the company to be giving an appraisal of stock, a valuation of stock which is based on information which the other side of the company knows to be incomplete. And it seems to me that creates an inherent conflict that we have to address and the investment community has to address.

My time is up, and I will pick up later. Thank you.

Chairman LIEBERMAN. Thanks, Senator Levin. That was a very interesting line of questioning.

Let me just for the purpose of clarity, because there was something assumed in the line of questioning. There is this so-called Chinese wall between the research departments, or the analysts always say, and the rest of the business of the firms you work for, correct? That is what we are talking about. But, Mr. Launer, I think you used the term—and we have all heard it here in these discussions—being "brought over the wall." I take it—am I correct that there are occasions when you as analysts are brought over the wall into other parts of your firm's business? Is that correct?

Mr. FEYGIN. That is correct.

Mr. LAUNER. Yes.

Chairman LIEBERMAN. But you were all saying in the specific instance that Senator Levin was interested in, you were not brought over the wall.

Mr. LAUNER. That is correct.

Chairman LIEBERMAN. Were there any occasions, since each of your firms, the four of you were doing—each of the firms was doing business with Enron, when you as analysts were brought over the wall with regard to any deals or business arrangements with Enron? Mr. Feygin.

Mr. FEYGIN. Certainly. In the case of Enron, on November 9, prior to the merger with Enron and Dynegy being announced, a couple hours prior to that I did receive—I believe I received the press release of the merger, at which point I was brought over the wall and was frozen and could not comment on the stock.

Chairman LIEBERMAN. And you were brought over the wall for what purpose?

Mr. FEYGIN. For the purpose of having the information and being able to respond to investor questions once the deal with announced.

Chairman LIEBERMAN. So you were no longer giving public analysis? Is that what I understand you to say?

Mr. FEYGIN. From the point that I was given that material nonpublic information that this merger was about to be announced and saw the details of that merger, I could not comment, I could not publish research until it was publicly announced and disseminated.

Chairman LIEBERMAN. Mr. Gross, were you brought over the wall in any business transactions related to Enron?

Mr. GROSS. Specifically here, we were the adviser to Dynegy, and I was brought over the wall in late October.

Chairman LIEBERMAN. So to advise your company about Enron——

Mr. GROSS. My primary role here was to gauge how investors would react to the merger, to gauge their concerns, and in that light help formulate but not actually execute due diligence that Dynegy would do on Enron.

Chairman LIEBERMAN. Did you continue to provide analysis that was——

Mr. GROSS. No. At that point, my ratings, according to company policy, are frozen.

Chairman LIEBERMAN. Mr. Launer.

Mr. LAUNER. I was over the wall relative to Enron for 6 weeks in the September-October period of the year 2000 for an IPO of the NewPower Company.

Chairman LIEBERMAN. Mr. Niles.

Mr. NILES. There was one occasion. In January 2001, I was brought over the wall for a 24-hour period, I believe, for a convertible security offering by Salomon Smith Barney for Enron securities.

Chairman LIEBERMAN. All right. I appreciate your responsiveness, and I see each of you in one sense or another presenting evidence that your companies had rules. But you can see how at least I, as one just sitting here, have doubts raised in my mind. You have got this expertise, and your companies have business interests in other dealings, including with Enron. The public is relying through the media, through websites, etc., on your analysis of Enron. And yet there is a feel of a conflict which, no matter how hard you tried with the freezing of your public analysis and all, still leaves me feeling that the rules were not adequate, particularly in light of your continuing recommendation to buy Enron after most everybody was selling it.

I am going to stop there. Senator Voinovich.

Senator VOINOVICH. It looks to me like there are a couple of things we have to be concerned about. Do you guys have a conflict of interest by owning stock, your family owning stock, and whether you ought to disclose ownership, or be prevented by law from owning any stock that you report on. That one is internal.

External is the Chinese wall. Should we have any Chinese walls at all? Should you all go into the business that Mr. Schilit is in, and that is that you are an analyst and you have got nothing to do with the other side of the business. And, this gets back to what Senator Lieberman was saying—if you are in the same outfit, there ought not to be a wall. If you have got information, inside information, and you are an analyst, that information should be made available when you do your reports. So there is no problem of whether you have got a wall or you don't have a wall. Also, Mr. Launer, you are complaining about the fact that you didn't have the information that you needed. What information more do you need to do a better job of being analysts if you stay in the same kind of outfit that you are in today? Is there something that we can do in terms of the law, requiring more information so you can make better judgments?

Have any of you changed the way you are doing business because of Enron? Are you doing things the same way as you did them before? Are you a little bit more cautious? Are there other things that have changed in terms of your operation?

I would like to hear from all of you. Do you think we ought to have legislation that says that you can't do any kind of analyst work on stock that you own? And, do you think that you should be required to disclose if you are an analyst of the stock that you own? Yes or no. We will start with you, Mr. Feygin.

Mr. FEYGIN. I agree that we should be required to disclose, which is J.P. Morgan policy, the stocks that we own, as well as some other disclosures that are standard in our research.

Senator VOINOVICH. And do you think it should be required by law that that be the case?

Mr. FEYGIN. I would like to fall back on something Senator Torricelli said, and that is the markets do take care of this issue. And to the extent that firms will be more trusted and their analysis will be deemed more valuable, the market itself will impose those disclosures.

Senator VOINOVICH. So you don't think you need legislation that requires that?

Mr. FEYGIN. I can't really comment on that. I know that at our firm we do disclose that, and hopefully that helps our product. And I would welcome any changes that would enhance our product offering. If that is one of them, by all means.

Senator VOINOVICH. Mr. Gross.

Mr. GROSS. No, disclosure I think is a good thing. And, in general, Lehman Brothers in the past has had outright bans for analysts owning stocks that they follow.

Senator VOINOVICH. Legislation or no legislation.

Mr. GROSS. That is a difficult call for me to make because——

Senator VOINOVICH. Mr. Launer.

Mr. LAUNER. No legislation, to answer your direct question. Our firm has adopted the SIA best practices. They effectively contain provisions which require——

Senator VOINOVICH. Yes, but before your firm did that, your family did own—had bought a bond, had stock. Your sons had stock in Enron. And then the firm changed the rules, and then you had to transfer stock, except you had to hold a bond that is not worth anything anymore. But did that color your judgment when you owned—I mean, you were working on Enron, you or your family members were buying stock in Enron. Did that color your judgment in terms of your analysis of Enron stock?

Mr. LAUNER. No, it did not, and it was fully disclosed each step of the way.

Senator VOINOVICH. But right now you don't have to—you can't deal with any stock that you are an analyst for, right?

Mr. LAUNER. That is right.

Senator VOINOVICH. And your family can't, according to the rules of the firm.

Mr. LAUNER. That is correct.

Senator VOINOVICH. And you don't think we need legislation to require that?

Mr. LAUNER. No, I don't.

Senator VOINOVICH. Mr. Niles.

Mr. NILES. Our firm prohibits buying stocks in companies that we cover, and as far as the policy matter, I haven't really given it a lot of thought. But I do know our firm prohibits buying stocks in companies——

Senator VOINOVICH. OK. How about the Chinese wall? Do you think that you ought to split off to avoid what Senator Lieberman and some others have talked about, the issue of having the same firm being analysts and at the same time being investment bankers and having all kinds of information on one side that the people who are doing the analysis can't have because it is not public? I know what Mr. Schilit is going to say.

What do you say, Mr. Feygin?

Mr. FEYGIN. Senator, I believe in your question and in a lot of the statements there is the presumption that there is a conflict of interest, and on some levels perhaps it exists. But the value that I bring to the firm, again, is in my independence and the credibility I have with my investors. And that is absolutely key. To the extent that that helps our firm gain business, that is great and the firm will prosper.

To the extent that it is a "buy" recommendation that helps me build credibility, we have commented—this panel has commented on numerous occasions that there were multiple buys on the stock.

Senator VOINOVICH. I understand the whole thing is trust and trustworthiness. Enron has destroyed that for a lot of people in this country. And those of you in the business are going to have to respond to it because it is really going to hurt the business, it is already hurting the business.

Let's say, for example, that your firm has a Chinese wall. Do you disclose to the people that you are analyzing stock for that there is a Chinese wall and that your firm is doing other work for the companies that you are analyzing the stock for?

Mr. FEYGIN. It is company policy to disclose if J.P. Morgan had a role as an underwriter or was involved in an offering for the company when we publish any reports.

Senator VOINOVICH. So that is something that you are already doing.

Mr. FEYGIN. Yes. Now, we do not disclose on every report that there is a Chinese wall because, again, our role focuses exclusively on publicly available information.

Senator VOINOVICH. Mr. Gross, how do you feel about it? Do you think you ought to break it up so you don't have a problem?

Mr. GROSS. No, I think that in general that the methods that we follow to handle potential conflicts are adequate. Going back to Senator Levin's comment, the investment bankers periodically have material non-public information. The vast majority of it is not applicable to what I do. It may be in the context of Company A wants to buy Company B, never does execute that transactions. That is material non-public information.

The type of disclosure that Senator Levin was talking about I think is more appropriately handled in that the rating agencies see consolidated balance sheets. We have some new disclosure rules which will allow us on the outside to do so. The auditors deem what is material or not. We have talked about in different forms tightening some of those screens.

So there are mechanisms that are out there that would provide that flow of information to the investment community without curtailing my role, which is a materially different role in how I would help the firm with—as I said, my role in the Dynegy deal was basically to tell the companies the investor reaction to doing this. So from a standpoint of the nature of serving multiple clients, I don't think the conflicts are all that prominent, nor are they that insurmountable when people——

Senator VOINOVICH. Well, I will finish because I am out of time, but you now have a problem of appearances. Before this you didn't. It is the issue of appearances of conflict of interest. And what we

are trying to do as quickly as possible is to restore people's faith in the financial markets in this country so we can get back to business. And I would say to all of you that are here, the faster you can move internally within your own organizations to get out and change some of these things—and I would love to have your recommendations, this Committee would, on some of the things in terms of legislation that we need to do so you have better information so that you can do your job better.

Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thank you, Senator Voinovich. Senator Torricelli.

Senator TORRICELLI. Thank you, Mr. Chairman, very much.

What is extraordinary about the Enron matter is the confluence of failures: Unethical business practices by executives which could constitute fraud or gross mismanagement; the failure of a proper accounting to basic standards that would be acceptable; and now the issue of whether the analysis was never properly at arm's length or simply failed because of inadequacy of information.

If any one of these three institutions had actually had the proper information and acted according to highest expectations, a great deal of pain would have been saved for a great number of people.

Our role here is to focus on the third of these functions, each of your roles in the marketplace. I can only supplement my colleagues' questions by asking your thoughts on several things to help me better understand some of these relationships.

First, let me go to this issue of information you were receiving from Enron. On this conversation of August 14 in which you received this analysis by Mr. Skilling and Mr. Lay, characterize for me whether in your judgments this constituted simply exaggerating information properly available, was just routinely misleading, or you consider yourself to have been defrauded by some of this information that was provided by Mr. Skilling? I go back to the quotes I provided to you earlier, which I assume you to be familiar with, the numbers, the projections, and particularly the references to the new businesses of the crude, the crude products, metal, pulp, paper, and coal. Some have doubled. Every one of them in the second quarter or the quarter before, all are profitable.

The characterization then put on the company in August, now that we know what, in fact, those executives knew about the company, about the partnerships, about the deteriorating situation, the warnings they had received from people internally, as professionals. Looking back on the conversation, the judgments you made based on it, how do you characterize this as a business?

Mr. FEYGIN. Thank you for that question. I will break it up into two parts. One, the characterization of the businesses' performance provided by Mr. Skilling. To date, there is no evidence yet that those new businesses were not performing in line with what Mr. Skilling said. I think one of the most impressive aspects was, as the company got into new products such as pulp and paper when it was about to collapse, the Scandinavian pulp and paper markets were panicked because of the size of Enron's presence in that marketplace, or perceived size of Enron's presence. So it appears today—and we have no evidence to the contrary—that those businesses were, in fact, gaining traction and growing.

In hindsight, it certainly seems that, as it relates to the partnerships and the exposures of Enron, we were misled.

Senator TORRICELLI. Mr. Gross.

Mr. GROSS. I would say obviously, in retrospect, that the nature of the disclosure was leading with your best foot and letting the other drag behind. And in the context of the subsequent information that has come out, there is no question that we weren't receiving the full story about the health of the company.

Senator TORRICELLI. In your mind, as someone who has done these calls before, is this in keeping with the culture of the business and the way these disclosures are made? Or do you feel that you personally and your clients were victims of a fraud?

Mr. GROSS. Well, without materially more information, I can't draw a line between the communications that we received and outside—outright fraud. I think that will be subject to further investigations.

Senator TORRICELLI. Anybody else want to comment on this?

[No response.]

Senator TORRICELLI. Explain to me further the operation of the separation of the firms. Apparently each of you are prohibited from owning positions in the stocks you analyze or are required to disclose those positions for yourself or family members. Is that accurate?

Mr. GROSS. In our case, I mentioned earlier that at times we have had that ban. We currently are able to own stocks, and we have severe restrictions about the nature of how we can own them and when we can buy or sell those securities.

Senator TORRICELLI. Now, in the way the separation works, are you then also not operating with knowledge about the positions that the firm may be holding on its own account? Or, for example, if you had done underwriting, the firm had done underwriting for a company, whether you have future positions with this firm, or separately whether you are holding large numbers of bonds for the firm. How knowledgeable are you about the exposure of the firm itself and its own position in any particular company, not necessarily this one? Mr. Feygin.

Mr. FEYGIN. No knowledge whatsoever of actions that are, again, on the other side of the wall.

Senator TORRICELLI. You wouldn't indeed know other than what might be publicly disclosed? I assume if you searched for it, you could find some public disclosures whether or not the firm had any of these positions?

Mr. FEYGIN. Sure. You know, in the case of Enron and our firm's involvement in particular, all I learned about our exposure I learned from the press.

Senator TORRICELLI. Well, we all did. Mr. Niles.

Mr. NILES. I am sorry, Senator. The question was am I aware of the firm's positions on——

Senator TORRICELLI. I want to get a feel for how these walls operate within these firms, whether, in fact, you have knowledge of the firm's exposure in what position it may have from doing underwriting for these firms and its future potential or the bonds that they are holding at the time.

Mr. NILES. I don't have access to that kind of information.

Senator TORRICELLI. So, in practice, not simply Enron but any of these firms, you find these absolute?

Mr. NILES. I don't have that information.

Senator TORRICELLI. Let me ask you finally, in seeking resolution to this and where this Committee ultimately will be left is whether to recommend statutory changes or, indeed, as I suggested earlier, this is worked out in the marketplace or professionally, is there an argument that, in fact, the analysis function should be professionalized and separated and be a product which is individually purchased by the brokerage firms rather than the investment bankers, the brokerage parts of this, having it in-house and connected in any case? These could indeed be separated, much as the accounting industry, we thought previously, had been separated and made independent. Is there an argument for taking these out of the same roof at all to restore public confidence?

Mr. FEYGIN. Well, Senator, again, these are obviously very large public policy decisions that we as a firm would be pleased to work with this Committee on. I firmly believe that there are plenty of rules and guidelines in place that ensure our independence and, from a legal framework, ensure our integrity, as well as the fact that it is, as you pointed out, paramount in the marketplace, that the marketplace perceive our product as one of integrity.

Senator TORRICELLI. Things are not going to be in the future as they were in the past. The status quo is not an option. We are either going to take a bright yellow sticker and put it on the windshield of all of your firms, revealing your gas mileage and your resale values, much as this Congress did 30 years ago with a different industry, to know what your track record is, what your rules are about disclosure, and the holding of equities and your conflicts of interest so the public can make its judgment in the marketplace, which is my own preferred solution; or indeed this Congress is going to write a regulatory framework to impose some of that.

One of the options is to simply separate the functions, that if Smith Barney wants analysis, buy it from an independent firm so the customers know that, in fact, they are—what is happening here is genuinely at arm's length and can have more than a Chinese wall, we can have a brick wall separating you by physical location and management.

I want to conclude this by asking your advice. Do you all favor simply letting this work out in the market: The public will have confidence in some firms, they won't have confidence in others? I suspect anybody with a portfolio right now is scurrying around town trying to figure out who was right, who was wrong. They are all looking at these sheets. Who came up with the right answer first to get out? That is one answer, how our system operates. Or we can go further. Is there anybody else who wants to add on this in a recommendation? That is, after all, why you are here. We are trying to figure out how to make recommendations to our colleagues to proceed with this.

Mr. SCHILIT. Yes, I have been sitting quietly for a long time because I am not part of the Wall Street community. There is a lot wrong, and to answer your specific question, it absolutely should be expected that the research should be an independent function,

should be set up separately. Customers should pay a fee for that, and the marketplace decides the value of that research.

In answer to Senator Voinovich in terms of what steps any of us have taken in the wake of Enron, sadly we are a tiny firm. We only had six analysts up until very recently, so one of the industries we did not cover was the energy group. But we have hired an additional six analysts, and we are looking at 100 percent of the S&P 500 companies just for these type of corporate governance problems, a weak control environment.

Also, I did want to—because I have the floor for a few moments, I did want to comment on were there any signs in any of the public filings that there were problems at Enron? A very logical question. Everybody is saying they hid from us, they lied to us, they committed a fraud. Did you read the public filings that were published at the SEC? I spent an hour of my time last night going through every quarterly filing proxy, no more than an hour, and I have three pages of warnings, words like "non-cash sales," words like "$1 billion of related-party revenue."

Chairman LIEBERMAN. These were all from last year?

Mr. SCHILIT. This was beginning in March 2000. Every single quarter there was a little blurb looking at the reported profits, for one quarter $338 million, and $264 million of that, a pretty material amount, represent earnings from unconsolidated affiliates, more than two-thirds of the earnings, and it goes on and on.

Senator TORRICELLI. These corporations we have heard about, the 3,000 or so Raptors or whatever, they were referred to in one of those footnotes.

Mr. SCHILIT. Well, they gave little snippets of information, but the point is this: I am heartbroken that I was not covering this company when I could have done some good. But for any analyst to say there were no warning signs in the public filings, they could not have read the same public filings that I did.

Senator TORRICELLI. Your disappointment is nothing compared to that of a lot of other people who wish that you were following it. When you see these footnotes, though, and it is clear a lot of this is happening off the balance sheets, in reference to Senator Thompson's question, are there references only to the gross amounts of these that are happening off the books? Or is there some indication, some window in the numbers of these partnerships?

Mr. SCHILIT. They don't give any clue. I was astounded when I heard it was 3,500. But just looking at the most basic things that any investor could understand, if a company reports a profit of a billion dollars and that same period the company says we had negative $1.1 billion of cash received from that operation, there has got to be some warning out there. And those numbers came right from the June 2001 quarterly report.

Senator TORRICELLI. Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thank you. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

In regard to some of Senator Torricelli's questioning, I want to refer to the J.P. Morgan, Lehman Brothers, First Boston, Citigroup Salomon Smith Barney. Tell me how much your companies were involved in the selling group or the underwriting groups or what equity position your company had in Enron. You can start with the

first and go on down, because from 1961 to 1986, I was in your business. And the same thing was going on in 1961 that is going on the year 2002. Our company would take a position in an underwriting group. Then they would come to the sales force and say: We have an equity position in this stock. We are recommending it to you to sell.

Now, help me out.

Mr. FEYGIN. Easy question for us. We are not involved in any equity underwriting for Enron——

Senator BUNNING. Or selling group?

Mr. FEYGIN. We were not a part of any syndicate on Enron equity offering.

Senator BUNNING. And you own none for your own personal——

Mr. FEYGIN. Own none for my own personal——

Senator BUNNING. Not your personal. The corporation's personal.

Mr. FEYGIN. I do not know whether the asset management side of J.P. Morgan holds or has ever held a position in Enron.

Senator BUNNING. That is impossible, sir. I am sorry. That is impossible for you to tell me that.

Mr. FEYGIN. Why is that?

Senator BUNNING. Because if you know that they weren't in the selling groups of any type and you know that they weren't in any underwriting group, you ought to know, if you are in the business of recommending, whether they are in the equity end of the—in other words, whose stock are you recommending, the stock that your company owns or the stock that is owned in the public market?

Mr. FEYGIN. The stock that is owned in the public market.

Senator BUNNING. Next?

Mr. GROSS. We have participated in several offerings that Enron—most of them were on the fixed-income side. The equity offerings——

Senator BUNNING. Debt instruments?

Mr. GROSS. Debt instruments.

Senator BUNNING. OK.

Mr. GROSS. We were a co-manager in an affiliate called Northern Border Pipeline in the last year.

Senator BUNNING. You were an adviser to them on your——

Mr. GROSS. We were a co-manager, which means we did not run the books.

Senator BUNNING. OK.

Mr. GROSS. We participate in the sales.

In general, once again, the vast majority of these sales will take place with companies that are already trading in the public domain. They will be distributed to institutional investors.

From a standpoint of our position, yes, the way a syndicate is formed is they own stock for a brief amount of time. We have a money management wing where we have a high-net-worth group of individuals——

Senator BUNNING. For which a portion——

Mr. GROSS. They may own Enron in that system. It is very difficult for me to know. But, in general, because it is investors' money, it is not ours. It is investors' money. The same thing with J.P. Morgan investment and management company. It is investors'

money, not J.P. Morgan's, that they are managing. It is an independent wing.

Basically what we will have is in and around, like I say, an offering, it will be for a brief and limited amount of time. It is generally in a security that is already publicly traded——

Senator BUNNING. But you have taken the position so that you can sell the securities?

Mr. GROSS. Yes.

Senator BUNNING. OK.

Mr. LAUNER. Senator, the disclosure on the bottom of our research report says that our firm may from time to time hold positions in the securities of the company that is the subject of the report.

Senator BUNNING. Thank you.

Mr. LAUNER. It does not say anything specifically. For me, over the wall, the period of time was only the 6-week period in 2000——

Senator BUNNING. Over the wall. It is in the *Wall Street Journal* who is in the underwriting groups. I mean, that is public knowledge, who is in the selling group, who is in the underwriting group. The position that your company might have in that equity, if you are selling as an owner of or as a broker for or——

Mr. LAUNER. The disclosure that needs to be made has been made relative to those things. Yes, we have been in selling groups. But it really comes down to the level of our specific involvement in those when we are over the wall. In 1998, I was at Donaldson, Lufkin & Jenrette before the acquisition of our firm by CSFB. I was involved in an equity offering where we were the lead manager for Enron securities. So for that period of time that I was over the wall, I was aware of the firm's position and how we were handling the entire equity offering. That ends at the time that the prospectus delivery requirement relative to that offering——

Senator BUNNING. You don't feel that inside, supposedly nonpublic information, that you got while you were over the wall would shade your judgment at all in your analysis now of that same corporation?

Mr. LAUNER. No.

Senator BUNNING. Mr. Niles.

Mr. NILES. Yes, Senator, our firm, it is a large institution. We have an investment bank, a corporate bank, and we have been involved in a number of offerings with regard to Enron. And, I would just say we definitely—that is part of our practice as a firm. I am not aware of the specific ownership interest in the securities or how that works or quantities.

Senator BUNNING. That blows my mind, because just as an account executive, I was aware of it. I was aware of whether we took a position and we were selling stock out of our own portfolio or if we were just going to the market and buying and then delivering the stock to a customer. So some of the things you are telling us are very difficult to believe.

Now, if we are going to solve this problem and we have come to you for assistance and you are going to testify as you have testified today, you are asking us to intercede, not by your suggestions but by our own initiative from what we hear. And what I hear from you is very difficult for me to believe. And I know about the walls.

But the walls are not impenetrable. People within your company know just what you are recommending and are for what you are recommending because they know it is going to help the other side of the wall. And I think that is something that we have to look at very closely, Mr. Chairman, and I am willing to go if you are.

Thank you.

Chairman LIEBERMAN. It is always good to be on the side of a member of the Hall of Fame. [Laughter.]

He threw some high hard ones in his day.

Senator LEVIN. Whichever side of the wall he is on, by the way.

Chairman LIEBERMAN. Well, your questions are right on target, and, you express the concerns that I certainly have. And I guess the question is: Each of the four of you have said at one point or another you went over the wall. You went over the wall according to the rules of the firms. But, the question that I have and I think Senator Bunning's and other questions raised is: If you can go over the wall, was it high enough? In other words, does it not raise questions in all of our minds about your ultimate independence or the intermixing of the different functions of your firm?

Thanks, Senator Bunning. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman. I won't re-rake the leaves. I think they have been gone over sufficiently. But I can't pass the opportunity while you are here to raise another question that occurs to me. I have not been an account executive like Senator Bunning, but I have been in the market a good bit in my career. I have made some fairly substantial money in the market, and I have lost some fairly substantial money in the market. And without the education that would be necessary to be an analyst for pay, I do remember something that I was taught when I was in my 20's, first getting into the market, very, very fundamental. Don't buck the trend. And when I inquired as to my counselor, well, how do you know when the trend is going on? He said, well, it is very simple. A trend, once established, continues until it is over.

I turn to your testimony. Here is the Credit Suisse sheet that says up at the top: "Recommendation, strong buy." And it is within inches of a chart that makes the trend pretty obvious. The stock has been going down on a very steady basis for a year.

My gut reaction is I don't want to buy that unless in the copy that says "strong buy" there is an indication as to why the trend is over. A trend, once established, continues until it is over. I want something here that says this is what has happened different in the firm that shows that there is going to be a bounce. And I read the copy, and there is nothing here that shows there is going to be a bounce. Everyone here—and the copy of the rest of it. I am not just picking this one out. I picked this one out because it happened to have a chart, and I like visual aids. But there is nothing in any of the copy of any of the recommendations that says there is a shift in the trend.

And so my question to you, which has nothing to do with what we are talking about, is just interest, the fact that you are here, and I hope you can educate me. What in your opinion caused the stock to go down? While analysts were recommending a buy all the way through, the market was saying this is a dog, we want out of it.

The uncoordinated decisions of hundreds of thousands of investors were sending a strong signal, we want out of this stock. The chart shows that the market says this is a dog.

What did the market see that the analysts didn't? What caused the stock to go down? Was it people like Mr. Schilit sitting up at night reading the footnotes? What in your opinion caused Enron, prior to the disaster—let's say the disaster didn't occur and we are back on October 24. You have got a stock that has gone down, according to this chart, index price has gone down from $100 to $30 in less than a year. It has lost 70 percent of its market value. Why in your opinion did the market decide this stock was worth only 30 percent of what it has been worth a year before? Anybody?

Mr. GROSS. Principally, the backdrop prior to that is that the stock had more than doubled to get to $90. And if you look at the backdrop for emerging market securities, new businesses, the NASDAQ had gone from 2800 to 5100 and in that same period had fallen to 1700. So a good portion of what you were seeing in Enron stock was the entry into emerging businesses which subsequently didn't work out for the entire industry, not just of Enron.

Increasingly what you saw was incremental pieces of information, whether it was the resignation of a chief executive officer, etc., that took little increments down. But the stock moving from $40 to $90 back to $40 was principally broadband bubble.

Senator BENNETT. Is there consensus on that?

Mr. FEYGIN. I think there is also, in addition to what Mr. Gross has said, which I absolutely agree with, there is also a period in this country and in investor sentiment of being extremely bullish on energy and the fact that we had a shortage, which would be a boon for companies, especially in the deregulated part of the energy business, and that also came and went in roughly the same period.

Senator BENNETT. Was the consensus in the analyst community to say "buy" during the slide from $100 to $30? Or do we know?

Mr. FEYGIN. I think your charts have shown pretty clearly, with some corrections, but there was a consensus to be recommending Enron stock throughout most of that period.

Senator BENNETT. So there was a "buy" when it was at an index price of $100, and there was a "buy" when it was at $70, and there was a "buy" when it was at $50, and there was a "buy" when it was at $40, and then we know there was a "strong buy" when it hit $30. Well, OK. I take your point about NASDAQ. I didn't participate in any of that because I decided in my own mind this is tulip time. And I don't know at what point the Dutch are going to wake up and discover that they can't get much nourishment out of eating the bulbs, and, therefore, they are not worth the total farm, which is what they went through. And we went through that with the dot-coms. And my kids would say, Should I be buying this? As I say, I said this is tulip time. And I would feel better just staying out of the market until the tulip bulbs have come back down to earth.

But as I say, I don't want to re-rake any of the other leaves. I am just interested in what might be the herd mentality of some analysts saying, well, everybody else is recommending it. That is a legitimate question. Is there that? Do you fear that, gee, all of my fellows who work for big fancy companies are saying buy this, and

if I say sell, I am going to be embarrassed? Believe me, the herd mentality rules this town. So it is not an unusual human reaction.

Does anybody have a comment on that? Or should we just go on?

Mr. FEYGIN. If I may, I think one of the premises, again, is that there is a bias to these "buy" recommendations. And to answer your question, as we now know, had somebody been clairvoyant, had we seen through some of these charades and some of these financials, nothing would have been more impactful or valuable for the analysts to have called that ahead of everyone else. I think I to some extent speak for the panel that we have very different views and arrive at our conclusions based on our own independent analysis, obviously. It happened to be that in this case we didn't have the right information.

Senator BENNETT. Well, I can understand a sense that as long as the core business is OK, you have shaken it down to $30, and $30 is the logical place for the core business to be. So at $30 you can buy it. I had a little problem with the "buy" recommendations before that. That is hindsight, and it is easy for me sitting up here to exercise hindsight. I appreciate your——

Mr. SCHILIT. While I am more of an expert on accounting tricks than on predicting stock prices, where they are going to stop dropping, very often after we have found problems at a company and the stock gets cut in half and gets cut in half again, and people would ask me, well, has this played out? What I typically tell them, a stock doesn't stop going down because it gets tired. There usually has to be some type of interventions as you were showing with your chart. Is there some change in the business dynamic? Perhaps a new chief executive comes in. Perhaps they are selling off a money-losing business. But very often, other than the bubble that we experienced, when a stock is on a long-term down draft, it usually doesn't stop going down because it gets tired. There is usually more problems that will be coming out.

Senator BENNETT. A trend, once established, continues until it is over.

Mr. SCHILIT. Absolutely.

Senator BENNETT. OK. Thank you.

Chairman LIEBERMAN. Thanks, Senator Bennett, for an interesting line of questions. We are going to have one more question each, and then we have got to go on to the second panel.

My question does relate to what Senator Bennett has just described as the herd mentality, and I am particularly thinking about what Dr. Schilit said earlier on about the hour he spent last night looking at reports at the SEC that Enron had filed. I want to show you two charts and then ask you one question about the second one.

The first is the Enron consensus recommendation versus the stock price, and the red line here is the consensus recommendation, mostly above the "buy" until real late; and, of course, the stock price is here.[1]

Chairman LIEBERMAN. But the other chart that I really want to ask you the question about is the one that I referred to earlier on,

[1] The chart entitled "Enron Consensus Recommdenation Versus Stock Price," referred to by Senator Lieberman appears in the Appendix on page 129.

and this is to speak more generally, not just of Enron but of Wall Street analysts. And here, this is the S&P 500 from January 2000 to February 2002, and you can see it is up, it is down, it is down, it is down. But the consensus recommendation on the S&P 500 is almost a straight line at "buy."

What you said, I think, Mr. Feygin, earlier, just a few moments ago about you would think that naturally an analyst would want to be the first to say that, no, this company is going down or this market is going down. Something is not working right here. To state this with the clearest edge that I can, I will quote David Becker from the SEC again, last year when he said, August 7, 2001, in a speech to the American Bar Association: "Let's be plain. Broker-dealers employ analysts because they help sell securities."

So the question is: Have analysts become more salespeople than analysts? And if not, how can we explain that only 1 percent, slightly more than 1 percent of the recommendations that analysts made over the period of time studied—that is the other, the Thomson study—were to sell and two-thirds were buy and the rest were to hold?

Mr. FEYGIN. Thank you, Mr. Chairman, for that question. First, again, I have to go back to the salespeople versus analysts issue, and especially in the context of this herd. How much impact can I have—and I believe on this panel I joined the ranks most recently. But how much of an impact can I have as an analyst coming into a herd and agreeing with the herd? I don't believe that that will give my firm any leverage in any business and will in any way promote my franchise. So I have to bring something different and something new and something that will establish my credibility and value to the investment community, the institutional investment community, my clients.

So at this point, just as a point of reference, in my space I only have two "buy" recommendations on the stocks that I cover.

Now, I do believe that the natural gas industry overall—and my ratings are relative to a benchmark. I do believe that the natural gas industry overall is in a very good position. It is a limited resource. It is domestic. It does have significant incremental drivers going forward from gas-fire generation and so on. So in my industry, I believe that there is a reasonable bias to be bullish on the performance of those companies, and yet only two are rated "buys."

Chairman LIEBERMAN. OK. Anyone else have different—obviously you understand that in the public mind, in our mind now, we are concerned that the pressure may be from the companies that you are analyzing and who are doing business with the other divisions of your firm, and that is an even greater pressure on you to recommend "buy" than the kind of pressure that you describe, which would be to give the most independent analysis you could.

Mr. Niles, I didn't get to ask you anything on the last round, so I wonder if you want to respond to that.

Mr. NILES. Well, I would just say this: I do my best to give the appropriate ratings. In fact, last year I downgraded an entire group of subsector of stocks I cover. I was actually the first one on Wall Street to do it. It was controversial. And, I endeavor to get the call right as often as I can. Right now not a lot of stocks are rated positively. There are few that are.

Chairman LIEBERMAN. So let me ask the broader question. Apart from what each of you may have done in this area, do you have any explanation for the average investor out there who goes on to the Internet, checks stocks, watches television when some of you come on, as to why only 1 percent of the recommendations during that period studied were to sell and the rest to buy? Dr. Schilit, maybe you get the last word.

Mr. SCHILIT. Again, I am not part of the Wall Street establishment, but every time I have seen an analyst go out on a limb and go against the conventional wisdom, which is you have to be very positive on the companies that you are writing about, that becomes a very controversial analyst. It could be a very good career step if they want to leave the sell side and go to work for a hedge fund. In fact, there is a fellow from Lehman Brothers who wound up with a wonderful job at a hedge fund. But if you want to move up the hierarchy in the Wall Street establishment, you don't rock the boat. And that is the reason why nobody at those firms will say there is a problem at a company.

Chairman LIEBERMAN. Time is really running. Senator Thompson.

Senator THOMPSON. Yes, Mr. Chairman, I was just wondering whether or not with regard to any of you or anyone on your research or brokerage sides of your companies, whether or not your compensation is in any way tied to the profitability of the investment banking side of your business, salaries, bonus, anything. Just yes or no, unless you care to elaborate.

Mr. FEYGIN. No.

Senator THOMPSON. It is not dependent upon the profitability of the mortgage banking side of the business in any way?

Mr. NILES. Yes, I think investment banking profitability, the profitability of the overall firm factors into my bonus, but it is a general matter.

Senator THOMPSON. Anyone else? Is that the case?

Mr. GROSS. It is the same issue.

Senator THOMPSON. Beg your pardon?

Mr. GROSS. It is the overall profitability of the firm where the ultimate pool is drawn from, but there is no direct link.

Senator THOMPSON. That the bonus is dependent upon?

Mr. GROSS. Overall profitability of the firm, yes, and the investment bank is part of our firm.

Senator THOMPSON. Is that the same thing, Mr. Feygin?

Mr. FEYGIN. That is correct.

Senator THOMPSON. All right. Thank you very much.

Chairman LIEBERMAN. Thanks, Senator Thompson. Senator Levin.

Senator LEVIN. Thank you, Mr. Chairman.

First, a comment, then my question. Mr. Launer, you said that, relative to Enron, you were on both sides of the wall relative to one deal, but that the information that you got when you were here on the investment side of the wall you did not use when you came back onto the analysis or the brokerage side of the wall.

I find that just difficult to accept, frankly—that you can put a wall in your mind between information that you get on one side and not use it when you go on the other side of the wall. I don't

think the wall can possibly mean that the same person can be on both sides of the wall. I think it has got to mean you are either on one side of the wall or the other.

It still has problems because the wall is penetratable, but in the example you give, it seems to me it defeats the purpose of the wall for one person to be on both sides of the wall structuring a deal relative to Enron and then going on the other side of the wall brokering the stock of Enron, because I think it is impossible to ignore what you have learned on the investment side of the wall.

Now, that is a comment, not a question, because I want to stick to the one-question rule. [Laughter.]

Mr. LAUNER. May I respond?

Senator LEVIN. I think in fairness, if you don't mind a response to——

Chairman LIEBERMAN. Go ahead.

Senator LEVIN. We get one response, and then I will reserve my question.

Chairman LIEBERMAN. We have walls here in the Senate that one is able to go over as well.

Senator LEVIN. We penetrate walls here.

Chairman LIEBERMAN. Do you want to respond?

Mr. LAUNER. I thought we set up a wall.

Chairman LIEBERMAN. No.

Mr. LAUNER. Senator, the circumstances I referred to and generally circumstances relative to being over the wall are quite similar. It is when you become in possession of material non-public information, and that is a decision made by many others surrounding me at the firm.

Relative to a public offering of securities, as I mentioned in response to the other question, I was over the wall for a period of time with my knowledge that that offering of securities was coming. Enron was doing an $850 million equity offering. For a period of approximately 3 weeks, that offering was pending. That offering needed to be filed for at the SEC. Then that offering needed to be announced.

During the period of the marketing of the offering, I was also over the wall because I had had the opportunity to have that material non-public information first. When the offering was completed and the stock began to trade the next morning and the syndicate relative to that offering was completed and, as it said to the SEC, the syndicate is broken, I then am not in possession of material non-public information anymore and go back to being an analyst as I had been before I was over the wall. So it is not a situation that continues beyond.

Senator LEVIN. My question does relate to IPOs, and let me ask all of you this question. In July of last year, Laura Unger, who was then the Acting Chairman of the SEC, reported on an SEC study of financial analysts that found that 16 of 57 analysts reviewed had made pre-IPO investments in a company that they later covered. Subsequently, the analysts' firms took the company public, and the analysts initiated research coverage with a buy recommendation. That is the SEC study, 16 of 57 analysts reviewed had made these pre-IPO investments in a company that they later covered.

My question is this: Have any of you personally participated in an IPO issue or bought stock in the IPO company before it went public and then recommended the stock? Putting aside your current company rules because that may have changed what you are allowed to do now, but at any time during your career as an analyst, did you recommend a stock where you had personally participated in the IPO issue or had bought stock in the IPO company before it went public? Mr. Feygin.

Mr. FEYGIN. Yes, I participated in an IPO issue, but I never bought stock in the companies that were brought public. One of the IPOs that I was involved with never came to fruition. In another I did end up recommending a buy rating.

Senator LEVIN. And are you allowed to do that under current rules?

Mr. FEYGIN. I am not allowed to own stock.

Senator LEVIN. Anymore.

Mr. FEYGIN. Anymore.

Senator LEVIN. You can still participate in the IPO?

Mr. FEYGIN. Sorry, participate in the IPO as a firm and underwriting——

Senator LEVIN. No. You personally, can you——

Mr. FEYGIN. No, absolutely not.

Senator LEVIN. You are not allowed to do that, nor have you ever done that?

Mr. GROSS. No and no.

Senator LEVIN. Mr. Launer.

Mr. LAUNER. In one instance, in the NewPower Company IPO, I was with Donaldson, Lufkin & Jenrette at the time. I referred to it in my opening statement. I invested $18,000 in NewPower prior to that IPO.

Senator LEVIN. And then recommended the stock?

Mr. LAUNER. Yes, I did.

Senator LEVIN. And can you do that now?

Mr. LAUNER. No, I cannot.

Senator LEVIN. Mr. Niles.

Mr. NILES. No.

Senator LEVIN. I don't think I have to ask you at all, Mr. Schilit. Thank you.

Chairman LIEBERMAN. Thanks, Senator Levin. Thanks to all of you. The testimony you have given has been very important to us and I believe—and I hope—very important to the investing public. Thanks very much.

Could I ask the members of the second panel to please come and stand by your seats and raise your right hand, if you would. Thanks. Do you swear that the testimony that you are about to give to this Committee today is the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. GLAUBER. I do.

Mr. BOWMAN. I do.

Mr. HILL. I do.

Mr. TORRES. I do.

Chairman LIEBERMAN. Thanks very much. Please be seated, and the record will show that each of the witnesses answered the question in the affirmative.

Let's begin with the Hon. Robert Glauber, chairman and chief executive officer of the National Association of Securities Dealers. Thanks to all of you for being here today.

TESTIMONY OF HON. ROBERT R. GLAUBER,[1] CHAIRMAN AND CHIEF EXECUTIVE OFFICER, NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Mr. GLAUBER. Thank you very much, Mr. Chairman. If I might just read a brief oral statement and have my entire comments——

Chairman LIEBERMAN. Please, let me say that the testimony that you have given, the complete testimony, will be printed in full in the record.

Mr. GLAUBER. Thank you very much. Thank you, Mr. Chairman and Members of the Committee, for the opportunity to testify.

First, let me briefly describe the NASD because who we are bears directly on both the substance of what I will be saying and on the usefulness of what we have been doing to strengthen analyst independence.

The National Association of Securities Dealers is the world's largest self-regulatory organization, or SRO. Under Federal law, every one of the roughly 5,500 brokerage firms and more than 700,000 registered representatives in the U.S. securities industry comes under our jurisdiction, which also includes every securities analyst employed by a member firm. Our mission and our mandate from Congress is clear: To bring integrity to the markets and confidence to investors.

Employing industry expertise and resources, we license and register industry participants, write rules to govern the conduct of brokerage firms, educate our members on legal and ethical standards, examine them for compliance with NASD and Federal rules, investigate infractions, and discipline those who fail to comply. We are staffed by 1,600 professional regulators and governed by a Board of governors, at least half of which are unaffiliated with the securities industry.

All of this has given NASD a special responsibility to do something about the lack of transparency and increasing conflicts of interest that have eroded public confidence in securities analysts' recommendations. And, Mr. Chairman it has given us the means to do something about it as well, for the NASD is equipped to provide a layer of real private sector regulation between the industry and the SEC.

In July of last year, well before Enron collapsed, NASD issued a proposed new rule: To significantly expand analyst disclosure obligations. And 3 weeks ago, culminating a process several months in the making, I joined several of your congressional colleagues and SEC Chairman Pitt in announcing far-ranging proposed new rules to govern the overall responsibilities of securities analysts when they recommend securities.

These tough, comprehensive rules represent a big step forward, I think, in investor protection. They will provide disclosure of much more information about analysts' potential conflicts of interest as

[1] The prepared statement of Mr. Glauber with an atachment appears in the Appendix on page 90.

when analysts or their brokerage firms own stock in the company being recommended or their brokerage firm receives investment banking revenue from the company. And they will prohibit certain kinds of behavior as simply being too riddle with such conflicts, such as analysts' receiving pre-IPO stock—the issue just raised a moment ago—or trading against their recommendations or promising favorable research to get underwriting business. The bottom line is not only enhanced investor protection, but enhanced analyst independence.

Now, will our analyst rules themselves prevent another future Enron? I am not going to sit before you and make that claim, for Enron was a multifaceted disaster, involving corporate governance that didn't govern and accounting that was unaccountable, as well as analysts who were far from analytical in ferreting out the truth. I think there is no doubt that analysts dropped the ball with Enron.

But I will say this: Under our new rules, the perverse incentives that may have causes analysts not to want to know or acknowledge the truth about Enron, because, say, their investment banks had lucrative client relationships with the company, those kinds of incentives will be reduced in part because sunlight is the most effective disinfectant. And if there is any remaining reason to wonder whether an analyst has a conflict, he will have to 'fess up to it and disclose why he has that conflict to the investing public.

Let me make one final point which I believe is critical. These new rules are a matter of private sector self-regulation, not self-regulation in name but self-regulation in fact. The proposed rules were hammered out by the industry's foremost SROs, acting under the strong oversight of Congress and the clear vision of SEC Chairman Pitt. They will strengthen the industry's own business practices and ethical standards, but as enforceable regulatory rules, not trade association best practices.

The new rules' impact is already being felt as some firms hasten to adopt tougher standards. They will be enforced by the NASD with a full range of disciplinary actions, which this year alone have included multi-million-dollar fines and expulsions from the industry. And as detailed in my written testimony, NASD has not hesitated in the past to use its existing enforcement authority against analysts whose conduct has undermined market integrity.

Simply put, Mr. Chairman, these proposed rules will have teeth because self-regulation in the securities industry does have teeth. It is what Congress wisely intended more than 60 years ago, and it is what we continue to deliver with these rules today. Thank you.

Chairman LIEBERMAN. Thank you, Mr. Glauber. I look forward to questioning you on some of those recommendations, which I appreciate.

Next we have Thomas Bowman, president and chief executive officer of the Association for Investment Management and Research. Thank you for being here.

TESTIMONY OF THOMAS A. BOWMAN, CFA,[1] PRESIDENT AND CHIEF EXECUTIVE OFFICER, ASSOCIATION FOR INVESTMENT MANAGEMENT AND RESEARCH

Mr. BOWMAN. Good afternoon. My name is Thomas A. Bowman. I am the president and CEO of the Association for Investment Management and Research and a holder of the Chartered Financial Analyst designation.

Thank you, Chairman Lieberman and other Members of the Committee, for the opportunity to speak on behalf of the 150,000 investment professionals worldwide who are AIMR members or candidates for the CFA designation.

Allegations that analysts lack independence are particularly important to us because they cut to the heart of our core ethical principles and taint a proud profession and its practitioners.

Most AIMR members are not subject to the majority of conflicts of interest under discussion today, but all of them are disadvantaged by companies' exploitation of financial accounting standards and the important principles of transparency and disclosure.

Enron's disgrace must primarily be attributed to Enron's management, who are alleged to have played the most egregious games with financial reporting rules and misled many of even the most sophisticated investors.

We are convinced that most companies play such games to a greater or lesser degree. And until financial reporting standards are developed and enforced for the benefit of investors rather than the benefit of issuers, investors will be disadvantaged. Until auditors renounce their advocacy of corporate interests, regain independence, and become vigilant watchdogs for fair disclosure, investors will be disadvantaged. Until corporate managements put shareholder interests first and stop retaliating against analysts for unpopular opinions, investors will be disadvantaged. Until Wall Street firms recognize that it is in their best interest to reward high-quality, independent research, investors will be disadvantaged. And, finally, until all Wall Street analysts adhere tenaciously to a code of ethics and standards of professional conduct that place their investing client's interest before their own and their firm's and require research objectivity and reasonable basis for recommendations, investors will be disadvantaged.

When Wall Street analysts are assigned companies whose public disclosures are opaque and for whom transparency is a dirty word, research reports and recommendations are made with great uncertainty. There is no obvious point where lack of transparency and uncertainty about a particular company's prospects should result in a no recommendation or a sell. Warren Buffett, one of the most respected investors in the world, advises that if you don't understand the company, don't buy it.

What is obvious is that even with the full disclosure financial analysis is more art than science. No analyst has a magic formula that accurately and consistently predicts stock prices. But their firms must reward them for high-quality research and success of their recommendations. That said, are Wall Street analysts sometimes pressured to be positive? Yes, but by many forces and not all

[1] The prepared statement of Mr. Bowman appears in the Appendix on page 100.

internal to their firms. These forces create an environment replete with conflicts of interest, one that undermines the ethical principles upon which AIMR and the CFA program are based, and we condemn all who foster and sustain it.

These pressures to be positive are intensified in a market that emphasizes short-term performance, one where investment recommendations are now prime-time news, often in 30-second sound bites, and where the serious business of investing becomes a sport like horseracing where investors are always looking for the hot tip.

But we don't dispute that the collaboration between research and investment banking is fraught with ethical conflicts. But it is critical to a firm's due diligence in evaluating investment banking clients under the current system.

To effectively manage these conflicts, we believe that firms must first foster a corporate culture that protects analysts from undue pressure from issuers or others and constantly communicate publicly the measures in place to ensure that this happens;

Second, have reporting structures that prevent investment banking from approving, modifying, or rejecting reports or recommendations;

Third, have clear policies for analysts' personal investment and trading to ensure that investors' interests come first;

Fourth, not link analyst independence directly to the success of the investment banking activities; and

Fifth, disclose conflicts in reports and media appearances that are prominent, specific, plain English, and not marginal or boilerplate.

At a minimum, analysts should disclose their personal investments, the compensation to their firm from the subject company, and material gifts received from the subject company.

Finally, security ratings systems must be concise, clear, and easily understood by the average investor. In addition to the recommendation itself, ratings should include a risk measure and a time horizon to provide investors better information to judge the suitability of the investment to their own unique circumstances and constraints.

In closing, I would like to impress upon the Committee that we appreciate the seriousness of the problems facing Wall Street analysts but also their complexity. A precipitous solution that addresses only one aspect of the problem is not the answer.

I will be happy to answer any questions later. Thank you very much.

Chairman LIEBERMAN. Thank you, Mr. Bowman, for a very strong statement. You are absolutely right, and just to make clear what I said at the outset, the analysts weren't the only watchdogs that didn't bark here. There were a lot of others who let the investing public down. Also, I think you have made some excellent recommendations, which I look forward to talking to you about in the question and answer period.

The next witness is Charles Hill, who is the director of financial research at Thomson Financial/First Call, which is one of the groups that we have cited with appreciation here today. Thanks, Mr. Hill.

TESTIMONY OF CHARLES L. HILL, CFA,[1] DIRECTOR OF RESEARCH, THOMSON FINANCIAL/FIRST CALL

Mr. HILL. Thank you. Chairman Lieberman, Ranking Member Thompson, and Members of the Governmental Affairs Committee, I am Charles L. Hill, director of research at Thomson/First Call. I appreciate the opportunity to testify in front of this Committee today. I believe the issue of analyst conflicts is an important issue that needs to be addressed. It is one of several investment issues that needed to be addressed before the Enron debacle, and now even more so. It is important not only to the future health of the investment community, but it is of greater importance to the public's perception of and confidence in the overall capitalist system.

Given the importance of these hearings, I appreciate the attendance at this hearing by the two Committee members that are still here today. Thank you.

The most obvious symptom of the analyst conflict problem is the positive bias of analyst recommendations in general, as well as the extreme positive bias of their recommendations on Enron in particular.

For at least the last several years, roughly one-third of all broker analyst recommendations were strong buys—or whatever their equivalent terminology was for the top category; similarly, one-third were buys and one-third were holds. The total of both sells and strong sells was always less than 2 percent. This is still true today despite the severe criticism analyst recommendations have been increasingly subject to in recent months. It is interesting that the analyst recommendations were at their most positive levels at the peak of the market in the spring of 2000.

That means that if an individual investor—oops, I have left something out.

The above normal positive bias persisted until early 2001, even though the stock market indices were in decline from the spring 2000 highs. The shift that did occur was fairly minimal, roughly 6 percentage points shifted from strong buy to buy, and above 5 percent from buy to hold, and about 1 percent from hold to sell.

In the specific case of Enron, the analysts were in a different position. Enron had morphed into what was essentially a hedge fund. As a result there was very little transparency in recent years as to where earnings were coming from. Analysts were virtually limited to Enron's historical earnings record and to the company's guidance for future earnings.

Therefore, it was not surprising that on the eve of Enron's third quarter 2001 earnings report, 13 broker analysts had a strong buy—or their equivalent terminology—three had a buy, and none had a hold, sell, or strong sell.

However, despite a number of red flags from October 16, 2001 on, the analysts dallied in lowering or discontinuing their recommendations in the face of increasing risk. By November 12, almost a month after Enron had announced a $1.2 billion write-off that Ken Lay could not explain on a conference call, almost a month after the *Wall Street Journal* reported Enron executives

[1] The prepared statement of Mr. Hill appears in the Appendix on page 109.

stood to make millions from Enron partnerships, 3 weeks after the CFO was fired, 2 weeks after Enron announced it was being investigated by the SEC, and 4 days after Enron announced that it had overstated 4 years of earnings by $600 million—after all these red flags, there were still eight analysts with a strong buy, three with a buy, one with a hold, and one with a strong sell. At that point, none had dropped their recommendations.

The new proposals from NASD go a long way toward addressing some aspects of the bias problems. They provide for better disclosure of the firm's investment banking relationships with the company, and of the firm's and the analyst's holdings. They provide for some standardization of recommendations across the brokerage industry. The requirement for analyst reports to show the recommendation distribution of all the firm's recommendations hopefully will lead to less of a positive bias in analyst recommendations.

Unfortunately, the new NASD rules do not sufficiently address the key issue of analyst compensation. It is the old story: Follow the money. Until the so-called Chinese wall between research and investment banking is restored at the brokerage houses, there will continue to be a problem with analyst objectivity.

In the interest of full disclosure, before coming to Thomson/First Call, I spent 4 years as a buy-side analyst and 16 years—or 18 years as a sell-side analyst. As a sell-side analyst, I did put sells—and not holds that meant sell—on investment clients, investment banking clients. But my monetary incentives in those days were heavily tied to doing objective, incisive research rather than what I did for investment banking. We need to try to return to those days of yesteryear.

Also, in the interest of full disclosure and in view of Mr. Skilling's being pilloried in yesterday's Senate hearing for being a Harvard Business School MBA, I also have to admit to being a Harvard MBA.

Chairman LIEBERMAN. Now you are in trouble. [Laughter.]

Mr. HILL. Harvard's motto is "Veritas"—truth. Hopefully I can do a better job of upholding that motto than Mr. Skilling did.

On the assumption that all of you have heard my earlier testimony in front of the House subcommittees, I have purposely kept my testimony short, although I guess I did run over slightly, so we can focus on the questions. I look forward to responding to those questions.

Chairman LIEBERMAN. Thanks, Mr. Hill. Thanks for all you have done. I don't know whether you will take this as a compliment from me as a Yale graduate, but I think you have not only upheld the "veritas," you have upheld the "lux" in the Yale motto. Light and truth. So I thank you.

Next, and last, is Frank Torres, legislative counsel of the Consumers Union. Thanks, Mr. Torres, for being here. Thanks for your patience.

TESTIMONY OF FRANK TORRES,[1] LEGISLATIVE COUNSEL, CONSUMERS UNION

Mr. TORRES. Mr. Chairman, Senator Levin, thank you for the invitation to be here today. We are here because the marketplace has failed. Market forces failed to discipline market participants. The watchdogs didn't just fail to bark; they let in the crooks and led them to the cash. And there is enough blame to go around. We are here today talking about the analysts, but we could be talking about the auditors or even the regulators and their failure to fully oversee the industry.

No one seems to be able to answer confidently, I don't think, given the testimony here today, that there are not more Enrons out there. In the end, that uncertainty is a problem not just for investors, institutional and individual, but also for the marketplace and the economy as a whole.

Today over half of American families invest, and I think we as a society encourage that. Companies benefit, the economy benefits. And it is a good thing. And they rely on the expertise of the analysts to digest raw data, to talk to insiders, to put together the recommendations. Analysts' research is likely to be the most detailed information some investors have. Unfortunately, too many securities analysts have become cheerleaders for the companies their firms are doing business with. Investors don't need more cheerleaders. They need critical evaluations and analysis.

It is apparent that the analysts aren't asking the tough questions. They believed the Enron sales pitch and got duped just like the Enron employees who were told by Ken Lay and others to buy and to hold on to their stock. But aren't analysts supposed to be the experts? We expect them to be more skeptical of sell jobs by company executives.

We are not saying that Congress needs to protect against bad advice. But how can investors have confidence in such an environment? And what value, then, are analysts recommendations? And how is this any different from the SEC going after the New Jersey teenager who was offering stock tips over the Internet? In fact, he might have been better off because he wasn't privy to all the inside information that apparently was leading all the analysts astray.

Now, no one has denied the pressures created by the conflicts in this industry. In fact, firms and analysts sometimes get punished for negative reports about companies, and there is enough evidence of that. Expert analysts are expected or should be expected to overcome those pressures.

This situation is amazing. No one seems to know anything about what these companies do or how things operate. Analysts point to the auditors. The auditors say Enron wasn't forthcoming. I am waiting for Enron to blame the investors for investing in their own company's stock. Where is this going to end? Who is going to be accountable and who is going to be the watchdog for investors?

We are pleased with the NASD proposed rule and will work on submitting comments to that. But the rule has some shortcomings and has some very good things.

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[1] The prepared statement of Mr. Torres with an attachment appears in the Appendix on page 111.

The rule seems to be focused on disclosure. However, no disclosure will create a Chinese wall big enough to prevent some of these conflicts from occurring in the first place.

Analyst ownership of stock and the restrictions on that are a good step, but as was pointed out by others here on this panel, the analysts know where their paycheck is coming from. Just because you are prohibiting the sale of stock and restricting some things around the IPO issuance isn't going to prevent the conflicts. And we heard from the earlier panel that profitability of the company plays a role in that.

When you have got companies—and somewhere on the earlier panel that I won't mention—having multi-hundreds of millions of dollars of investments in companies like Enron, how can the analyst not recognize that and not work to protect that in some way, if not directly then indirectly? If not intentionally, how can you not picture that in the back of their minds as influencing their decisions?

We have some recommendations on the NASD proposal that I would like to go over now very briefly. One is: Why don't we give a boost to the independent analyst? Why not create some sort of certification system for them so that investors reading a report from an independent analyst or listening to one on TV would know right away that that analyst is conflict-free? Investors could choose to disregard advice by analysts without this independent designation.

Second, why don't we require analysts and firms to publish their research quality ratings, a step that would likely encourage them to produce more reliable recommendations? Better yet, develop standardized measurements of the success of analyst recommendations, publish the good ones, let people know who are the bad ones are, too. I think the NASD rules get us halfway there. We need to take the next step.

Disclosing conflicts is important, but it won't get rid of the underlying bias. They are important, though. They are important, but we think that they should not just simply say that there are conflicts that exist, but extend that to include both the nature and extent of the conflicts. How much money does a firm have invested in a particular company that they are developing a report on?

Finally, uniform language should be developed that all firms should be required to use about their recommendations. It is kind of weird English that "hold" really means "sell." What is up with that? A lot of investors I think are confused about this. It is great for the insiders who know what is going on, but the analysts knew full well that people will make—investors were making decisions based upon those types of advice.

One firm has proposed using the terms "overweight" and "underweight" to describe those recommendations. While this sounds like more appropriate for junk food labels, I think that is a promising start.

And, finally, I would like to commend this Committee for taking a look beyond some of the villains in the company themselves, and I think it is important to take a look at some of those players, but in looking beyond that and in trying to get to some ideas that will help the investors and the consumers in this country.

Thank you very much.

Chairman LIEBERMAN. Thanks, Mr. Torres, for very constructive testimony.

It is true that this Committee is trying to more broadly focus on the lessons we learned from Enron, not just from within Enron, and in this case we were drawn to the analysts and the fact, as you have all indicated, that they continued to recommend buying Enron stock long after, it seems to the casual observer, there should have been reason to do so, and then that led to the larger concern about the independence of analysts, which I want to get to in a moment.

Senator Levin has to leave in a few moments, and I am going to yield to him to ask the first questions, and then I will wrap up.

Senator LEVIN. Thank you so much, Mr. Chairman. I appreciate your yielding. As always, you are courteous, and it is most appreciated. Three questions of Mr. Bowman and that is it.

One, you indicate in your prepared testimony—and you also said something about this in your oral testimony—that firms should implement compensation arrangements that do not link analyst compensation directly to their work on investment banking assignments or the success of the investment banking activities. Then under that formulation, they could continue to receive compensation based on the overall firm—the overall well-being of the firm or how well the firm did in a particular year. Would you leave that open?

Mr. BOWMAN. Yes, that is being left open as it currently exists, Senator. We have had a research objectivity standards task force in place now for about 18 months, and as you can imagine, this has been the subject of great debate within that council.

Certainly, I think Senator Lieberman is the one that referred to it, the implicit risk that is inherent in any situation where, directly or indirectly, analyst compensation is tied to success of the overall firm, which means primarily in many cases the investment banking side. And certainly, the implicit risk would, in effect, go away with regard to that aspect of it if analyst compensation had nothing to do with the success of the investment banking side. I don't think anybody could argue with that point.

The issue, however, is that once—what seems like a very reasonable and simplistic change could have implications that really need to be discussed and debated.

For example—you could argue both sides of this, but, for example, Wall Street firms will make the claim that they need to be able to attract the top-quality analysts to their firms, and in order to do that, they have got to pay for it. And in order for them to pay for it, they have got to go to the place where most of the money is made, and that is investment banking. And their bonuses are heavily dependent upon the investment banking success.

Wall Street firms will then tell you that if they can't do that, they are not going to be able to afford these high-quality analysts because they will be attracted to other firms——

Senator LEVIN. Well, the other firms are bound by the same rules.

Mr. BOWMAN. Well, no, other non-sell-side firms who don't have this conflict.

Senator LEVIN. Which may not be all bad.

Mr. BOWMAN. And their argument is—I am the messenger here, but their argument is that in the end, therefore, investors who are relying on Wall Street research will be hurt.

I think, frankly, Senator, speaking as an individual investment person and one who grew up on the buy side, it would certainly be more appropriate if they could find—if the sell-side group could find some way to compensate their analysts in a way that would attract and keep them and keep them out of this conflict that we are all concerned about, it would be all to the good.

Mr. HILL. Senator, could I respond to that as well?

Senator LEVIN. Sure.

Mr. HILL. As I mentioned, I was on the sell side for 18 years. In those days, we got paid for doing research. The way the system worked was that every quarter the institutions sent a letter in to the firms saying we did X amount of commission business with your firm in return for services provided by the following analysts. If my name was on those lists more than anybody else, I got the biggest piece of the Research Department bonus pool. In those days, there was a meaningful Research Department bonus pool because the commissions were more meaningful. Since then, they have brought them down to almost nothing. The institutions need to look in the mirror. They are complaining that their research isn't as good a quality or as objective as it used to be. It is the old story: You get what you pay for. It is the same with the individual investors that are paying almost nothing today in commissions.

We have to do something about changing the way the brokerage firms can get compensated for research. We probably can't put the fixed commission rate genie back in the bottle. Whether the institutions would be willing to pay hard dollars for research instead of just commissions remains to be seen. We know that that is anathema to institutions. They try to soft-dollar everything. If they could soft-dollar the janitor service, they would.

Senator LEVIN. Thank you. The second question I am just going to put in for the record, if, Mr. Glauber, both you and Mr. Bowman would answer this for the record.Tell us what the current rules are relative to gifts from companies that are being analyzed to those analysts—just for the record, what current rules exist? Mr. Bowman, you made reference to the need for disclosure of material gifts received by the analysts from either the subject company or the Wall Street firms' investment banking department. If you would for our record give us the detail of what you are recommending on that, I would appreciate it.[1]

Senator LEVIN. This would be the last question, and it would be for Mr. Bowman. Your association has surveyed your members relative to stock options and whether they ought to be reported or not. And here is what a release of yours says back in November 2001: "More than 80 percent of the financial analysts and portfolio managers around the world who responded to a survey believe that any stock options granted to employees are compensation and should be recognized as an expense in the income statements of the compa-

[1] The information requested entitled "AIMR Standards of Professional Conduct pertaining to Gifts," from Mr. Bowman appears in the Appendix on page 131.

nies that grant them." As you know, that is a position that I have espoused personally, but can you give us——

Chairman LIEBERMAN. Your time is up, Senator Levin.

Senator LEVIN. Right. [Laughter.]

Taking advantage of your good nature——

Chairman LIEBERMAN. Go right ahead.

Senator LEVIN. Can you tell us, if you would, why you believe that such a large percentage of your members take that position?

Mr. BOWMAN. With regard to gifts, Senator——

Senator LEVIN. No, not gifts. Skip the gifts. Give us that for the record. Just respond to the press release saying that 80 percent of financial analysts and portfolio managers believe stock options should be expensed.

Mr. BOWMAN. Well, for many, many years, AIMR has taken the position that stock options should indeed be reflected on the income statement, the balance sheet. And I think the reason why 80 percent of our members have indicated that they believe that should be the case is that they tell us they believe that it is a form of compensation and, therefore, an expense to the firm and, therefore, should, like any other expense, be included on the income statement. That is the reason that they give us, and, frankly, we have made a very strong position that that should be the case.

Senator LEVIN. Would you submit for the record the way the question was asked that was responded to by the 80 percent? Could you give us the questionnaire's question? For the record, just submit it later.[2]

Mr. BOWMAN. Let's see——

Senator LEVIN. If you could give it to us after the hearing is over, that would be good.

Chairman LIEBERMAN. You don't have to do that now, Mr. Bowman.

Senator LEVIN. I am trying to save time.

Chairman LIEBERMAN. Thanks, Senator Levin. I have a feeling this topic will come up on other occasions, in other places, I am sure. [Laughter.]

Senator LEVIN. Thank you.

Chairman LIEBERMAN. Not at all.

Let me ask a final series of questions. First, Mr. Hill, the research that Mr. Hill's firm did on the recommendations of analysts over a period of time was, as I mentioned in my opening statement, one of the more stunning facts that I learned in preparing for this hearing, this business that less than 2 percent of the recommendations were to sell, when the market was going up and down, and even as the S&P 500, as our chart showed, was going down.

I just want to ask—and so that raises in me and others this concern, suspicion, conclusion in some that there can't be any rational basis for that, it has to be that for one reason or another, either at one extreme that the analysts have become salespeople, or in another sense that they have just gotten so swept off their feet by the companies they are analyzing that they are on longer independent. Each of you has thought about this and worked in this area to one

[2] The information requested entitled "Association for Investment Management and Research (AIMR) Survey on Accounting for Stock Options," from Mr. Bowman appears in the Appendix on page 132.

degree or another. Is there any other explanation for why, as the S&P 500 went up, and particularly went down, the consensus recommendation continued to be buy, buy, buy? Mr. Glauber.?

Mr. GLAUBER. Sure. I think the points you have made are clearly part of the answer to the puzzle. I think investors also are looking to invest, and so they are looking for companies to buy. Most investors want to buy stocks rather than sell them short. So I suppose there is going to be some kind of bias.

I think one good way to deal with this—and, clearly, it is a form of grade inflation or bias—is to give investors information. One of our rules that we have proposed is that each firm publish the distribution of buy, hold, sell recommendations——

Chairman LIEBERMAN. Yes, that was, I thought, a very important recommendation because that information itself may have an effect on the analysts. Certainly it will have an effect on the consumers of their analysis.

Mr. GLAUBER. I think so. And, of course, related to that is a rule that is in our proposal to require a price chart to accompany each research report in which the price of the stock is shown together with the analyst's "buy" and "sell" recommendations during that historical period. Again, I think it is going to alert investors to just how good—Mr. Torres said he would like some more information on just how good the analyst's record is.

Chairman LIEBERMAN. Right.

Mr. GLAUBER. That is going to be that kind of information.

Chairman LIEBERMAN. Mr. Bowman.

Mr. BOWMAN. Yes, Senator, I spent 17 years as an analyst and a portfolio manager before joining AIMR, and I can give you a little personal perspective about some other forces that might be in place here besides the conflict issue that we have talked about earlier. That is, when an analyst, especially in a smaller firm, is assigned two or three different industries to follow, that individual, if he were to follow or she were to follow every publicly trade company in each of those industries, would literally be responsible for following and giving due diligence to hundreds of companies, which is just—there is not enough hours in the day or the week or the month in order to do that.

So when I was practicing, in my firm what we did was we had certain screens, basic criteria and characteristics that we wanted to look for in a company before we even look at it and do research on it. And a lot of the companies fell out of those screens because they didn't meet the minimum criteria that we had in place to look at the company.

So right away the analysts are looking at a biased group of stocks before they begin research, so what would traditionally have been sells, had they been covering them all, are filtered out.

So I think that is one of the things that is going, that since analysts can't follow every company there is to follow, some screens, screen out some of the inferior companies, and so they end up following an upwardly biased select group of companies.

So I am not really surprised that there are significantly more buys than sells out there, just because an analyst can't cover every stock in the universe. I think that is one thing.

And I think the other thing—and you called it the ambassador effect earlier, of who is the ambassador advocating, and I believe Senator Bennett mentioned something about the Stockholm effect, which has to do with not seeing—you get so close to something that you can't see the forest for the trees. I think there is some of that that goes on, too. I think that analysts can get very close to their companies, fall in love with the companies, but a very important point is you can be in love with a company but not necessarily be in love with the stock because the stock fluctuates in price. So what might be a wonderful company, if it is too rich and the PE is too high or whatever else you are looking at, you shouldn't be in love with the stock as well.

So I think those are a couple of things——

Chairman LIEBERMAN. I hear you. We talked about this as we were preparing for the hearing, about the first point you made and the filtering-out effect in terms of how many stocks are evaluated. But I do think that the chart with the straight red line at "buy" was a consensus of the S&P 500. So I think we were measuring apples and apples there.

Mr. HILL. That is the average of the consensus recommendation for each of the 500 companies.

Chairman LIEBERMAN. Right. I don't know whether either of you want to add anything, because you——

Mr. HILL. I do.

Chairman LIEBERMAN. Go ahead.

Mr. HILL. I agree on this filtering-out process, but let's put it into perspective. If you go back to the peak of the market in the spring of 2001—or spring of 2000, I guess it was, the ratio of buys and strong buys to sells and strong sells was over 100 to 1. Now, filtering out doesn't get you to that.

Chairman LIEBERMAN. I agree.

Mr. HILL. The other thing, too, is that the analysts are only recommending buy, where is the money coming from to buy those stocks? You have got to sell something. So, if they want to generate business, they ought to be putting some sells out there, too. But I think it is part of the Lake Wobegon problem. All the children are above average.

Mr. TORRES. Senator, we would attribute the problem directly to some of the conflicts of interest that I think will only grow worse in the future as the Gramm-Leach-Bliley act comes into play, where you have bigger consolidation in the financial services industry. The thing that I am surprised at, if the analyst doesn't have enough resources to cover all that they are supposed to cover, why are the buy recommendations left hanging out there? Why isn't there another designation, need to be updated, need more information, instead of having a recommendation out there that you might not be solid on?

Chairman LIEBERMAN. Mr. Bowman, I was going to ask you, you made a very interesting point, which I guess others may have made along the way, though not today, that part of what we are dealing with at Enron is a good system gone to extreme, gone bad, and the pressure of companies to continue to generate more quarterly earnings, leading people to make—leading what I might say are good people to make bad decisions, leading people to lose sight

of their ethical bearing. And you make a proposal about attaching ethical standards, if I understand, to either CFA certification or maybe to the conduct of analysts generally. And, you do wonder whether if they were under some explicit series of standards personally—I know the analysts now, some of them I guess are certified, but a lot of them are accountable through their companies that come under the NASD.

If they had a clearly articulated standard that their responsibility, like a fiduciary, was to serve their clientele, the public, that they were to be purely independent, and you wonder at some point whether if any of them were under pressure. There has been testimony here on the Hill that Mr. Lay and Mr. Skilling were pressuring analysts, or perhaps even under pressure from the investment banking side of the business, they could say at those points, hey, wait a second, pal, I would like to help you but I am about to lose my certificate if I do this.

Is this kind of ethical standard that Mr. Bowman proposes capable of being administered and enforced?

Mr. GLAUBER. Well, it is an interesting idea. We think of our rules as embodying a set of principles of proper behavior, if you want to call it ethical standards. And we think the articulation of these specific rules is the enforcement of those standards. So I agree with you that in the end, so much of what we are discussing here is not an issue of fraud. It is not an issue of violation of the 1933 or 1934 act. It is an issue of proper behavior for professionals.

Chairman LIEBERMAN. Right.

Mr. GLAUBER. We think that can be embodied in private sector regulatory rules, like our rules, which in essence set what you would call an ethical standard. Your idea of going to an explicit ethical standard is an interesting one, I think.

Chairman LIEBERMAN. Mr. Bowman, did you want to add something?

Mr. BOWMAN. Yes, I do, Senator. We as chartered financial analysts and members of AIMR, some 55,000 of us, as a condition for retaining the right to use that designation, have got to annually sign a statement that says we comply with our code and our standards. And AIMR regulates its members. And if there are violation, AIMR has the processes to investigate them, and if those violations are deemed to be egregious enough, we have every right to basically prevent that person from continuing to use the CFA designation.

And all of these individual codes of ethics and standards of professional conduct embody everything we have talked about here today: Reasonableness of recommendation, objectivity, everything.

Chairman LIEBERMAN. Am I right—excuse me a second—that a lot of the Wall Street analysts are not chartered?

Mr. BOWMAN. They are not. A very small percentage of Wall Street analysts are chartered financial analysts.

Chairman LIEBERMAN. Is one possibility that we require or that NASD require that they be chartered?

Mr. BOWMAN. I think that is a definite possibility, and we would be more than happy to work with you on that.

Mr. GLAUBER. The point I would make is that the standards embodied in our rules are imposed upon all security analysts. You

cannot be a member of a broker-dealer if you don't meet our rules, because violations of them, we toss you out.

Chairman LIEBERMAN. Mr. Hill.

Mr. HILL. I agree that I think at least one of the analysts covering a company should be a CFA. I am a CFA even though my sign doesn't say it, like Mr. Bowman's.

Chairman LIEBERMAN. It is implicit.

Mr. HILL. But in my career as a sell-side analyst, I was a CFA during that time.

It is interesting, if we bring that down to Enron, the analysts that moved soonest and most aggressively in lowering their recommendations and actually going to strong sells, I mean, first to a hold and then to a strong sell, one was a CFA, the other was a CFA candidate. And out of the 16 analysts that covered Enron, only four were CFAs, plus the one that was a candidate in the midst of taking the exams.

Chairman LIEBERMAN. Very interesting.

Let me ask a final question. You have been very generous with your time. Senator Torricelli raised a good point earlier, and it is the point that all of us are considering, which is: How can we act on the lessons we have learned from the Enron scandal and collapse? And how can we be constructive and restore confidence in the capital markets and, particularly, to give some greater confidence to these millions of middle-class families that have come into the market in the last two decades? I would like to think that the hearings that are being held on Capitol Hill and, I must say, the investigative work being done by journalists, people in the media, has given some warning and information, if you will to the investing public about where to put their confidence and where not to put their confidence. But now we also have to try to restore confidence. Some of it will come by natural forces of the market. There is a way in which I think Enron's experience—perhaps even the analysts who were here today and others analysts may not want to be called before a congressional committee. Certainly Enron and executives of other companies presumably don't want to be the targets of investigative journalists, etc.

So there is a way in which the process going on now will have some effect, at least for a period of time, but then the question is what follows that beyond the natural forces of the marketplace. And the question is some things can be done within industry and professional groups to raise standards, as we have talked about. The question for us ultimately is: Is there any area—I know there are some areas where we should legislate in response to Enron. But in the specific case of the analysts, is there a proper place that any of you see for legislation?

Mr. GLAUBER. Mr. Chairman, I think that the question of getting the balance right between legislation and SEC rulemaking and self-regulatory rulemaking is a very difficult one. The one place that you have discussed frequently during these hearings today is the question of structural separation between investment banking and security research.

I would prefer to see if we can't make that work through private sector and SEC rulemaking rather than going to that kind of struc-

tural separation because I think it runs a risk of seriously reducing the amount of information available to investors.

Chairman LIEBERMAN. But you would keep the option open?

Mr. GLAUBER. I surely would keep the option open. I think it is one you should discuss. It is a completely debatable issue. In my view, I think we can do it—that is, we, the SEC, the SROs can do it—through rulemaking, but I think the issue has to be kept on the table.

Chairman LIEBERMAN. Mr. Bowman, any place for lawmaking here?

Mr. BOWMAN. Well, as I said during my comments, Senator—and I would agree with Mr. Glauber—we would very much prefer to see the industry itself resolve these problems. It has been our experience, anyway, through establishing the CFA program and others, setting other standards, that if it comes from the business, it is probably more apt to be embraced and obeyed than if it comes from outside sources.

But certainly I would agree that in the absence of the industry being able to handle this on their own, it should be kept on the table.

I think that one—there are two things, I think, that legislation cannot do, but I think we all really need to be aware of it in terms of protecting the public. The first one is that the FASB and the SEC have got to be allowed to act independently and set rules on behalf of investors rather than on behalf of issuers of financial statements. There has been way too much money being spent by the issuers of financial statements to lobby against accounting rules and accounting proposals that will actually favor investors but will cause companies, or whatever, to not be able to manage their earnings as effectively. And I think that the SEC and the FASB have got to be given the independence to do that, and the money, frankly.

The other thing is that individual investors—we are in a very early stage of individual investors becoming involved in the stock market. Before 1990—I can't remember what the percentages are, but the percentage of individual investors who had investment in the stock market was infinitely smaller than it is today. And I think individual investors are still going through an educational process here. What is investment? And what am I listening to on the TV?

And I think that we need to be able to educate investors to understand that this is serious business. They are not going to treat their own medical problems without going to a doctor, and they are not going to represent themselves in a court of law without hiring an attorney. And I would like to see some of the same mentality be there on the part of individual investors that this is something that they can't do alone and they should rely on professional help to save their precious retirement accounts and their assets.

Chairman LIEBERMAN. And, of course, that is the problem. Right now there is a lack of confidence in the professional help, and that is what we have got to restore. Mr. Hill.

Mr. HILL. I strongly echo Mr. Bowman's comments about the FASB and the SEC. As a matter of fact I spent all day yesterday at FASB as part of a financial performance reporting task force

where hopefully we will make some changes that will alleviate some of these problems.

But it is the money, again. FASB needs more money and needs to be treated independently, as was mentioned. The SEC, I think Arthur Levitt as chairman, set a new standard there. Hopefully that tradition can be carried on. But, again, they are understaffed because of not getting enough money.

Chairman LIEBERMAN. But right now you wouldn't propose any legislating regarding analysts?

Mr. HILL. I think we have to move carefully there. Like the others, I wouldn't rule it out. As I said before, you have got to follow the money, and until we do something about changing analyst compensation, the problem is going to continue because, either consciously or subconsciously, it is likely to creep into the analyst's thinking. So if there was a way that you could solve the problem of the firms getting paid again for research so we could get it back to where it was, that would be helpful.

I don't have a good answer myself, but that is the issue.

Chairman LIEBERMAN. It is a pretty good one. Mr. Torres.

Mr. TORRES. Mr. Chairman, I think there is a very appropriate role for Congress to make sure that there is accountability in this industry and that there is an appropriate watchdog group set up to oversee it.

I would go back to the lessons that we learned when Arthur Levitt was chairman of the SEC. He tried to push for strong rules on the accounting industry, and those got pushed back. When Chairman Pitt took over, there was talk that he was going to dismantle the fair disclosure rules that were passed. And, of course, in light of Enron, all that has changed.

Congress needs to—should step in to ensure that the right rules are put into place and give some direction to both the industry and the regulators on how to handle this. The best way to restore the confidence in the marketplace for consumers and investors is for Congress to take a leading role here.

Chairman LIEBERMAN. I thank all of you for your time. You have made a substantial contribution to this Committee's effort to constructively respond to the Enron collapse and scandal.

I am going to leave the record of the hearing open for an additional 2 weeks, if any of you or the other witnesses have any additional testimony you would like to submit, and to allow my colleagues on the Committee to submit questions to you in writing. But for now I thank you, and the hearing is adjourned.

[Whereupon, at 1:22 p.m., the Committee was adjourned.]

APPENDIX

STATEMENT OF ANATOL FEYGIN ON BEHALF OF JPMORGAN

SUBMITTED TO

THE COMMITTEE ON GOVERNMENTAL AFFAIRS

Mr. Chairman and Members of the Committee, my name is Anatol Feygin. I am a Senior Analyst and Vice President of J.P. Morgan Securities Inc. ("JPMorgan"), a subsidiary of JPMorgan Chase & Co.

JPMorgan is a leading global financial services firm with operations in more than 50 countries, serving more than 30 million consumers and the world's most prominent corporate, institutional and government clients, including over 99% of the *Fortune* 1000 companies.

JPMorgan has an established reputation for integrity. The Firm welcomes the opportunity to discuss my role as an analyst and the analysis underlying my recommendations regarding the stock of Enron Corporation ("Enron") prior to its bankruptcy.

I am pleased to appear before you today at the invitation of this Committee. In 1997, I joined JPMorgan as an intermediate analyst following my graduation from New York University's Stern Business School, where I earned a Masters of Business Administration degree in Finance. I currently work in the U.S. Equity Research Department of the Firm (the "Research Department"). At the present time, I follow eight companies in the Natural Gas sector and make specific recommendations to institutional investors concerning the equity securities of those clients.

Before turning to my evaluations of Enron, I would like to make a few preliminary but very significant points. First, absolute integrity is critical in this line of work. Second, I do not own any stock of the companies that I follow, and I did not own Enron stock. In addition to that, my family

does not, and did not, own Enron stock or any of the securities of the companies that I follow. Third, I have complete freedom with respect to the recommendations that I make concerning any equity security and my compensation is not tied to the recommendations that I make with respect to any particular company. Finally, I have never received any compensation in any form from any company that I analyze, including Enron.

Independence and integrity form the foundation of JPMorgan's investment research. The Firm has well-established and comprehensive policies designed to ensure analysts' independence, which require the physical separation of investment banking from research and the close monitoring of our contact with investment banking personnel by the Compliance Department of the Firm.

Consistent with JPMorgan's policies of analyst independence, in analyzing the companies that I follow, I rely on publicly available information. My sources of information include the audited financial statements of the companies, their filings with the Securities and Exchange Commission ("SEC") and other regulatory bodies, annual reports and company presentations to analysts. The accuracy of the publicly available information provided by the issuer is essential to the accuracy of the resulting analysis.

In June 1999, I began following Enron equity securities. Prior to issuing my report and my initial "Buy" recommendation on Enron stock, I conducted extensive research tapping all available public sources of information. This process lasted close to a year. I met with Enron senior management and other personnel in the wholesale and retail energy businesses of the company. I was impressed at the outset with Enron's business model and its management team. The rapidly deregulating energy markets offered Enron tremendous opportunity to grow earnings through the application of its innovative business model. I believed that it could be successfully applied in other industries to generate stable and growing earnings with minimal risk.

It was clear from my review of Enron's audited financial statements and other available public information that the company used off-balance sheet financing in a variety of circumstances. This was not in and of itself surprising. These techniques, which were widely used by other companies, were, and still are governed by generally accepted accounting principles and we had no reason to believe that Enron's audited financial statements were not prepared in accordance with such principles.

From the date of the initiation, I issued numerous research notes and updates pertaining to Enron that were distributed to JPMorgan clients. These updates and reports contained my analysis of significant news and events as they related to the company.

In 2000, Enron's revenue grew from $40 billion to $101 billion. EnronOnline was among the largest revenue generating websites. Enron's telecommunications business was generating growing revenues and expanding its customer base. Its recently founded retail energy business turned profitable in the fourth quarter.

The next year, 2001, started out well for Enron. Management reported that the company would continue to pursue its wholesale and retail energy businesses and that its developing businesses would continue to gain critical mass and momentum. First quarter results as publicly reported were strong, as expected. Enron reported that its business, both in the United States and abroad, was growing rapidly. Trading power volumes in North America almost doubled from a year ago; European volumes tripled. We viewed these increases as a testament to the sustainable competitive advantage Enron had amassed through its systems, scale and scope.

Second quarter results were similarly impressive with the company reporting earnings of $0.45 per share, ahead of our estimate of $0.43 per share. The results in all of Enron's business units, save for Enron Broadband, were excellent and we believed that the current energy environment presented an abundance of long-term opportunities.

In mid-August 2001, Enron's then CEO, Jeff Skilling resigned abruptly. We viewed this as a negative event, but we saw ample senior management talent to fill this gap. Indeed, Enron, in our view, had uniquely engineered a culture of innovation, with a deep and broad management team. Shortly thereafter, Enron made two new appointments to the "Office of the Chairman" which in my opinion returned the company's focus to its core, successful business model.

On the morning of October 16, 2001, Enron reported a $618 million third quarter loss and disclosed a $1.2 billion reduction in shareholder equity, related to the partnerships run by Andrew Fastow, Enron's then Chief Financial Officer. However, core earnings were up 35% and the stock finished the day 2% higher.

Nevertheless, during the next week, we saw a developing crisis of confidence, fueled by press reports, the SEC's disclosure that it had commenced an informal investigation and Enron's failure to address the resulting investor concerns head-on. On October 24, 2001, I downgraded Enron's rating from a "Buy" to a "Long-Term Buy" and removed it from the firm's "Focus List", which contains the firm's top near-term recommendations. A "Long Term Buy" means that the company is facing near term challenges that, once resolved, should allow the stock to outperform its peers. It does not mean that the stock should be purchased prior to the resolution of those issues.

On November 8, 2001, Enron filed documents with the SEC revising its financial statements for the past five years to account for $586 million in losses. However, its results for the previous three quarters of 2001 were not materially impacted and I did not believe that a further downgrade of the company was warranted.

On November 9, 2001, a proposed merger was publicly announced between Enron and Dynegy. As the Committee is aware, JPMorgan was one of the advisors to Enron with respect to the merger. I, however, was not involved in the proposed transaction, and was only informed of it a few hours before it was publicly announced. Otherwise, I was not privy to any non-public

information with respect to Enron, Dynegy or the proposed transaction. I viewed the proposed merger as a positive event and believed that if the merger had been consummated the combined entity would go on to outperform.

The merger was abandoned on November 28, 2001, following Enron's downgrade to below investment grade. Immediately following, on November 29, 2001, we suspended coverage of Enron. Enron filed for bankruptcy on December 2, 2001.

Thank you, Mr. Chairman. I would be pleased to respond to any questions that you or the other Members of the Committee may have.

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Written Statement of Richard Gross
February 27, 2002

Good morning. Mr. Chairman and Members of the Committee, my name is Richard Gross. I am an analyst in the Equity Research division at Lehman Brothers, Inc. Lehman is a global investment bank and securities firm that provides research, investment banking, brokerage and other services to corporations, institutions, governments and high net worth investors.

I have been an equity analyst covering the energy industry for 27 years. I have been an analyst at Lehman since 1991. Prior to joining Lehman I worked as an analyst at other firms for 16 years. I have a B.S. and M.S. in finance from the University of Illinois.

At Lehman Brothers, I cover companies in a sector called "United States, Energy/Power, Natural Gas." One of the companies I covered was Enron. As an analyst, I analyze the publicly available information about a company and its industry. Information I consider includes: information made available by the company such as SEC filings, press releases and company presentations; material made available by the rating agencies; information about competitors; general information about the industry, as well as whatever other publicly available information I can reasonably obtain. I compile the information that I gather as a framework for my analysis.

My analysis includes relative valuations arrived at by reviewing historical and current industry trends, reviewing market valuations; and comparing the company being analyzed to its peers. Based on my analysis, I develop opinions about the companies I follow. My opinions and recommendations, and the many factors on which they are based, are reflected in my research reports. My research reports are available to clients of Lehman Brothers. Lehman Brothers' business and clients are primarily institutional in nature. Lehman also provides services to high net worth individuals.

I appreciate the opportunity to answer questions the Committee might have.

Testimony of Curt N. Launer
Senate Committee on Governmental Affairs
Enron Hearings
February 27, 2002

Introduction

Good morning, Mr. Chairman. My name is Curt Launer and I am a Managing Director at Credit Suisse First Boston (CSFB)[1] in the Equity Research Group. I head the Global Utilities Research Group of CSFB that comprises 28 professionals, including 14 senior analysts around the world. My specific research coverage is the Natural Gas & Power sector. As a research analyst for the past 18 years, I have followed Enron and its predecessor companies.

My career on "Wall Street" began as a research analyst in 1984 with the firm of LF Rothschild. In 1987, I joined Donaldson Lufkin & Jenrette and was there until its October 2000 merger with CSFB. Prior to 1983, I was in the Energy business as an accountant with Gruss Petroleum and Mobil Oil for three years. I began my career in 1977 as an auditor with Arthur Young & Company following graduation from the State University of New York at Buffalo (B.S. Accounting).

[1] Credit Suisse First Boston (CSFB) is a leading global investment bank serving institutional, corporate, government and individual clients. CSFB's businesses include securities underwriting, sales and trading, investment banking, private equity, financial advisory services, investment research, venture capital, correspondent brokerage services and retail online brokerage services. It operates in over 87 locations across more than 39 countries on 6 continents, and has some 28,000 staff worldwide. The Firm is a business unit of the Zurich based Credit Suisse Group, a leading global financial services company.

Summary

In discussing the role of an analyst and the Enron situation, I would like to make four main points today.

First, the role of the analyst is to make informed judgments about companies based on publicly available information. We assume such information is complete and truthful. To that end, we depend on senior corporate officials and independent accountants – who are subject to regulatory and professional standards – to ensure the accuracy of public disclosures. We rely on the same public information about a company that is disclosed to individual investors. If that information is inaccurate or incomplete, then no analyst can make sound judgments about a company. Without accurate and complete financial reporting from a company, I simply do not have the proper tools to do my job.

Second, I want to answer an obvious question: whether inaccuracies and lack of information in Enron's financial reporting affected my conclusions and ratings on Enron. The answer is yes. Each day there are new allegations in the media concerning Enron about which I previously was unaware. Examples include the number of off balance sheet partnerships and the magnitude of their debt obligations, Enron's apparent misuse of fair value accounting, and Enron's "Raptor" transactions.

Third, I would like to address any questions regarding the independence of my work. The fact is that my research has no value unless investors believe in the quality of the information provided and the sound analytical framework upon which it is based. I performed my analysis independently and objectively, and I never felt pressure from Enron or any investment banker or other employee of my Firm to reach any conclusions other than my own. Not only have I done my work independently, but, in addition, my Firm has strict rules that

prevent me from even having access to the kind of confidential nonpublic information that investment bankers often have. CSFB also has adopted rules banning stock ownership by analysts in the companies we cover. We are firmly committed to taking whatever steps are necessary to protect the integrity of our research.

In this regard I would like to note that my sons were each the beneficial owners of 100 shares of Enron held in trust accounts until these shares were sold in December 2001 to comply with new CSFB rules. My family's only current direct or indirect investments relating to Enron are an $18,000 investment in the NewPower Company, a public retail natural gas and electricity provider in which Enron has an interest, and an Enron bond held by my mother, which is now in default.

Finally, I would like to address certain public policy concerns raised by the Enron situation. While we need to guard against overreaction, I applaud any effort to craft thoughtful responses to improve the overall quality of public company disclosures and restore confidence in our markets.

My Role as an Analyst

CSFB's client base, the group of customers who use my research, is largely comprised of sophisticated, institutional investors. It is not individual retail customers. My clients have their own research staffs that make their own investment decisions. They look to me for quality information and projections. They challenge information and analysis I provide and form their own conclusions.

As a research analyst I am a user of information provided by publicly held companies. My job is to analyze that information, bringing to it my understanding of the industry and my experience in reviewing similar material. I develop an understanding of how a company generates earnings and its performance and potential as compared to others in the industry sector I cover. If the information a company provides is incomplete, incorrect or misleading, my analysis will be undermined.

I begin my job by gathering and reviewing in detail a company's public disclosures. These include annual and quarterly reports on Forms 10K and 10Q. Principal among the things I rely on are the company's audited financials. These are the foundation for my conclusions. I also review the company's press releases and public statements. These steps are only the beginning. I stay informed about industry developments, including market and regulatory issues. I gather information from many sources, including resources in the research area such as strategic analyses, customers of companies I follow, operating managers and suppliers, among others. I also review media coverage.

With this information, I work towards my ultimate goal of estimating a company's future earnings, cash flow, and balance sheet, comparing those estimates to other companies in the Natural Gas & Power sector. The critical step here, starting with the company's certified

financial statements, is to build my own model of the company's future financial performance. I compare my projections both to the company's public guidance, and to information about other companies in the same industry. All of this work results in a report, which includes a "recommendation" relative to the current price of the stock.

Independence and Objectivity

To protect the integrity of our research, CSFB consistently and without exception follows "Chinese wall" procedures. These procedures separate me from other areas of CSFB's business, particularly its investment banking arm. To maintain our independence and ensure that our research is not influenced improperly, the research group is not permitted access to files of the investment banking department or other units of the Firm that handle confidential information. Nor can we discuss such information with other employees of the Firm. In addition, the offices and floor space of the research group are separated physically from other CSFB units, and research analysts are not permitted unescorted access to investment banking floors.

If an investment banking team wants my expertise on the industry or the markets, I am (to use the industry's jargon) "brought over the wall" under a set of strict conditions to maintain the independence of our research. In order to bring me over the wall, the banking team must contact the Control Room of the Firm, a unit within the Firm's Legal and Compliance Department that is responsible for compliance review of research, and requests that an analyst be "brought over the wall." Either a member of the banking team or the Control Room contacts a research supervisor and discusses the request to bring an analyst "over the wall." The research supervisor then decides whether it is appropriate for that to occur. When we are "over the wall" we are very carefully limited to the use of previously published research in our comments and other public information.

As I have previously noted, CSFB now bans stock ownership by me and my family in companies I cover. CSFB not only complies with the Securities Industry Association's Best Practices for Security Analysts but also has worked with the SEC, the NYSE, and the NASDR to create new rules for analysts and investment banks, which after months of work were recently announced. These new requirements will mandate disclosure of existing investment banking relationships and ownership in a company by the firm or by analysts if their firms allow analysts to own stock (which CSFB does not).

CSFB takes the rules regarding analyst independence and objectivity seriously and again, I have never been pressured in any manner to alter my research or recommendations by any part of the firm.

Coverage of Enron

In general, I believe that Enron as a company was unique in terms of its complex business model, rapid growth, aggressive accounting and contract valuation, and "dot-com" characteristics. Enron utilized outside financings, outside partnerships, fair-value accounting and other techniques and vehicles. Some companies may use one of these techniques; Enron used all of them in an array of interwoven transactions that were apparently not fully disclosed and that we are just beginning to understand.

It now appears that some critical information on which I relied for my analysis of Enron was inaccurate or incomplete. One example was a disturbing press report after Enron filed for bankruptcy protection. In January 1998, I attended an analyst meeting at Enron along with over 100 analysts. During this meeting we toured a trading floor of Enron Energy Services. In viewing the activity in the trading room, I was impressed at the progress Enron had made in

developing this business. It has been alleged that Enron may have "staged" the activity on that trading floor and if these allegations were true, the progress they were making was illusory.

In addition, as has been reported, during the August 15, 2001 analyst conference call following Jeff Skilling's resignation, I specifically asked him whether his departure suggested that there were likely to be future disclosures with respect to Enron's finances. Mr. Skilling responded that there was "nothing to disclose" and that the company was in "great shape."

Another example of the lack of completeness in Enron's disclosures involves the question of how approximately $1.5 billion in cash from ChevronTexaco/Dynegy provided to Enron was used. It does not appear to have gone to its intended purpose of satisfying Enron's pending debt obligations.

Furthermore, Enron never publicly disclosed the alleged use of the Raptor investment vehicles. It now appears that these entities may have engaged in trades with Enron simply to establish artificially higher asset values. If this is true, those trades would have artificially inflated Enron's financial statements.

Had I known of any or all of these items, this information would have significantly affected my analyses and recommendations.

However, in my opinion, much of the public debate surrounding Enron's demise misses crucial points related to the firm's finances, accounting and structure. In general, we should not regard complex financings or off balance sheet financings as problematic in and of themselves – some very sound firms use such mechanisms. Even earnings restatements may not be fatal where the underlying business of the company is sound. Here again, Enron was a different matter: even its restatements appear to have been incomplete and inaccurate, and thus they too exacerbated Enron's downward spiral.

If Enron had taken the appropriate steps, I believe that the company could have survived. A substantial capital infusion, combined with complete disclosure of off balance sheet liabilities and debt levels plus a decision to slow growth could in my opinion have resulted in Enron's survival. These actions may not have restored the share price to historic highs, but the interests of employees, shareholders and communities would have been improved.

Essentially these are the elements that could have been provided by the Dynegy merger.[2] Indeed, it appears that ChevronTexaco and Dynegy had much the same view of Enron as I did. ChevronTexaco was willing to commit $2.5 billion in cash to its view of Enron and Dynegy was willing to issue $8.5 billion worth of additional shares to acquire Enron.

In sum, hindsight allows a view that I, as an analyst, never had. I based my views and ratings on the information that was available at every step of the way.

Policy Implications of Enron Collapse

As an analyst for 18 years, I have watched with interest the policy debates that have taken place over the last two years about disclosure and the role of analysts. It is time to recognize that the corporate disclosure system can be improved.

The goals of "full disclosure" to investors and analysts (immediate, complete and clearly understandable disclosure from all publicly registered companies) and "equal access to information" (providing that information to everyone) are both extremely important. There can, however, be a tension between the two, and, with Enron, the balance has tipped decidedly against "full disclosure."

The Securities and Exchange Commission (SEC) adopted regulation FD in 2000 in order to promote "equal access" by preventing the selective disclosure of information to some

[2] CSFB was not involved in the proposed Dynegy merger.

individuals, but not the public at large. As laudable as that goal is, the regulation can be used as an excuse by company officials, as it was by Enron, to duck tough questions from analysts and thus, thwart "full disclosure." The point, of course, is that those tough questions should be answered and the answers made available not just to the questioners but also to the public. That is not what always happens. And that is certainly not what happened in the case of Enron.

I am aware that there are many initiatives being currently considered to improve corporate disclosure. The focus of any such changes should be more complete, more timely, and more understandable disclosure. To accomplish these goals, we should consider full disclosure of off-balance sheet financing and related party transactions, more accelerated disclosure of insider transactions and corporate reports, and enhanced disclosure of stock option programs. It should also require greater scrutiny of accountants and other professionals, and additional resources for regulatory agencies like the SEC.

Thank you again for the opportunity to appear today and I will be happy to answer any questions.

U.S. Senate Committee on Governmental Affairs
February 27, 2002

STATEMENT OF RAYMOND C. NILES

THANK YOU, MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE.

SINCE MARCH 2000, I HAVE BEEN THE SENIOR ANALYST AT SALOMON SMITH BARNEY FOR THE INTEGRATED POWER AND NATURAL GAS SECTOR. BEFORE THAT, AND SINCE 1997, I WAS THE SENIOR ANALYST FOR THE INTEGRATED POWER AND NATURAL GAS SECTOR AT SCHRODER. I COVERED ENRON AT BOTH SCHRODER AND AT SALOMON SMITH BARNEY.

AS AN ANALYST, MY JOB IS TO REPORT TO INVESTORS ABOUT BUSINESS AND MARKET DEVELOPMENTS IN MY INDUSTRY SECTOR. I ALSO DEVELOP AND COMMUNICATE TIMELY AND DETAILED RECOMMENDATIONS ABOUT PARTICULAR COMPANIES IN THAT SECTOR.

IN ORDER TO DO THIS JOB, I WORK WITH PUBLICLY AVAILABLE INFORMATION TO DEVELOP FINANCIAL MODELS, EARNINGS ESTIMATES, AND PRICE TARGETS FOR THE STOCKS OF THE COMPANIES THAT I FOLLOW. I ALSO FOLLOW AND ANALYZE INDUSTRY TRENDS, SUCH AS POWER PRICES, SPARK SPREADS, GENERATING CAPACITIES, THE TREND TOWARD DEREGULATION, AND SIMILAR ITEMS. PART OF MY JOB IS TO FORECAST THE IMPACT ON INDIVIDUAL STOCK PRICES OF THE SUPPLY AND DEMAND FOR ELECTRICITY AND NATURAL GAS, THE OVERALL HEALTH OF THE NATIONAL ECONOMY AND SUCH VARIABLES AS THE WEATHER. IN PERFORMING THESE ANALYSES, I MAKE USE OF COMPUTER MODELING TECHNIQUES, ECONOMIC THEORY, AND OTHER TOOLS.

AT THE HEART OF MY WORK ARE THE FINANCIAL STATEMENTS OF THE COMPANIES THAT I FOLLOW. I REVIEW, AND ANALYZE, A COMPANY'S FINANCIAL STATEMENTS, PRESS RELEASES, AND PUBLIC FILINGS BEFORE MAKING A RECOMMENDATION. I ALSO GO BEYOND THE PAPER RECORD, AND PARTICIPATE IN REGULAR CONFERENCE CALLS HELD FOR ANALYSTS BY SENIOR AND FINANCIAL MANAGEMENT OF THE COMPANIES THAT I COVER. I VISIT THE COMPANIES, AND CALL ON COMPANY PERSONNEL TO OBTAIN CLARIFICATION AND CONTEXT REGARDING THE COMPANY'S FINANCES AND BUSINESS PROSPECTS.

ALTHOUGH I COLLECT AND ANALYZE A GREAT DEAL OF INFORMATION, I MUST STRESS THAT ALL OF THE INFORMATION I USE IS AND MUST BE PUBLIC INFORMATION. UNDER SEC RULES, A COMPANY CANNOT MAKE SELECTIVE DISCLOSURE OF CONFIDENTIAL INFORMATION ONLY TO CERTAIN ANALYSTS.

ALSO, INVESTMENT BANKS THAT TRADE SECURITIES ESTABLISH INFORMATION BARRIERS, SO THAT CONFIDENTIAL INFORMATION THAT MAY BE KNOWN TO A COMPANY'S BANKERS DOES NOT REACH THE ANALYSTS AND SALES PERSONS WHO MAY BE RECOMMENDING OR TRADING THAT COMPANY'S STOCK. THEREFORE, WHEN I ISSUE A REPORT ON A COMPANY ON BEHALF OF SALOMON SMITH BARNEY, I AM PREVENTED BY RULES AND REGULATIONS, AS WELL AS BY FIRM POLICY, FROM ASKING MY BANKING COLLEAGUES ABOUT THEIR NONPUBLIC DEALINGS WITH THE COMPANY THAT IS THE SUBJECT OF MY REPORT.

IF AN ANALYST IS EVER BROUGHT "OVER THE WALL" TO RECEIVE NONPUBLIC INFORMATION, HE IS NOT PERMITTED TO MAKE RECOMMENDATIONS WITH RESPECT TO THE PARTICULAR COMPANY UNTIL THE INFORMATION LEARNED BY THE ANALYST BECOMES STALE OR HAS BEEN DISCLOSED PUBLICLY.

WITH THIS BACKGROUND, I WOULD LIKE TO SUMMARIZE FOR THE COMMITTEE MY REPORTS CONCERNING ENRON.

I INITIATED COVERAGE OF ENRON IN JANUARY 1998, WHEN I WORKED AT SCHRODER. I DEVELOPED MY OWN METHODOLOGY FOR FORECASTING ENRON'S EARNINGS. BASED ON MY ANALYSIS OF THE COMPANY'S REPORTED FINANCIAL RESULTS AND BUSINESS PROSPECTS, I PLACED ENRON ON THE FIRM'S "RECOMMENDED LIST."

IT WAS MY PROFESSIONAL OPINION THAT ENRON WAS WELL POSITIONED TO TAKE ADVANTAGE OF THE DEREGULATION OF THE ELECTRICITY INDUSTRY. BY THAT TIME, ENRON HAD BUILT A REPUTATION AND ACHIEVED DOMINANCE IN THE COMPETITIVE NATURAL GAS INDUSTRY.

IT WAS ALSO MY PROFESSIONAL OPINION THAT ENRON'S CORE MERCHANT ENERGY BUSINESS MODEL WAS SOUND. UNDER THAT MODEL, ECONOMIES OF SCALE, INNOVATIVE MARKETING AND STRINGENT RISK MANAGEMENT COULD ALLOW ENRON TO OFFER CHEAPER AND MORE CUSTOMIZED ENERGY-RELATED SERVICES THAN THOSE PROVIDED BY ITS COMPETITORS. I BELIEVED THAT ENRON'S OBJECTIVE – USING RISK MANAGEMENT PRODUCTS AND LONG-TERM CONTRACTS TO ADDRESS THE NEEDS OF WHOLESALE ENERGY CUSTOMERS IN THE VOLATILE COMMODITY MARKETS – WAS A

SUCCESSFUL PARADIGM. THE STRENGTH OF ENRON'S REPORTED RESULTS APPEARED TO CONFIRM THE CORRECTNESS OF THIS OBJECTIVE AND ENRON'S SUCCESS IN ACHIEVING IT.

WHILE I WAS AT SCHRODER, ENRON'S PERFORMANCE IN THE GAS AND ELECTRICITY COMMODITY MARKETS WAS IMPRESSIVE. I BELIEVED THAT ENRON'S CORE PLATFORM COULD BE APPLIED TO OTHER INEFFICIENT MARKETS FOR COMMODITIES THAT WERE DELIVERED OVER A NETWORK, SUCH AS BANDWIDTH.

IN MARCH 2000, JUST BEFORE OUR FIRMS MERGED, I JOINED SALOMON SMITH BARNEY AS A SENIOR ANALYST. I ISSUED MY FIRST REPORT ON ENRON AT SALOMON SMITH BARNEY IN APRIL 2000. AT THAT TIME, I RATED ENRON AS A "1H," WHICH MEANS A BUY RECOMMENDATION, WITH HIGH RISK ATTACHED TO IT. THE "HIGH RISK" NOTATION REFERRED TO BUSINESS RISK SUCH AS ENRON'S POSITION AS THE FIRST MOVER IN NEW MARKETS.

I CONTINUED TO RECOMMEND ENRON DURING THE REST OF 2000 AND WELL INTO 2001.

IN A REPORT DATED AUGUST 14, 2001, SHORTLY FOLLOWING AN ANNOUNCEMENT THAT DAY THAT ENRON'S CEO, JEFF SKILLING, HAD RESIGNED, I NOTED THAT ALTHOUGH SKILLING HAD BEEN THE ARCHITECT OF THE COMPANY'S MERCHANT ENERGY STRATEGY, I BELIEVED THAT THE SOUNDNESS OF ENRON'S BUSINESS MODEL WOULD SUSTAIN THE COMPANY. I NOTED, HOWEVER, THAT MY POSITIVE OPINION ASSUMED THAT THERE WOULD BE NO FURTHER DISCLOSURES OF MATERIAL EVENTS.

BEGINNING IN OCTOBER 2001, ENRON BEGAN TO MAKE PUBLIC DISCLOSURE OF THE TRANSACTIONS AND FINANCIAL RESTATEMENTS AND WRITEOFFS THAT EVENTUALLY LED TO ITS BANKRUPTCY. I MADE TIMELY REPORTS AS THE SIGNIFICANT FACTS WERE ANNOUNCED.

ON OCTOBER 16, 2001, I NOTED ENRON'S DECISION TO TAKE $2.2 BILLION IN CHARGES, BUT REPORTED THAT THE CHARGES, AS DESCRIBED BY ENRON, DID NOT RELATE TO ITS CORE MERCHANT ENERGY BUSINESS. ACCORDINGLY, I CONTINUED TO RATE THE COMPANY AS A "BUY," WITH "HIGH RISK."

ON OCTOBER 19, 2001, WHEN ENRON STOCK WAS STILL TRADING AT OVER $32 PER SHARE, I ISSUED A REPORT WHICH NOTED THAT THE COMPANY'S "COMPLEX OFF-BALANCE SHEET VEHICLES HAVE RAISED CONCERN," THAT FURTHER WRITE-OFFS WERE LIKELY, AND THAT MOODY'S HAD PUT ENRON'S SENIOR DEBT ON REVIEW FOR A POSSIBLE

DOWNGRADE. I ALSO NOTED THAT, WHILE I STILL CARRIED ENRON AS A BUY, "WE ARE EVALUATING THESE ISSUES."

IN A SUPPLEMENTAL REPORT ISSUED THAT SAME DAY, I SIGNALED THAT MY VIEW OF ENRON COULD CHANGE "GIVEN THE COMPLEXITY OF ITS OFF-BALANCE SHEET FINANCING VEHICLES" AND "THE UNCERTAINTY AND MAGNITUDE OF POTENTIAL WRITE-OFFS."

I DOWNGRADED MY RATING TO 1-S, OR "BUY, SPECULATIVE," ON OCTOBER 25, AND LOWERED IT AGAIN TO 3-S, OR "NEUTRAL, SPECULATIVE," ON THE FOLLOWING DAY. IN THAT OCTOBER 26 REPORT, I NOTED THAT MANAGEMENT HAD TO ADDRESS ISSUES AS TO CREDIT AND LIQUIDITY, AND PARTICULARLY THE USE OF OFF-BALANCE SHEET FINANCING.

GIVEN EVERYTHING THAT HAS HAPPENED SINCE LATE OCTOBER, IT IS APPROPRIATE TO QUESTION WHY THE ANALYST COMMUNITY – AT LEAST THE VAST MAJORITY OF ITS MEMBERS – MISSED THE MARK ON ENRON.

THE SHORT ANSWER, MR. CHAIRMAN, IS THAT WE NOW KNOW WE WERE NOT PROVIDED WITH ACCURATE AND COMPLETE INFORMATION.

A COMPANY'S PUBLIC CERTIFIED FINANCIAL STATEMENTS ARE THE BEDROCK OF ANY ANALYSIS OF THE VALUE OR THE PROSPECTS OF THAT COMPANY'S STOCK.

IT IS NOW COMMON KNOWLEDGE THAT ENRON'S FINANCIAL STATEMENTS, WHICH HAD BEEN CERTIFIED BY ITS INDEPENDENT AUDITOR, DID NOT REPRESENT THE COMPANY'S TRUE FINANCIAL CONDITION. THE ANALYST COMMUNITY RELIED ON THOSE CERTIFIED FINANCIAL STATEMENTS, WHICH ENRON ITSELF HAS SINCE RESTATED.

WHEN ANALYSTS LOOK AT CERTIFIED FINANCIAL STATEMENTS, WE ASSUME THAT THEY ARE ACCURATE, AND THAT THEY FAIRLY AND COMPLETELY PRESENT THE COMPANY'S FINANCIAL CONDITION. IN ENRON'S CASE, THAT CORE ASSUMPTION TURNED OUT TO BE INVALID.

AS ANALYSTS, OUR REPUTATION, AND ULTIMATELY OUR LIVELIHOOD, DEPENDS ON OUR MAKING TIMELY AND CORRECT CALLS. I DID NOT WANT TO GET THIS WRONG. I RECOMMENDED ENRON'S STOCK BECAUSE I BELIEVED IN THE COMPANY'S CORE BUSINESS MODEL, AND I TRUSTED THE INTEGRITY OF THE COMPANY'S CERTIFIED FINANCIAL STATEMENTS AND THE REPRESENTATIONS OF ENRON'S MANAGEMENT. AT ALL TIMES, I EXERCISED, AND COMMUNICATED TO INVESTORS, MY BEST PROFESSIONAL JUDGMENTS, BASED ON THE INFORMATION THAT WAS AVAILABLE TO ME.

THANK YOU, MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE.

Testimony of Howard M. Schilit

President and Founder
Center for Financial Research & Analysis, Inc.

Senator Lieberman and your esteemed colleagues, I am pleased to appear before this Committee to describe my role as an independent financial analyst and some of the important differences between Wall Street (or "sell-side") research and our independent boutique.

Before proceeding, I want to emphasize that my comments are based solely upon personal observations over the last decade, rather than on an comprehensive study of the Wall Street establishment or other independent research boutiques.

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My name is Howard Mark Schilit and am founder and President of the Center for Financial Research & Analysis ("CFRA") in Rockville, MD. Prior to that, I was employed for seventeen years as an accounting professor at American University. I also authored the book, FINANCIAL SHENANIGANS: How to Detect Accounting Gimmicks and Fraud in Financial Reports.

About CFRA

My organization, CFRA, has been writing research reports since 1994, warning institutional investors about companies experiencing operational deterioration or using unusual accounting practices. Our reports are published daily and distributed over our web site http://www.cfraonline.com

We use a variety of quantitative and qualitative screens to initially select companies for review. Then, a CFRA analyst reviews the financial reports and other public documents to search for any problems. If any are found, we interview the Company management to discuss these issues. If concerns remain, we publish a report on our web site. We make no buy or sell recommendations; rather, we simply discuss the issues of concern.

Our clients are mainly institutional investors who purchase the research on a subscription basis. We are paid a fixed fee based on the number of actual users at a firm, similar to a license fee on software. Subscribers receive an e-mail each morning with a notification of the companies profiled and the reports are posted on our web site each morning at 9:00 A.M. EST.

All CFRA subscribers receive the information in the same way and at the same time. In addition, all subscribers have equal access to discuss issues with our analysts.

CFRA has a variety of strict editorial policies and ethical guidelines that protect clients' interests and ensure CFRA employees receive no remuneration based on stock price performance of companies they profile. (I have attached our policies and guidelines.)

In short, we have no brokerage, investment banking, or money management operations. We have no conflicts-of-interest. We have one client class (those who make economic decisions based on

financial disclosures). And, we have one overarching goal – to help them make the best decisions.

About Wall Street ("Sell Side") Research

In contrast to our independent research boutique, Wall Street research is fraught with real or potential conflicts-of-interest.

Wall Street brokerage firms have at least two major client groups; they include companies purchasing investment banking services and institutional investors. Typically, a company needing funding will hire a brokerage firm to underwrite securities in a public offering. The brokerage firm receives a fee (generally 6 percent or higher) for this investment banking service. Shortly thereafter, the research analyst at the brokerage firm will begin coverage on this new client with a positive research report. Generally, future reports on this investment banking client will remain positive. Future investment banking fees on stock or bond offerings depend on a close relationship with the corporate client.

If CFRA, or another critic raises concerns to investors, the brokerage firm often publishes a rebuttal to show support for its investment banking client.

This shows the inherent conflict-of-interest; the brokerage firm serves both the underwriting client (the subject of the report), and the investor, who must be informed when problems arise.

The method of payment for research also differs substantially at Wall Street firms. Whereas CFRA receives a cash payment for selling subscriptions, brokerage firms are paid by investors in commission dollars. The trading volume affects the amount, the timeliness of information and the access to speak to research professionals. That is, bigger clients typically get "the first call" from institutional brokers and salesmen, while smaller clients have lesser access.

Moreover, non-institutional investors who generate no commissions often have no (or very limited) access to such research. CFRA, for example, was not permitted to purchase brokerage research from First Call (a distributor of brokerage research) because we generate no commission. They refused our offer to purchase the research for cash.

Comparison of CFRA and Wall Street Research

The following table summarizes ten important differences between my independent research boutique and the typical Wall Street research groups.

	CFRA	Wall Street Firm
Decision to write initial report based on	**Screening for and identifying problems**	**New investment banking client of the firm**
Typical client	**Institutional investors**	**Corporation paying underwriting fees; institutional investors**
Method of payment	**Subscription-based fee**	**Brokerage commissions**
Scope of services provided	**Research and training**	**Securities underwriting and advisory services for corporations; asset management; brokerage; research**
Financial interest in company profiled	**None**	**Usually provide services for the company profiled and/or own stock in that company**
Distribution to clients	**Simultaneous, regardless of size of client**	**Variable, in part based on size of client**
Personal trading permitted	**No**	**Usually**
Warn investors about problems	**Regularly**	**Rarely**
Write rebuttals on reports of other analysts	**Never**	**Occasionally, to support clients paying investment banking fees**
Offer investment opinion	**No**	**Yes**

In Conclusion

As result of the conflicts-of-interest and internal policies, Wall Street research has regularly failed to regularly warn investors about problems at companies. I would be happy to answer any questions at this time.

Center for Financial Research & Analysis, Inc.

CFRA'S ETHICAL GUIDELINES AND EDITORIAL POLICY

Our role as financial journalists is to seek out companies exhibiting signs of operational weakness and aggressive accounting and to alert investors about our findings in a responsible manner. We perform extensive research in identifying problem companies and in thoroughly reviewing SEC documents and other applicable written material within the public domain. For all cases in which CFRA decides to proceed with a written report, we attempt to interview a senior financial executive at the company to gain greater insights.

- **CFRA PROVIDES NO BROKERAGE OR MONEY MANAGEMENT SERVICES**
- **COMPANIES SELECTED FOR OUR RESEARCH COMPENDIUM ARE DERIVED FROM INTERNALLY GENERATED SCREENS, ON-LINE SEARCHES, AND SEC DOCUMENT REVIEW**
- **SUBSCRIBERS RECEIVE REPORTS AT THE SAME TIME**
- **CFRA AND ITS EMPLOYEES MUST REFRAIN FROM "SHORTING" STOCKS**
- **MOST OF CFRA'S REVENUES AND CLIENTS ARE "LONG" ONLY**
- **CFRA CALLS ALL COMPANIES BEFORE REPORTS ARE SENT OUT**
- **CFRA REFRAINS FROM SPEAKING TO THE MEDIA FOR WEEKS AFTER REPORTS ARE SENT TO OUR CLIENTS**
- **CFRA ACCEPTS NO "CONTINGENCY" OR "SUCCESS" FEES FROM CLIENTS**

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Testimony

Of

Robert R. Glauber,
Chairman and Chief Executive Officer
National Association of Securities Dealers, Inc.

Before the
Senate Committee on
Governmental Affairs

Hearing
On
Analyst Independence

February 27, 2002

Introduction

On behalf of the NASD, I want to thank the Committee for this opportunity to testify.

I am here today to tell you about the NASD's recently proposed rules governing analyst recommendations. In light of what we have heard today and in the weeks following the Enron revelations, I think you will agree that these rules will help American investors. Among other measures, the proposal will require increased disclosures of conflicts in research reports and public appearances, prohibit tying analyst compensation to specific investment banking transactions, and restrict an analyst's personal trading of securities. The proposal also will prohibit firms from offering favorable research to induce investment banking or other business.

NASD – A Private Sector Regulator

As the world's largest securities self-regulatory organization, NASD has been helping to bring integrity to the markets and confidence to investors for more than 60 years. Market integrity and investor confidence are at the core of NASD's mission and are the foundation of the success of U.S. financial markets.

Under federal law, virtually all securities firms doing business with the American public are members of the NASD, a private sector, not-for-profit organization. Roughly 5,500 brokerage firms, and almost 700,000 registered securities representatives come under our jurisdiction.

NASD writes rules that govern the behavior of securities firms, examines them for compliance with these rules, as well as the rules of the SEC and the federal securities laws, and disciplines members and their employees if they fail to comply. Our market integrity responsibilities include regulation; professional training; licensing and registration; investigation and enforcement; dispute resolution and investor education. We monitor all trading on The Nasdaq Stock Market -- the largest-volume market in the world. We are staffed by 1600 professional regulators and governed by a Board of Governors – at least half of whom are unaffiliated with the securities industry.

During the more than six decades since the NASD was established under a Congressional mandate for securities industry self-regulation, investors worldwide have flocked to our markets.

The co-existence of strong self-regulation and investor participation in the markets is no mere coincidence. Self-regulation brings to bear a keen practical understanding of the industry. It taps resources and perspectives not readily available to governments. It fosters investor protection and member involvement by promoting high standards that go beyond simply obeying the law. And it has helped to make our markets the most successful in the world.

Self-regulation works because the brokerage industry understands that market integrity leads to investor confidence, which is good for business. The overwhelming majority of NASD members comply fully with the word and the spirit of the rules and the law. They view their own reputation for fair dealing and high standards as a competitive necessity in a competitive industry.

Tough and even-handed enforcement is a fundamental part of NASD's mission. It not only ensures compliance and punishes wrongdoing, but also benefits the vast majority of our members who obey the rules and place investors first. Investors feel more confident using the markets when they know a tough cop is patrolling the beat.

On average, NASD files more than 1,000 new disciplinary actions annually, with sanctions ranging from censures to fines and suspensions to expulsion from the securities industry. We supplement our enforcement efforts with referrals to criminal authorities and the Securities and Exchange Commission. In one major 2002 settlement alone, reached jointly with the SEC, NASD imposed sanctions of $50 million against a major investment bank for violating SRO rules by extracting illegal paybacks from favored customers to whom it allocated "hot" initial public offerings (IPOs).

NASD Role In Regulating Analysts

The NASD's jurisdiction over analysts stems from the fact that most "sell-side" research analysts are employed by dealers that are required by law to belong to the NASD. These research analysts are considered to be "associated persons" of the broker/dealers that employ them, and this status subjects them to the NASD's rules.

The NASD has been using its existing rules effectively to investigate and bring enforcement actions against analysts whose behavior undermines investor confidence. For example, we successfully litigated a case where a firm touted an issuer's stock through a nationally distributed research report that contained numerous misrepresentations and omitted material information. The firm was expelled from the securities industry, and its president was fined and suspended.

Currently, we have several analyst investigations underway. We are examining whether firms adequately disclose risk factors. Certain reports, for example, fail to tell investors that issuers have no revenues or that they have received "going concern" audits. We are also looking at firms that made exceedingly bullish price predictions in the face of negative information and rapidly falling prices. In some instances, the issuers being promoted declared bankruptcy shortly after brokerage firms issued "Strong Buy" recommendations. Finally, with respect to certain recommendations, we are investigating whether firms had an adequate basis for price targets. The proposed new rules will greatly expand our enforcement capability in this important area.

Enron Highlights Need for Transparency

Many individuals were seriously harmed by the collapse of Enron when they lost their jobs and their retirement savings. Also problematic is the potential loss of investor confidence in the markets as a result of Enron. While all the reasons behind the collapse of Enron have not been discerned, we can be fairly certain that at a minimum there was information withheld from the public and a situation that was fraught with conflicts of interest.

The conflicts of interest in the Enron saga range from the most obvious - a CFO involved on both sides of corporate transactions - to the revolving door of public accountants moving into the corporation. There was also a potential conflict when analysts who were recommending Enron stock were employed by investment banks engaged in multifaceted businesses with Enron including investment banking, lending and advisory work.

These potential conflicts of interest are troubling from many perspectives but most of all because they were not disclosed to the investing public so that they could be considered in evaluating the objectivity of the analysts' recommendations.

One of the jobs of the NASD is to help ensure that there is transparency for investors and that investors are aware of situations that may pose conflicts of interest. That is why we have proposed rules for analysts to disclose potential and actual conflicts of interest – so that the investing public is better able to evaluate the vast amounts of information on companies in which they may choose to invest.

Information

With stock market participation expanding from Wall Street to Main Street, the role of investment information has exploded as well. TV financial news, business magazines, newspapers, Internet websites and chat rooms, corporate filings and news releases, stock analyst reports -- there is a din of data for investors to sift through today. Unfortunately, quantity does not guarantee quality: It has never been harder for small investors to assess which information they should rely upon in making their investment decisions. As a result, some investors have depended too heavily on the summary recommendations of just a few securities analysts -- not understanding the particular context in which such recommendations often are generated, and the particular ways in which they often must be read.

Research analysts study companies and draw on a wealth of company, industry, economic and business trend information to help their clients make better investment decisions. Everyday retail investors may believe that most analysts work for them -- that their primary obligation is to the investing public. In fact, the full story is much more complicated.

"Sell-side" analysts typically work for large financial firms that underwrite securities. (An underwriter typically is an investment bank that acts as an intermediary between the

securities issuer and investors in a public offering of securities.) "Buy-side" analysts typically work for institutional money managers -- such as mutual funds, hedge funds, or investment advisers. Both sell-side and buy-side analysts may provide research and advice for institutional clients, whose investment decisions often bear little relation to those faced by everyday investors. Analysts also can be unaffiliated with either the sell side or the buy side -- in which case they sell their independent research and findings to financial or investing institutions, banks, insurance companies or private investors on a project or subscription basis.

Proposed NASD Rules

Even before the tragedy of Enron, analysts were already under the scrutiny of Congress, the SEC and the self-regulatory organizations. When the Internet Bubble burst and stock prices fell dramatically in the second half of 2000, many people began to wonder why the analyst recommendations sounded strangely the same as during the bull market.

Under the leadership of the House Financial Services Committee and SEC Chairman Harvey Pitt, the NASD and the New York Stock Exchange began working with the SEC and securities industry representatives to develop uniform NASD/NYSE rules addressing conflicts of interest that arise when research analysts recommend securities in public communications. The rules that we developed were filed with the SEC on February 8, 2002, and we expect the Commission to publish them for comment shortly.

These comprehensive, tough rules, when adopted, will improve the objectivity of research and provide investors with more useful and reliable information when making investment decisions. To that end, the rules will minimize the influence that a member's investment banking department has over its research department and will restrict severely analysts' personal trading of securities. And the rules will require extensive disclosure of potential conflicts of interest facing firms and analysts.

Conflicts can arise when analysts work for firms that have investment banking or other business relationships with the issuers of the recommended securities, or when the analyst owns securities of the recommended issuer. The rules will require disclosure of financial interests held by the member firm, the analyst and his or her family members, and any other material conflict of interest associated with a recommendation of a security. The rules will require firms to clarify the meanings of their research ratings and provide historical price and ratings distribution data in research reports to better enable investors to evaluate and compare the quality of research.

Investment Banking Relationships

Providing investment banking services, such as underwriting an IPO or advising on a merger or acquisition, can generate substantial revenues for an analyst's firm. Thus, an analyst may have an incentive not to say or write things that could jeopardize client relationships for their investment banking colleagues. Accordingly, our rules will limit the relationship between investment banking departments and the research departments in firms. For example, research

department personnel will not be subject to the supervision or control of the investment banking department. Similarly, the investment banking department could not review or approve research reports prior to distribution, but could check research reports prior to distribution as necessary only to verify the accuracy of information or to review for any potential conflicts of interest that may exist. These communications between the two departments – written and oral – will have to be made through the firm's legal and compliance department and documented.

Similarly, the subject company could not approve research reports prior to distribution, but could review sections of a draft research report as necessary to verify facts in those sections, so long as the firm doesn't share the research rating, the research summary or the price target. Any changes to the analyst's rating or price target for the subject company made after the company completes its factual review will have to be justified in writing and submitted to the firm's legal or compliance department for approval.

Our rules will allow firms to notify a subject company whose rating will be changed but only after the close of trading in its principal market the evening prior to a morning announcement of the change.

Compensation of Analysts and Firms

Sell-side analysts serve a very important role in our securities market's capital raising process. As part of their job responsibilities, research analysts advise investment banking departments concerning such matters as whether a potential underwriting client is financially or operationally prepared for an initial public offering. Nevertheless, there are inherent conflicts of interest related to analyst compensation for these activities. In this regard, brokerage firms' compensation arrangements can put pressure on analysts to issue positive research reports and recommendations by tying analyst compensation to specific investment banking services.

To address those concerns, our proposed rules will prohibit a firm from tying analyst compensation to specific investment banking services transactions. Thus, for example, an analyst may not receive a bonus that is based on the analyst's contributions to a specific investment banking deal. However, a firm will not be prohibited from compensating an analyst based upon the analyst's overall performance, including services provided to the investment banking department. If the analyst received compensation based upon (among other factors) the firm's investment banking revenues, this must be disclosed in the report.

Our rules will also provide that a firm must disclose in research reports if the firm or its affiliates received compensation from the company that is the subject of the research report within the last 12 months prior to the date of the research report. A firm also will have to disclose if the firm or its affiliates reasonably expects to receive compensation from the company within the next three months following the date of the research report. When a research analyst in a public appearance recommends securities, the analyst will have to disclose if the company is a client of the firm or its affiliates, provided that the research analyst knows or has reason to know of this fact.

Our rules will prohibit promises of favorable research or specific price targets in return for investment banking or other business. While our rules already prohibit this type of fraudulent conduct, this provision will make this prohibition more explicit. We will also require quiet periods during which a firm could not publish a research report regarding an issuer for which the firm acted as manager or co-manager of an initial public offering within 40 calendar days following the effective date of the offering. A firm could not issue a research report regarding an issuer for which the firm acted as manager or co-manager of a secondary offering within 10 calendar days following the effective date of the offering. A firm could permit exceptions to these prohibitions (consistent with other securities laws and rules) for research material that is issued due to significant news or events.

Analyst Trading of Securities

There has been much public discussion about analysts' personal trading. Our rules will provide that no analyst or member of the analyst's household could purchase or receive an issuer's securities prior to its initial public offering (*e.g.*, so-called pre-IPO shares), if the issuer is principally engaged in the same types of business as companies that the analyst issues research reports about.

Under the rule, no analyst or household member could trade securities issued by companies the analyst follows for a period beginning 30 calendar days prior to the issuance of a research report and ending five business days after the issuance of such a research report. This prohibition will also apply to a period beginning 30 calendar days before and ending five calendar days after the analyst changes a rating or price target of a subject company's securities. And no analyst or household member could make trades contrary to the analyst's most current recommendations (*i.e.*, sell securities while maintaining a "buy" or "hold" recommendation or buy securities while maintaining a "sell" recommendation).

Very limited exceptions to these prohibitions will be permitted under circumstances of significant personal hardship and only where such trades are pre-cleared by the firm's legal and compliance department.

Analyst and Firm Ownership of Securities

Many members of the public want to know whether analysts own stocks in the company they recommend. An analyst and the firm itself may own significant positions in the companies an analyst covers, either directly, or through employee stock-purchase pools that invest in companies they cover. Our proposed rules will require that a firm disclose in research reports and an analyst disclose in public appearances if the analyst or a household member has a financial interest in the securities of the subject company. The firm and analyst will have to disclose any other actual, material conflict of interest of which the firm or analyst knows or has reason to know at the time of the research report's issuance or the public appearance.

Likewise, a firm will have to disclose in research reports and an analyst will have to disclose in public appearances if, as of 5 business days before the publication or appearance, the firm or its

affiliates beneficially own 1% or more of any class of common equity securities of the subject company. Firms will compute beneficial ownership of securities based upon the same standards used to compute ownership for purposes of the reporting requirements under Section 13(d) of the Securities Exchange Act of 1934.

The firm will have to disclose any other actual, material conflict of interest that it has with respect to the subject company, and the research analyst must disclose in public appearances any such conflict of interest of which the analyst knows or has reason to know at the time of the public appearance.

Other Disclosures

Under our rule, the front page of research reports will have to contain disclosures or else refer the reader to the page on which disclosures are found. Disclosures must be clear, comprehensive and prominent. These disclosures include the valuation methods used, and any price objectives will have to have a reasonable basis and include a discussion of risks.

A firm will have to disclose in research reports if it was making a market in the subject company's securities at the time the research report was issued.

A firm will have to disclose in research reports and analysts will have to disclose in public appearances if they or a household member is an officer, director or advisory board member of the subject company.

The rules will require that firms disclose in research reports the meanings of all ratings used by the firm in its ratings system. For example, a firm might disclose that a "strong buy" rating means that the rated security's price is expected to appreciate at least 10% faster than other securities in its sector over the next 12-month period. Definitions of ratings terms also will be required to be consistent with their plain meaning. Thus, for example, a "hold" rating may not mean that an investor should sell a security. Firms will *not be* required to adopt the same ratings system.

Regardless of the ratings system employed, a firm will have to disclose in research reports the percentage of all securities that the firm recommends an investor "buy," "hold," or "sell." A firm should determine, based on its own ratings system, into which of these three categories a particular securities rating falls. This information will have to be current as of the end of the most recent calendar quarter (or the second most recent calendar quarter if the publication date is less than 15 calendar days after the most recent calendar quarter). For example, a research report might disclose that the firm has assigned a "buy" rating to 58% of the securities that it follows (which would include both "buy" and "strong buy" ratings), a "hold" rating to 15%, and a "sell" rating to 27% (which would include both "reduce" and "sell" ratings). Within each of the three categories, a firm must also disclose the percentage of subject companies that are investment-banking clients of the firm. Thus, for example, if 20 of the 25 companies to which a firm has assigned a "buy" rating are investment banking clients of the firm, the firm will have to disclose that 80% of the companies that received a "buy" rating are its investment banking clients. These disclosures will demonstrate how the firm distributes its ratings among different ratings

categories. They will also indicate whether the firm tends to assign positive ratings to the securities it follows and to its investment banking clients.

A firm must include in research reports a price chart that maps the price of a stock over time and indicates points at which an analyst assigned or changed a rating or price target. An example of this price chart is attached. This chart will enable investors to compare the ratings and price targets that a firm has assigned to a particular security with the stock performance of the security itself. This provision will apply only to securities that have been assigned a rating for at least one year, in recognition of the long-term nature of many ratings. Moreover, the price chart will not have to extend more than three years before the date of the research report. The information in the price chart will have to be current as of the end of the most recent calendar quarter (or the second most recent calendar quarter if the publication date is less than 15 calendar days after the most recent calendar quarter).

Supervisory Procedures/Reporting Requirements

Our proposed rules require firms to adopt written supervisory procedures reasonably designed to ensure that the firm and its employees comply with the rules. A firm's senior officer will have to attest annually to its SRO that it has established and implemented procedures reasonably designed to comply with these rules.

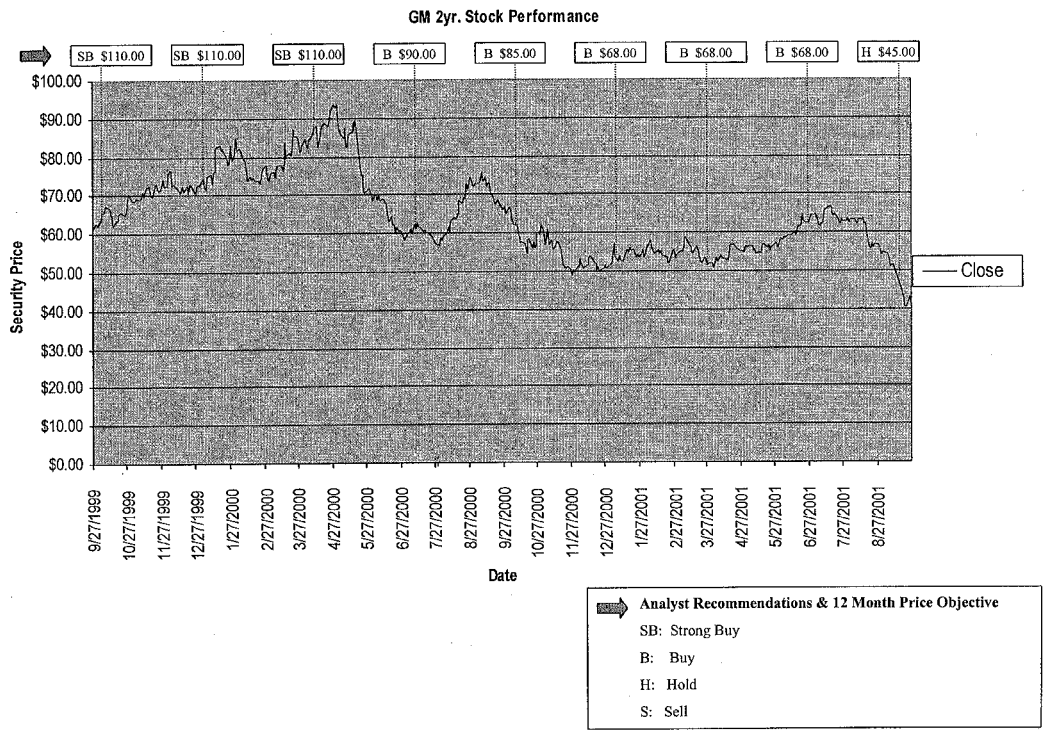
This new rules is a matter of private sector self-regulation. And not self-regulation in name, but self-regulation in fact. It will strengthen the industry's own business practices and ethical standards. And it will be enforced by the NASD with a full range of disciplinary options -- which include stiff fines and the potential for expulsion from the industry.

Conclusion

The NASD mission is clear: to bring integrity to the markets and confidence to investors by employing industry expertise and resources. As Congress recognized over 60 years ago, self regulation properly implemented has an important role in securities market regulation. Enron hasn't changed that. These proposed rules will have teeth because self-regulation in the securities industry has teeth.

Thank you for the opportunity to highlight one area where self regulation has been a resounding success, in no small part due to the support of Congress. While our proposed rules do not solve all the problems revealed in the wake of Enron, it is an important step in restoring investor confidence in the markets. The work of your Committee and the Congress will be vital in addressing the myriad other issues that Enron highlights. I look forward to working with you as Congress examines the range of suitable remedies to address these issues.

Sample Price Chart



Analyst Recommendations & 12 Month Price Objective

SB: Strong Buy

B: Buy

H: Hold

S: Sell

STATEMENT OF THOMAS A. BOWMAN, CFA
PRESIDENT AND CHIEF EXECUTIVE OFFICER
THE ASSOCIATION FOR INVESTMENT MANAGEMENT AND RESEARCH
UNITED STATES SENATE
COMMITTEE ON GOVERNMENTAL AFFAIRS
Enhancing Analyst Independence and Improving Disclosure to Investors
FEBRUARY 27, 2002

➢ **Opening Remarks**

Good morning, my name is Thomas A. Bowman. I am President and Chief Executive Officer of the Association for Investment Management and Research® (AIMR®) and a holder of the Chartered Financial Analyst® (CFA®) designation. I would like to thank Senator Lieberman, Chairman, Senator Thompson, and other members of the committee for the opportunity to speak on the important issue of analyst independence on behalf of the more than 150,000 investment professionals worldwide who are members of AIMR or are candidates for the CFA designation. Most of these constituents are not subject to the majority of conflicts of interest under discussion today. But all of them are disadvantaged in their ability to conduct research, make investment recommendations to, or take investment action on behalf of, their investing clients by companies' exploitation of or disregard for financial accounting standards and the important principle of disclosure.

I am not here today to defend those Wall Street firms and their analysts who condone or accept an environment replete with conflicts of interest that inhibit, or worse prevent, research objectivity. Indeed, AIMR condemns such an environment and those who foster or sustain it. They undermine the ethical principles upon which our organization and the CFA program are based. They taint a proud profession and its practitioners.

I am here, however, to avow that the fallout from the scandalous activities at Enron, which resulted in severe financial losses by investors and a consequent lack of confidence in the financial markets, should not and cannot be borne totally by Wall Street analysts. It must be attributed to Enron's management, who are alleged to have played the most egregious games with financial reporting rules and misled even the most sophisticated investors until the moment of collapse, and to Enron's directors who failed in their fiduciary responsibility to shareholders.

We strongly believe that the current environment allows all companies to play such games to a greater or lesser degree. To remedy these problems, we are convinced that:

- Until the Financial Accounting Standards Board and the Securities and Exchange Commission are truly free of undue external influences so that they can establish and enforce financial reporting standards that command full transparency and disclosure, users of financial statements, such as analysts and their investing clients, will be disadvantaged.
- Until financial reporting standards are developed for the benefit of investors, the primary *users* of financial statements, instead of for the benefit of issuers, enabling management

to manipulate earnings and hide liabilities and losses, analysts and their investing clients will be disadvantaged.

- Until auditors renounce their advocacy of corporate interests, regain their independence, and become vigilant watchdogs for fairness in financial reporting, analysts and their investing clients will be disadvantaged.
- Until corporate management understands and embraces the need to put their companies' long-term business targets and shareholder interests first, rather than managing earnings to maximize their own personal compensation— and publicly acknowledge their commitment to this end— analysts and their investing clients will be disadvantaged.
- Until corporate management desists in retaliating against analysts and their firms for issuing negative opinions on the attractiveness of the company's securities, analysts and investors will be disadvantaged.
- Until Wall Street firms recognize that it is in their best interest, including their financial interest, to reward high quality research, which can only be done with independence, and require analysts to express their objective views on their assigned companies without recrimination or financial disincentives, investors will be disadvantaged.
- And certainly, until all Wall Street analysts
  - demand quality financial reporting so they are confident in the reasonableness and adequacy of the information that forms the basis for their recommendations,
  - ferret out information *not* contained in the primary financial statements but obscured and hidden in footnotes and other disclosure documents, and
  - adhere personally and tenaciously to a code of ethics and standards of professional conduct that require them always to place the interests of their investing clients before their own— or their firm's— investors will be disadvantaged.

➢ **Background on AIMR**

AIMR is a non-profit professional membership organization with a mission of advancing the interests of the global investment community by establishing and maintaining the highest standards of professional excellence and integrity. AIMR is most widely recognized as the organization that conducts qualifying examinations and awards the CFA designation. In 2002, almost 100,000 candidates from 143 countries have registered to take the CFA exam.

Although not a license to practice financial analysis or investment management, the CFA charter is the only globally recognized standard for measuring the competence and integrity of financial analysts. The CFA Program consists of three levels of rigorous examination, which measure a candidate's ability to apply the fundamental knowledge of investment principles at a professional level. The CFA exam is administered annually in more than 70 countries worldwide.

To be awarded the CFA charter, a candidate must pass sequentially all three levels of the examinations, totaling 18 hours of testing. They must have at least three years of acceptable professional experience working in the investment decision-making process and fulfill other requirements for AIMR membership. All AIMR members, CFA charterholders, and candidates must sign and submit an annual Professional Conduct Statement that attests to their adherence AIMR *Code of Ethics and Standards of Professional Conduct (*AIMR *Code*

and Standards). A violation of the AIMR *Codes and Standards*, including failure to file the Professional Conduct Statement, can result in disciplinary sanctions, including suspension or revocation of the right to use the CFA designation.

All CFA charterholders and candidates, and other investment professionals who are AIMR members must adhere to AIMR's strict *Code of Ethics and Standards of Professional Conduct*. The AIMR *Code of Ethics* requires AIMR members to always:

- Act with integrity, competence, dignity, and in an ethical manner when dealing with the public, clients, prospects, employers, employees and fellow members;
- Practice and encourage others to practice in a professional and ethical manner that will reflect credit on members and their profession;
- Strive to maintain and improve their competence and the competence of others in the profession; and
- Use reasonable care and exercise independent professional judgment.

The AIMR *Standards of Professional Conduct* support the AIMR *Code of Ethics* and, in their relationships with clients and prospective clients, specifically require AIMR members to:

- Exercise diligence and thoroughness in making investment recommendations;
- Have a reasonable and adequate basis, supported by appropriate research and investigation, for such recommendations or actions;
- Use reasonable care and judgment to achieve and maintain independence and objectivity in making investment recommendations or taking investment action;
- Act for the benefit of their clients and always place their clients' interests before their own;
- Distinguish between facts and opinions in the presentation of investment recommendations; and
- Consider the appropriateness and suitability of investment recommendations or actions for each client.

AIMR members are individual investment professionals, not firms. They work in various capacities in the global investment industry. Approximately 9,000 (18%) of our members work for "Wall Street" or similar firms worldwide, known as the "sell-side" (i.e., broker-dealers and investment banks). Those who work as research analysts for these firms, whose independence and objectivity have been questioned, are an even smaller percentage of AIMR members. In contrast, more than 65% of AIMR members work as investment advisors or fund managers for the "buy-side," the traditional, and still the primary, purchasers of "sell-side" or "Wall Street" research and are not subject to these conflicts.

➢ **Analyst Independence**

I understand that the focus of today's discussion will be on what can be done to enhance the independence and objectivity of Wall Street research. I hope that it will also focus on what must be done to improve the disclosure of financial information to all investors so that better financial analysis and valuation, and hence better investment decision-making, can be conducted by all.

As a preface to my remarks, and based on our experience in setting ethical standards for AIMR members, I can tell you that ethical standards are most effective when developed by the profession and voluntarily embraced rather than externally and unilaterally imposed. Therefore, in drawing your conclusions and making your recommendations to the Senate, we hope that you have confidence in the private sector to solve these problems. I assure you that AIMR is firmly committed to continuing to develop and recommend practical, long-term solutions for the conflicts that Wall Street analysts face and for the ethical dilemmas that we are discussing today. But I must remind you, as an organization of individual investment professionals, AIMR cannot mandate that Wall Street firms adopt these standards nor do we have the power to enforce them.

Since investment professionals work in a global marketplace and investors have access to and act on investment recommendations globally as well, implementation of a domestic standard or solution in the U.S. would solve only part of the problem. As a global organization, I believe that AIMR is in a unique position to effect positive change throughout the world.

Clearly, deteriorating investor confidence in the independence and objectivity of Wall Street research reports and recommendations does *not* advance the interests of the global investment community. Before we discuss this important issue, however, we first must understand who Wall Street analysts are, what they are expected to accomplish, and what pressures they face in the complex environment in which they work.

Who are Wall Street analysts? Although some Wall Street analysts have many years of experience and might be considered experts, many are early in their careers. If they have earned the right to use the CFA designation, these analysts would have the appropriate tools and training to do effective analysis and valuation. But they may not have the experience yet to be considered truly expert. In fact, no matter how expert some Wall Street analysts may be, they are not equipped, and should not be expected, to detect fraud. Managements who lie have the ability to— and do— fool even the most astute and sophisticated of investors.

What are Wall Street analysts expected to do? These analysts are assigned companies and industries to follow, are expected to research fully these companies and the industries in which they operate, and to forecast their future prospects. Based on this analysis, and using appropriate valuation models, they must then determine an appropriate " fair price" for the company's securities. After comparing this "fair price" to the current market price, the analyst is able to make a recommendation. If the analyst's "fair price" is significantly above the current market price, it would be expected that the stock be rated a "buy" or "market outperform."

How do Wall Street analysts get their information? Through hard work and due diligence. They must study and try to comprehend the information in numerous public disclosure documents, such as the annual report to shareholders and regulatory filings (i.e., 10-Ks, 10-Qs, etc.), and gather the necessary quantitative and qualitative inputs to their valuation models.

This due diligence isn't simply reading and analyzing annual reports. It also involves talking to company management, other company employees, competitors, and others, to get answers to questions that arise from their review of public documents. Talking to management must go beyond participation in regular conference calls. Not all questions can be voiced in those calls because of time constraints, for example, and because analysts, like journalists, rightly might not wish to "show their cards," and reveal the insights they have gotten through their hard work, by asking a particularly probing question in the presence of their competitors.

Wall Street analysts are also expected to understand the dynamics of the industry and general economic conditions before finalizing a research report and making a recommendation. Therefore, in order for their firm to justify their continued employment, Wall Street analysts must issue research reports on their assigned companies and must make recommendations based on their reports to clients who purchase their firm's research.

Wall Street firms also expect their analysts to identify attractive new companies within their assigned industry so that they can make new recommendations to the firm's clients —who expect their broker-dealer to find and recommend such companies. Companies whose prospects appear unattractive never make the initial cut, and no report or recommendation is ever issued. Therefore, it is not surprising that Wall Street analysts have more "buy" recommendations than "sell" recommendations. I believe that only if all analysts, on both the "buy-" and the "sell-side," were to reveal their opinions on every publicly-traded company would we even come close to having a bell-shaped curve for "buy-hold-sell" recommendations.

Therefore, even in the absence of pressure for a particular recommendation, Wall Street analysts are expected to have the necessary skills to come to a conclusion about the attractiveness of a company. When Wall Street analysts are assigned companies who are particularly close-mouthed about their activities, whose public disclosure documents are opaque, and for whom transparency is a dirty word, the conclusions and recommendations the analysts must make become more difficult and are made with greater uncertainty.

I do not know at what point lack of transparency and uncertainty about a company's earnings prospects should result in "no opinion" or "no recommendation." What I do know is that financial analysis is more art than science. No analyst, whether Wall Street or not, has a magic formula that accurately and consistently predicts stock prices. Individual analysts must make independent judgments, hopefully with the full support of their employers, based on their own due diligence and the information provided by the companies they follow. Each analyst must decide whether the uncertainty about the information provided is so severe that a reliable valuation and recommendation cannot be done.

However, Wall Street analysts must not be complacent or lazy. Their firms must require high-quality research and compensate them primarily for this and for the success of their recommendations. Neither should analysts or other investors have to accept shoddy accounting and disclosure. Managements of publicly-traded companies must be required to answer the tough questions, even when they touch on material non-public information, and

should be expected to make prompt, full disclosure to the public of both the question and answer.

I must add here that maintaining a "buy" recommendation in the face of falling stock prices is NOT *prima facie* evidence of lack of independence, objectivity, or a reasonable basis for a recommendation —as has been insinuated in the press. There are many reasons that stock prices rise and fall. Some are totally unrelated to a company's long-term prospects. Even companies who have gone into bankruptcy, such as Texaco, have gone on to be good companies and good investments. That said, however, falling stock prices should be a "red flag" and the research report should adequately explain the analyst's recommendation in light of this and provide solid justification for maintaining, or starting, a "buy."

Aside from the pressure to do research and make a recommendation in the face of sometimes opaque and misleading financial information, do Wall Street analysts face pressures to be positive about the prospects of their assigned companies? Yes. But the pressure to provide these positive reports and recommendations comes from many sources, not all of them internal to their firms. Before effective solutions to reduce the impact of these pressures on the research process can be developed, not only the pressures, but also the contributors and processes that cause them, must be identified and addressed.

It is important to recognize that the conflicts that Wall Street analysts face are not new, but they have been magnified in an environment that emphasizes short-term performance. In this environment, the pressures have escalated to a point where penny changes in earnings-per-share forecasts make dramatic differences in share price, where profits from investment-banking activities outpace profits from brokerage and research, where shifting demographics have caused an increase in individual investors who use and rely on Wall Street research, and where investment research and recommendations are now prime-time news, often in little 30-second sound-bites. The serious business of investing one's assets for retirement has become "sport" like "playing the odds" or looking for "tips" at the racetrack.

The particular conflict posed by Wall Street analysts' involvement in their firms' investment-banking activities has again been the focus of media attention in the wake of Enron. However, even prohibiting Wall Street investment banks from selling research to investing clients would not solve the objectivity problem. Collaboration between research and investment banking is by no means the only conflict that must be addressed if we are to provide an environment that neither coerces nor entices analysts to bias their reports and recommendations.

For example, strong pressure to prepare "positive" reports and make "buy" recommendations comes directly from corporate issuers who retaliate in both subtle, and not so subtle, ways against analysts they perceive as "negative" or who don't "understand" their company. Issuers complain to Wall Street firms' management about "negative" or uncooperative analysts. They are also known to bring lawsuits against firms— and analysts personally —for negative coverage. But the more insidious retaliation is to "blackball" analysts by not taking their questions on conference calls or not returning their individual calls to investor relations or other company management. This puts the "negative" analyst at a distinct

disadvantage relative to their competitors, increases the amount of uncertainty an analyst must live with in doing valuation and making a recommendation, and disadvantages the firm's clients who pay for that research. Such actions create a climate of fear that does not foster independence and objectivity. Analysts walk a tightrope when dealing with company managements. A false step may cost them an important source of information to their decision-making process and ultimately can cost them their jobs.

In addition, institutional clients, the "buy-side," may have their own vested interests in maintaining or inflating stock prices. They do not want to be blind-sided by a change in recommendation that might adversely affect their portfolio performance, and hence their compensation. The "buy-side" has been known to "turn in" a negative analyst to the subject company.

An investment professional's personal investments and trading pose another conflict, one that AIMR addressed extensively in a 1995 topical study that now forms an important component of the AIMR *Code and Standards*. We do not believe that it is in clients' best interests to prohibit Wall Street analysts or other investment professionals from owning the securities of the companies they follow or in which they invest their clients' money. Rather, permitting personal investments better aligns analyst and investor interests as long as strict and enforced safeguards are in place that prevent analysts from frontrunning their clients' or their firms' investment actions, and that prohibit analysts from trading against their recommendations.

Human factors also affect the content and quality of a research report or investment recommendation. No matter how experienced, expert, or independent, Wall Street analysts do not have crystal balls; they are not infallible. Even in the absence of fraud, the more opaque a company's disclosures and the more reticent company management is to embrace transparency, the more difficult it is for the analyst to predict changes in the company's fortunes. As I said earlier, much has been made about some research analysts' failures to change their recommendations as the price of Enron began and continued to fall. I wish to remind the committee that many "buy-side" investment managers with major positions in Enron, who do not suffer from the alleged investment-banking conflicts of Wall Street analysts, have admitted that they too could not predict soon enough the downturn in Enron's fortunes or the speed with which it would spiral into bankruptcy. This was not due to either a lack of independence, a lack of skill, or a lack of due diligence, but to the supposed lies told them by a company that betrayed their trust.

We are here today to discuss some specifics about what might be done to assist Wall Street analysts to fulfill their responsibility to their investing clients. Whatever these specific measures might be, they should also protect those investors who may not be aware of the pressures on Wall Street analysts from all of these sources and the limitations in analysts' ability to make foolproof recommendations. This is especially true for those investors who receive shorthand information through various media outlets rather than by purchasing and reading the full research report directly from the Wall Street firm. Surely, no one would recommend that individuals make important decisions, such as taking medication or buying a home, based solely on what they read in the press or hear on television. This is even more

true for critical investment decisions that can adversely affect individuals' and their families' financial well-being.

We do not dispute that some Wall Street firms pressure their analysts to issue favorable research on current or prospective investment-banking clients, or that this practice must stop. However, the relationship between research and investment banking is symbiotic and an important part of the firm's due diligence in evaluating whether or not to accept a company as an investment banking client. Although we do not believe that this collaborative relationship is inherently unethical, it poses serious conflicts that can lead to ethical problems when a large portion of the firm's profitability comes from investment banking. The investment-banking firm must take particular care to have policies and procedures in place that minimize, manage effectively, and fully and fairly disclose to investors any and all potential conflicts.

To effectively manage these conflicts, firms must:

- Foster a corporate culture that fully supports independence and objectivity and protects analysts from undue pressure from issuers and investment-banking colleagues;
- Establish or reinforce separate and distinct reporting structures for their research and investment-banking activities so that investment banking never has the ability or the authority to approve, modify, or reject a research report or investment recommendation;
- Establish clear policies for personal investment and trading to ensure that the interests of investors are always placed before analysts' own;
- Implement compensation arrangements that do *not* link analysts' compensation directly to their work on investment-banking assignments or to the success of investment-banking activities; and
- Make prominent and specific, rather than marginal and "boilerplate," disclosures of conflicts of interest. Such disclosures must be written in "plain English" so that they are accessible and understood by the average reader or listener.

At a minimum, we believe that Wall Street analysts must disclose— and their firms must require them to disclose— the following information prominently on the front of the research report and, even more importantly, in all media interviews and appearances:

- Investment holdings of Wall Street analysts, their immediate families, the Wall Street firm managements and the firms themselves;
- Directorships on the subject company's board by the analyst, a member of their immediate family, or other members of the Wall Street firm;
- Compensation that was received by the Wall Street firm from the subject company;
- Where and how to obtain information about the firm's rating system, and policies to protect and promote independence and objectivity; and
- Material gifts received by the analyst from either the subject company or the Wall Street firm's investment- banking department.

We do caution, however, that effective disclosure in media interviews and appearances can only be accomplished with the full cooperation of the media themselves. Neither Wall Street

analysts nor their firms should be held accountable for what the media won't publish or broadcast. We call upon the media to ensure that these disclosures reach their intended audience.

We also think that rating systems need to be overhauled so that investors can better understand how ratings are determined and compare ratings across firms. Ratings must be concise, clear and easily understood by the average investor. We would also suggest that the "rating," in addition to the "buy-hold-sell" recommendation itself, should also include a risk element, to provide a measure of expected price volatility, and a time horizon, to provide an estimated time period for the stock price to reach the price target. We believe that adding a risk measure and time horizon to the rating systems will provide those investors who do not read or receive the full research report better information with which to judge the suitability of the investment to their own unique circumstances and constraints.

Finally, Wall Street analysts and their firms should also be required to update or re-confirm their recommendations on a timely and regular basis under normal circumstances, but more frequently in periods of high market volatility. They should also be required to issue a "final" report when coverage is being discontinued and incorporate a reason for discontinuance. Quietly and unobtrusively discontinuing coverage or moving to a "not rated" category, i.e., a "closet" sell, does not serve investors' interests.

- **Closing Remarks**

In closing, I would like to impress upon the committee that AIMR and its members appreciate the seriousness of the problems facing Wall Street analysts, but also their complexity. A precipitous solution is not the answer. Nor is one that addresses one aspect of the problem without the others. We believe that the profession can address the issues and develop effective, workable solutions, and this process is well underway. Even we did not understand how complex and interrelated the issues were until we convened our task force last year and began to discuss and uncover all of the forces at work. We are confident that AIMR will recommend an effective solution that, if embraced and adopted by those who have a stake in preserving the integrity of research and the professionals who conduct it, will help restore investor trust in our financial markets and the investment professionals on whose expertise and opinions they rely.

AIMR has also, for over twenty years, been on record advocating a financial reporting system that favors users of financial statements instead of issuers, who may have reason to cloak results in fuzzy and "creative" reporting rules. In our opinion, this has as much, if not more, detrimental effect on investors' confidence in the financial markets as the Wall Street analyst issue. If we put even a fraction of the creative and energy into strengthening our financial reporting system that has gone into undermining it, we will all be rewarded— with renewed investor confidence— with greater reliance on financial reporting information— and with the kind of transparency that only be a long-term benefit for investors in U.S. financial markets.

I will be happy to answer any questions that you might have. Thank you.

Statement of Charles L. Hill, CFA
Director of Research, Thomson Financial/First Call
U.S. Senate Government Affairs Committee
Enhancing Analysts Independence and Improving Disclosure to Investors
27 February 2002

Chairman Lieberman, Ranking Member Thompson, and members of the Government Affairs Committee. I appreciate the opportunity to testify in front of this committee today. I believe the issue of analyst conflicts is an important issue that needs to be addressed. It is one of several investment issues that needed to be addressed before the Enron debacle, and now even more so. It is important not only to the future health of the investment community, but is of greater importance to the public's perception of and confidence in the overall capitalist system.

The most obvious symptom of the analyst conflict problem is the positive bias of analyst recommendations in general, as well as the extreme positive bias of their recommendations on Enron in particular.

For at least the last several years, roughly one-third of all broker analyst recommendations were strong buys (or whatever the brokers terminology was for the top category). Similarly, one-third were buys and one-third were holds. The total of both sells and strong sells was always less than 2%. That is still true today despite the severe criticism analyst recommendations have been increasingly subject to in recent months. It is interesting that the analysts recommendations were at their most positive levels at the peak of the market in the Spring of 2000.

That means that if an individual investor was able to decode what the broker recommendation terminology really meant (for example, most investment institutions translate "hold" to mean that the analyst is really saying "sell"), and was guided by the relative changes in their recommendations, those changes on average would not have been very helpful.

The above normal positive bias persisted until early 2001, even though the stock market indices were in decline from the spring 2000 highs. The shift that did occur was fairly minimal, roughly six percentage points shifted from strong buy to buy, and about five from buy to hold and about one from hold to sell.

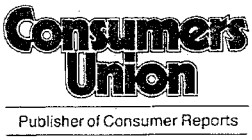
In the specific case of Enron, the analysts were in a difficult position. Enron had morphed into what was essentially a hedge fund. As a result there was very little transparency in recent years as to where earnings were coming from. Analysts were virtually limited to Enron's historical earnings record and to the company's guidance for future earnings.

Therefore, it was not surprising that on the eve of Enron's third quarter 2001 earnings report, 13 broker analysts had a strong buy (or their equivalent terminology), 3 had a buy, and none had a hold, sell, or strong sell.

Despite a number of red flags from 16 October 2001 on, the analysts dallied in lowering or discontinuing their recommendations in the face of increasing risk. By 12 November, almost a month after Enron had announced a $1.2 billion write off that Ken Lay could not explain on a conference call, almost a month after the Wall Street Journal reported Enron executives stood to make millions from Enron partnerships, three weeks after the CFO was fired, two weeks after Enron announced it was being investigated by the SEC, and four days after Enron announced that it had overstated four years of earnings by $600 million - after all these red flags, there were still 8 analysts with a strong buy, 3 with a buy, 1 with a hold, and 1 with a strong sell. At that point, none had dropped their recommendations.

The new proposals from the NASD go a long way toward addressing some aspects of the bias problems. They provide for better disclosure of the firm's investment banking relationships with the company, and of the firm's and the analyst's holdings. They provide for some standardization of recommendations across the brokerage industry. The requirement for analyst reports to show the recommendation distribution of all the firm's recommendations hopefully will lead to less of a positive bias in analyst recommendations.

Unfortunately, the new NASD rules do not sufficiently address the key issue of analyst compensation. Until the so called "Chinese Wall" between research and investment banking is restored at the brokerage houses, there will continue to be a problem with analyst objectivity.



TESTIMONY

OF

FRANK TORRES
LEGISLATIVE COUNSEL
CONSUMERS UNION

BEFORE THE

UNITED STATES SENATE

COMMITTEE ON GOVERNMENTAL AFFAIRS

ON

THE COLLAPSE OF ENRON:

THE ROLE ANALYSTS PLAYED AND THE CONFLICTS THEY FACE

FEBRUARY 25, 2002

BACKGROUND

Consumers Union[1] is pleased to provide this testimony on securities analysts' conflicts of interest. Investors need a credible source of information about investments. Individual investors often rely on the advice provided by Wall Street analysts. Yet, that advice may be far from independent or objective.

In hindsight, Enron's demise shows that potential conflicts at research operations at full-service brokerage houses may compromise the quality of research, and that the effects on individual investors, market stability, and the economy as a whole can be devastating.

According to expert testimony during congressional hearings last year, including statements by former Commissioners of the Securities and Exchange Commission, market forces put tremendous pressure on analysts to make positive recommendations. Analyst compensation is often based on investment banking fees linked to the companies on which the analyst offers advice. Analysts, or their firms, may own stock or have other interests in the companies on which the analyst is providing advice.

Conflicts of interest have a direct impact on individual consumer investors. Studies show that investors do worse listening to analysts with ties to companies and better with independent analysts. Investors were told to buy even when the analyst making the recommendation was selling the same stock. Overall, the vast majority of analyst recommendations are to buy. Only rarely are investors advised to sell.

Why is this discussion important? In 1990 less than a quarter of all American households directly owned stocks, today that number is more than half. Testimony by the AFL/CIO put it best:

> Families have an enormous state in the honesty of the investment information they receive from the analyst community. Few individual investors have the ability to digest raw data from financial markets, and even fewer may have access to insiders in the companies they invest in. Analyst research is likely to be the most detailed and analytical

[1] Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide consumers with information, education and counsel about goods, services, health, and personal finance; and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of *Consumer Reports*, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, *Consumer Reports* with approximately 4.5 million paid circulation, regularly, carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

information small investors have to consult in making investment decisions.

In response to rising concerns about analyst independence and conflicts of interests the National Association of Securities Dealers (NASD) recently proposed improved disclosures of potential conflicts. The NASD first proposed rules on required disclosures for securities recommendations in response to the decline of technology stock. Consumers Union, Consumer Federation of America, and Consumer Action filed comments in response to that initial proposal. A copy of our comments is attached to this testimony. The current NASD proposal expands the reforms discussed pre-Enron and incorporates some of the recommendations made by Consumers Union and others. We are encouraged by these developments.

VIEW OF THE MARKETPLACE: THE PROBLEMS AND SOME SOLUTIONS

- Conflicts of interest will always exist where analysts are part of the same firms that loan money or have other business relationships with the companies on which the analysts offer their recommendations.

- These conflicts are likely to grow with the passage of the Gramm-Leach-Bliley Act, which repealed Glass-Steagall and allows banking, investment and insurance firms are allowed to merge – mergers that will create a myriad of potential conflicts of interest.

- Disclosure of conflicts does not get rid of the conflict of interest. Analyst recommendations may still be influenced by the relationships between the investment firm and its affiliates and the companies recommended by the analysts.

- Meaningful disclosures may serve as useful warnings to investors that the recommendations may be tainted. Disclosures should provide details of the nature of the relationships between the analyst, the analyst's firm and the company being recommended. Disclosures should be made any time a recommendation is being made and in a manner that calls the investor's attention to the disclosure. A uniform "food label" may be an appropriate mechanism to allow investors to quickly identify potential conflicts.

- A "certification" system for independent analysts should be created. Investors reading a report from an independent analyst or listening to an independent analyst on TV that is so designated would know right away that the analyst is conflict-free. Investors could chose to disregard advice by analysts without the "independent" designation.

- A mechanism to rate the accuracy and reliability of Wall Street analysts would also help investors judge advice and recommendations.

- Addressing analysts' conflicts of interest alone will not be enough to restore investor confidence. If the circumstance that create the potential unreliability of analyst advice cannot be completely removed, then investors need assurances that other watchdogs are in place. Regulatory oversight and independent audits are key components. The SEC must be provided the resources to fulfill this mission.

- Another solution that may benefit investors would be the development of an independently funded investor driven watchdog organization.

THE ROLE OF ANALYSTS

Securities analysts enjoy a privileged position in the markets because of the central role they play in the efficient pricing of equities. The public losses confidence when market corrections, like the ones in the tech sector, go virtually unrecognized by industry analysts, many of whom continued to plaster "buy" recommendations on the stocks they covered, even as share prices plummeted. That colossal failure by analysts prompted many in the media, the regulatory community, and on Capitol Hill to ask what went wrong and what, if anything, can be done to fix it. With the collapse of Enron, we find ourselves asking the same questions.

One answer, acknowledged even by leaders in the industry, is that Wall Street research is pervaded by conflicts of interest that can, and have, corrupted the objectivity of research. Instead of turning a skeptical eye on questionable "operational earnings" numbers presented by corporate mangers or pointing to a lack of any prospect for company profits in the near term, or brazen refusals to provide clarification of company practices as reported with Enron, or a lack of understanding of company operations, too many securities analysts became cheerleaders for companies their firm was bringing public or had other financial dealings.

Conflicts of interest will exist as long as investment banking, trading and research are permitted to be bundled together in one firm. Beyond the industry's failure to recognize and warn investors – one reason analysts find themselves in the hot seat – several things have changed in recent years to make analysts' conflicts of interest an issue that policy-makers are compelled to address:

- The magnitude of research-tainting conflicts has grown as investment banking and proprietary trading have become increasingly dominant sources of revenue for full-service brokerage firms.

- The Internet and financial media, particularly broadcast media, has given analys research new prominence. By turning securities analysts into media stars, the media has helped to magnify analysts' influence on share price.

- In part because of that new media exposure, retail investors suddenly have access to Wall Street analysts' research, but without the understanding more sophisticated players generally have of the conflicts that may bias that research.

ANALYST RECOMMENDATIONS

Media, academics, and experts who have testified before Congress over the past two years have offered convincing testimony on the nature, extent, and effects of analyst conflicts of interest. That testimony has shown that substantial conflicts pervade Wall Street research operation, that the quality of research is impaired by those conflicts, and that the economy and individual investors are harmed as a result.

- Former SEC Chairmen Arthur Levitt testified about a study that found sell recommendations account for just 1.4 percent of all analysts' recommendations, compared to 68 percent being buys.

- In the case of Enron, 16 out of 17 analysts had a buy or strong buy rating, one had a hold, none had a sell – even as the company stock had lost over half of it's original value and it's CEO suddenly resigned.

- William Mann, a senior analyst with The Motley Fool, told a congressional panel that Enron isn't the first time analysts maintained cherry ratings on a company as the company itself was collapsing and investors faced tremendous losses. During the descent of Lucent of the 38 analysts who covered the company 32 had buy ratings on the sock, 6 had holds, and none had a sell rating. Investment banks that had generated significant revenue from Lucent's acquisition and debt placement activities employed many of those analysts.

- Over the last 12 months 233 public companies have had to restate their earnings, and not surprisingly, none of these restatements have made the companies' operating results look better, according to Mann of the Motley Fool.

GROWING CONFLICTS OF INTEREST

It is difficult not to point to possible conflicts of interests between analysts, the firms that employ them and the financial relationships between those firms and the companies subject to the analysts' recommendations. What chance do consumers have of making informed choices when they can't depend on auditors or analysts to tell them the truth about the financial well being of companies?

The passage of the Gramm-Leach-Bliley Act also raises new concerns. The

consolidation of the financial services industry creates new further potential conflicts. Issuers are in a position to withhold business from the firms of critical analysts across a wide range of markets, including commercial loans and commercial banking services, pension fund and treasury money management, and insurance contracts. This leverage is particularly powerful when the issuer is itself a financial services company.

- CFO Magazine reported last year that First Union cut off all bond trading business with Bear Stearns in response to negative comments by their analyst, and Bear Stearns ordered the analyst to be more positive. Recent press reports of similar threats made by Enron executives.

- According to USA Today, Lehman Brothers could not downgrade its strong buy recommendation on Enron (even if it was inclined to do so) because it was restricted as an advisor in the Dynegy buyout bid.

- An article appearing this Saturday in the Washington Post points directly to the relationship between banks and Enron. The article highlights how J.P. Morgan made loans to Enron, bought Enron stock, and recommended Enron stock to investors. Some of the largest banks in the country had similar arrangements. Analysts for some of those firms kept strong buy recommendations in place for Enron until it became painfully obvious that the company was collapsing. J.P. Morgan faces over $1 billion in losses and has lined up with other Enron creditors in bankruptcy court.

If you were an analyst, where would your place your allegiance? Do you act to protect the investment of your firm and try to boost the stock? Or do you advise investors to sell?

THE NASD PROPOSAL

The NASD proposal to address these developments, driven in part by the Enron debacle, is a good first step. The proposal relies heavily on disclosure. Even the best disclosure, however, does not get rid of the underlying conflict. Therefore, improved disclosure alone will not be enough to restore confidence in Wall Street analysts' research. But improving the ability of investors to assess the conflicts of interest is an appropriate place to start. More comprehensive solutions will take time. In the interim, there seems to be near universal agreement that improved disclosure is badly needed.

Reforms should also focus on creating incentives to produce objective research, boosting the competitiveness of that research, improving the clarity of analysts recommendations, prohibiting certain inherently abusive practices, supporting strong enforcement against abuses, and enhancing Regulation FD.

As long as research is offered within firms that combine investment banking,

trading, and research, it will be subject to powerful conflicts of interest with significant potential to bias recommendations. And, as long as firms earn the bulk of their revenues on investment banking and proprietary trading, management will have little incentive to protect research departments from the corrupting influence of those conflicts. When analysts are rewarded (e.g., with sizable bonuses) for playing the game, when institutional clients continue to purchase Wall Street research despite its obvious biases, and when financial media continue to give prominent play to biased research, there is little up-side for either the analyst or the firm in issuing objective research. As a result, combating the problem will require a multi-faceted approach that combines enhanced disclosures, effective enforcement, and new incentives to produce objective research.

FURTHER RECOMMENDATIONS

We are encouraged that the NASD rule addresses some of the concerns consumer advocates raised in comments of earlier industry proposals. In those comments Consumers Union, Consumer Federation of America, and Consumer Action made the following recommendations:

Create an incentive to produce objective research

The primary goal of an effective policy to address research conflicts should be to provide an "up-side" for objective research. In other words, since powerful financial incentives to produce biased research will persist, policy makers should seek to provide equally powerful incentives to provide objective research. The best way to do that, in our view, is to put analysts' and firms' reputations clearly on the line.

We believe the National Association of Securities Dealers should be encouraged to develop standardized measurements of the success of analysts' recommendations and apply them to all analysts and firms making research publicly available. At a minimum, the ratings should be publicly available through the NASD. A better approach might be to require their disclosure on research reports.

Just as requiring airlines to publish their on-time records helped to improve their on-time performance, requiring analysts and firms to publish their research quality ratings would likely encourage them to produce more reliable recommendations. After all, no one wants to end up featured in a Gretchen Morgenson column on the worst analysts in the industry. Conversely, firms that perform well are likely to use that fact in promoting their services. Finally, using such ratings might encourage the media to be more selective in its use of analysts, choosing those with a reputation for quality research rather than those with a snappy line of patter.

Help make independent research more competitive

Given the disdain many institutional investors express for the recommendations of sell-side researchers, it is difficult to understand why they don't turn to independent research instead. The answer appears to be that they don't actually "pay" for Wall Street research. They get it as a part of a bundle of services that also includes trading and access to IPO shares. The fact that the research is, to all appearances free makes if extremely difficult for independent researchers to compete. One suggestion is to require Wall Street firms to bill separately for research. By making the costs of the research explicit, rather than hiding it in commissions that are passed on to shareholders, such an approach could open the door to greater use of independent research firms by institutional investors. If Wall Street firms had to compete on the basis of the quality of their research, this would provide an added incentive to improve that research's objectivity and clarity.

Require explicit, graphic disclosure of conflicts of interest

Almost everyone seems to agree that current disclosures of conflicts are inadequate and need to be improved. In fact, if the intent of the disclosures is to put average, unsophisticated investors on notice of conflicts, current disclosures are all but meaningless. The NASD has taken an initial step toward improving disclosures, for which they are to be congratulated. We want to ensure that the NASD proposal will produce the kind of disclosures that would grab investors' attention and make them aware of the nature and extent of those conflicts. To be effective, disclosures must be clearly labeled as disclosures about conflicts of interest; they must describe the nature of the conflict; they must expose the extent of the conflict; and they must extend to all the ways in which research is conveyed to average investors, including oral representations by brokers to clients.

Truly effective disclosure should arm investors with the kind of healthy skepticism that institutional investors bring to the reading of Wall Street research. To the degree that the practices disclosed are embarrassing when laid out in unvarnished language, improved disclosure might also discourage some firms and analysts from engaging in certain types of behaviors that create conflicts.

Mandate standardized terminology for analyst recommendations

It has repeatedly been noted that, while insiders understood that "buy" means "hold" and "hold" means "sell," average investors weren't always up on the lingo. In its best practices, the SIA recommends that firms adopt formal ratings systems and publish the definitions of those ratings. At a minimum, firms should be required to do so and to disclose those ratings on every research report. A better approach would be for regulators to work with industry to develop uniform language that all firms are required to use. This would enable investors not only to understand the significance of an individual analyst or firm's ratings, but also

to better compare the ratings issued by different analysts and different firms.

In addition, firms should be required to disclose on each research report, the percentage of stocks it currently covers that fall into each category. If an investor learns that every company the firm covers is rated a "buy," he or she may be less likely to rely exclusively on the recommendation. Instead, the investor may be inclined to probe more deeply to determine if the stock is appropriate for his or her portfolio.

Prohibit certain practices that create significant, unwarranted conflicts of interest

Certain practices that carry enormous potential for abuse and ought to be prohibited. These include analysts' practice of selling against their own recommendations and purchasing pre-market shares of a company and then issuing positive research to support the offering and some firms' practice of tying analyst compensation directly to specific investment banking projects on which they are involved. Similarly, to the degree that the practice of issuing "booster shots" is not already in violation of existing prohibitions on manipulation, it should be expressly prohibited.

Take strong enforcement action against abusive practice

When teenager Jonathan Lebed was hauled before the SEC on stock manipulation charges, he expressed some confusion over how what he had done differed from the practices of the main Wall Street players. He made a good point. After all, when Wall Street firms or their analysts issue positive research to promote interest in a stock as they prepare to unload their own holdings (against the analysts' buy recommendation), they are running their own version of the "pump and dump" scheme. The SEC should be at least as aggressive in going after these Wall Street insiders as it has been in going after the relative small fry who use Internet chat rooms to run their schemes.[2] If the SEC lacks either the resources or the authority to pursue that sort of aggressive enforcement program, Congress should give them what they need. If the SEC lacks the will to pursue such cases, Congress should use its oversight authority to help supply the backbone.

CONCLUSION

Substantial conflicts of interest are deeply embedded in the structure and practices of Wall Street firms. Voluntary industry efforts will do little to change behavior. However, we believe a multi-faceted approach that lays bare those conflicts, creates incentives for producing unbiased research, clarifies the language of recommendations, prohibits particularly abusive practices, and provides strong enforcement to back up standards has the potential to prompt significant improvements.

[2] This is not to imply that we condone the stock manipulations of Lebed and others, rather that we believe Wall Street insiders should be held to at least as high a standard.

Consumer Federation of America

Consumers Union
Nonprofit Publisher of Consumer Reports

Consumer @ction

August 15, 2001

Barbara Z. Sweeney
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, N.W.
Washington, D.C. 20006-1500

RE: NASD Notice to Members 01-45 -- Request for Comment (Required Disclosures for Securities Recommendations)

Dear Ms. Sweeney:

We are writing on behalf of the Consumer Federation of America (CFA),[1] Consumers Union (CU),[2] and Consumer Action (CA)[3] in response to NASD Regulation's request for comment on its proposal to improve disclosure of securities analysts' conflicts of interest. NASD Regulation is to be congratulated for taking the lead among the industry self-regulatory organizations in addressing this important issue. While we agree that investors would be best served by standards that "apply to all financial services providers on an equal basis," we applaud the decision not to use the desire for uniformity as an excuse to delay action.

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[1] CFA is a non-profit association of more than 250 pro-consumer organizations. It was founded in 1968 to advance the consumer interest through advocacy and education.

[2] CU is a non-profit membership organization chartered in 1936 under the laws of the State of New York to provide consumers with information, education and counsel about goods, services, health, and personal finance; and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of Consumer Reports, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, Consumer Reports (with approximately 4.5 million paid circulation) regularly carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

[3] Consumer Action is a San Francisco based educational and advocacy organization that works on a wide range of consumer and privacy issues through its national network of 6,500 community based organizations.

We are also encouraged that NASD Regulation is presenting these disclosure proposals as a first step in addressing "issues related to the quality and independence of research and recommendations issued by member firms and associated persons." Improved disclosure alone will not be enough to restore confidence in Wall Street analysts' research. But improving the ability of investors to assess the conflicts of interest is an appropriate place to start. More comprehensive solutions, if they are to be adopted, will take time. In the interim, there seems to be near universal agreement that improved disclosure is badly needed.

I. Background

The existence of conflicts of interest for sell-side analysts is as old as Wall Street itself. Furthermore, these conflicts will persist as long as we permit investment banking, trading, and research to be bundled together in one firm. Beyond the industry's spectacular failure to recognize and warn investors of the latest market correction -- which is the immediate reason analysts find themselves in the hot seat -- several things have changed in recent years to make analysts' conflicts of interest an issue that policy-makers are compelled to address.

- The magnitude of the research-tainting conflicts has grown as investment banking and proprietary trading have become increasingly dominant sources of revenue for full-service brokerage firms.

- Analyst research has been given new prominence by the Internet and financial media, particularly broadcast media. By turning securities analysts into media stars, the media has helped to magnify analysts' influence on share price.

- In part because of that new media exposure, retail investors suddenly have access to Wall Street analysts' research, but without the understanding more sophisticated players generally have of the conflicts that may bias that research.

NASD Regulation's proposal is designed to address these new developments both by improving the quality of disclosure about conflicts of interest in written advertisements and sales literature and by extending an abbreviated version of those requirements to recommendations made during public appearances. We support this general approach. We particularly applaud the decision to apply disclosure requirements to public appearances, an increasingly important means by which research is conveyed to the general public.

We believe, however, that the required disclosures can and should be improved. Specifically, more needs to be done: 1) to ensure that investors understand that the disclosures are being made to expose conflicts of interest; 2) to ensure that the disclosures reveal not just the existence, but also the extent, of those conflicts of interest; and 3) to extend disclosure requirements to all the ways in which research is communicated to retail investors, including oral representations by individual sales representatives to their clients.

II. Written Disclosures

A. More can be done to ensure that investors understand the intent of the disclosures.

While the regulators and industry insiders who follow this issue may take for granted the purpose of enhanced disclosures, it is not safe to assume that average, unsophisticated investors who are the intended beneficiaries of the rule will do the same. For example, some investors may read statements about a firm or analyst's investment in a particular stock not as a warning about conflicts that may bias the research, but as a positive message that the firm or analyst in question really believes in the stock's prospects. Similarly, a statement that a firm is a market maker in the stock may be meaningless to the investor who does not understand how a market maker makes its profits. In other words, disclosures that are clear to someone who already understands the conflicts that may bias analyst research may be less meaningful to the average investor and thus may be largely ignored by the intended beneficiaries of the rule.

One relatively simple way to address this issue would be to require that written disclosures appear under the heading "Conflicts of Interest." A brief statement, along the following lines, should precede the disclosures: "XYZ firm and the analyst who prepared this report are subject to certain conflicts of interest in evaluating this stock. Specifically:" The required disclosures should then follow in bullet points. Such an approach would ensure that investors understand the purpose of the disclosures and, as a result, might encourage them to read disclosures they would otherwise be inclined to skip over.

B. More can be done to ensure that investors understand the nature and extent of the conflicts of interest.

The NASD Regulation proposal does a good job of zeroing in on the factors that may create a conflict: whether the firm makes a market in the stock or trades in the stock on a proprietary basis, whether the firm or analyst owns the stock in question or has any other financial stake in the company, and whether the firm currently serves the issuer as an investment banker or has done so in the recent past.[4] Furthermore, the requirement that disclosures be specific and prominent should help to guarantee that they are not lost in tiny footnotes or offered in the kind of vague language that is all too common today.

As we noted above, however, it is not safe to assume the average investor will understand how these relationships create a conflict. Nor do these disclosures shed much light on the extent of any conflict created. Without improvements to clarify these points, the disclosures are likely to be little more than a somewhat improved version of the current boilerplate and, as a result, are

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[4] Disclosure that the firm is currently seeking the issuer's investment banking business would also be useful. While it would not be possible to capture all such situations, any instance in which the firm has made a formal proposal to the issuer to offer investment banking services should have to be disclosed.

likely to have little effect on investor behavior. With improvements, however, the disclosures could be made truly meaningful to investors. For example:[5]

- instead of simply disclosing that the firm has received compensation from the recommended issuer for investment banking services within the last 12 months, disclose that the firm has received roughly $__ million from the issuer for investment banking services in the past year and has a financial interest in keeping the issuer as a client;

- instead of disclosing that the person responsible for the recommendation has a financial interest in the stock, disclose (as relevant) that the person responsible for the recommendation purchased X number of pre-market shares of the stock at a price of $__ per share, will soon become eligible to sell those shares, and stands to make a significant profit if the stock price rises;

- instead of disclosing simply that the firm makes a market in the stock, also disclose that, as a result, the firm stands to profit if the research report generates increased trading interest in the stock;

- instead of disclosing simply that the firm will buy the security from or sell the security to customers on a principal basis, also disclose that, as a result, the firm stands to profit from any increased interest in the stock that may result from the recommendation and, in particular, that the company will profit if it is able to sell shares it already owns to customers for more than it paid; and

- instead of disclosing simply that the firm owns five percent or more of the company's outstanding stock, disclose that, at the time the report was published, the firm owned roughly X shares of the company's stock purchased at prices ranging from $__ to $__ per share, that the value of its portfolio will rise if the report causes the company's share price to rise, and that the company may be able to realize a significant profit by selling the shares for more than it paid.

Such disclosure would help the investor distinguish between major and minor conflicts. Where significant conflicts are exposed, the investor would receive a clear warning to take the recommendation with a grain of salt. In other words, the investor will be fore-armed with the kind of healthy skepticism about analyst objectivity that institutional investors already bring to the reading of Wall Street research. That kind of appropriate skepticism is exactly what the Securities and Exchange Commission and almost everyone else who has testified before Congress on the issue agree is needed. It will not be produced by general disclosures that fail to expose the nature and degree of conflicts.

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[5] The following examples are not offered as definitive disclosure language but as general guidance to the kind of explicit statements needed to make the nature and extent of conflicts clear.

Explicit disclosures of this type could have a second salutary effect. To the extent that such disclosures are embarrassing to the analyst or to the firm, they may discourage the most egregious types of behavior that can bias research.

III. Disclosures Made During Public Appearances

A. NASD Regulation is right to extend more abbreviated disclosure requirements to recommendations made during public appearances.

The NASD Regulation proposal recognizes that public appearances by analysts have become an increasingly important means by which Wall Street research is conveyed to average investors. Investors who never read a copy of the written report, and thus never see the written disclosures, may nevertheless be exposed to its findings when analysts appear on tv or radio shows or participate in interactive on-line forums. Disclosure requirements that fail to cover such appearances would likely leave the bulk of retail investors who are only indirect consumers of Wall Street research without any meaningful warnings about conflicts of interest.

NASD Regulation is therefore to be congratulated for attempting to tackle the thorny question of how best to get across meaningful information about conflicts in the often fast-moving formats of public appearances. Obviously, the First Amendment precludes the NASD from mandating the disclosures media outlets must provide. Instead, NASD has focused appropriately on what information about conflicts its members are required to provide when discussing recommendations during public appearances.

Similarly, NASD has recognized the limitations of the public appearance format. When an analyst may spend little more than a few minutes on screen (or on air), he or she cannot be expected to consume half that time explaining the conflicts that may bias the recommendation under discussion. Any such disclosures would quickly find their way onto the cutting room floor.

In light of those limitations, we believe NASD Regulation has done a good job of identifying the key types of information that must briefly be disclosed: any financial interest the analyst has in the company, whether the firm owns stock in the company, and whether the issuer is an investment banking client of the firm. As with the written disclosures, however, we urge NASD to make some effort to clarify the reason for the disclosure. The analyst or other company employee making the recommendation should have to explain that they and/or the firm have a conflict of interest in recommending the stock; that these include (as appropriate) the fact that the analyst owns stock (or has some other financial stake) in the company, the fact that the firm owns stock (or has some other financial stake) in the company, and the fact that the issuer is an investment banking client of the firm, which produces significant income to the firm; and that, as a result, the analyst and/or the firm stand to benefit financially if the share price rises or trading interest in the stock increases. While this is far from comprehensive, it would at least put the investor on warning about possible limitations of the recommendation.

B. Similar requirements should apply to oral representations by salespeople to clients.

The NASD Regulation proposal ignores a third channel through which investors may be exposed indirectly to Wall Street research -- oral recommendations from their broker. As the media turns analysts into celebrities, and investors become more aware of research as a source of buy and sell recommendations, brokers may be increasingly inclined to refer to analyst recommendations in their sales pitches to clients.[6] For example, in recommending a stock to a client, the registered rep may state something along the following lines: that a particular analyst at the firm has rated the stock a buy and has put a price target of $80 on the stock, which is currently trading at just $54 per share. The registered rep may further note that this analyst is among the best known in the industry, making regular appearances on CNBC and MSNBC. In such a situation, the investor may rely on the recommendation without ever seeing the actual report or the written disclosures that accompany it.

To ensure that investors relying on recommendations from their sales rep get some warning of conflicts, registered representatives who refer to research in oral representations to clients should also have to make some disclosure about conflicts of interest. At a minimum, those requirements should mirror the requirements covering recommendations made during public appearances -- that the analyst who prepared the report and/or the firm have conflicts of interest in recommending the stock, that these include (as appropriate) the analysts's financial stake in the stock, the firm's financial stake in the stock, and that the issuer is an investment banking client of the firm, and that, as a result, the analyst and/or firm stand to profit if the recommendation produces additional trading interest in the stock or if the share price rises. In addition, the registered representative should have to inform the client that the full research report is available and that it contains more complete information about the basis for the recommendation and about the conflicts of interest that may bias the research. Again, such disclosures should encourage more investors to stop and get a fuller picture before proceeding on biased recommendations.

IV. Conclusion

NASD Regulation has made a good start by attempting to improve disclosure of analyst conflicts of interest. In order to be effective, these disclosures must make clear that the practices being disclosed create a conflict of interest, and they must provide information that allows the investor to assess the nature and extent of any conflict created. Also, disclosure requirements must apply to oral representations made to retail clients of the broker-dealer firm. If NASD adopts these changes, this proposal has the potential to provide clear, meaningful warnings on which investors can act. Without the changes proposed, the rule is likely to be only a tiny, incremental improvement over the existing inadequate disclosure system.

Finally, NASD Regulation has asserted that this rule proposal is merely a first step in its efforts to address the broader issue of analyst conflicts. We would like to suggest some additional areas for study and possible action:

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[6] Already, brokers refer to the quality of their research in advertisements designed to attract retail clients.

- developing standardized language for buy/sell recommendations and requiring firms to disclose what percentage of stocks covered by the firm are rated in each category;

- developing a standardized system for measuring the success of research recommendations and requiring that those ratings be disclosed both for individual analysts and for the firm's research department as a whole;

- requiring that full-service brokers provide institutional clients with a separate bill for research that reflects the cost of producing that research, rather than allowing research to be bundled with other services (thus making it easier for institutional clients to justify paying for independent research); and

- prohibiting certain types of questionable conduct, such as the analyst's selling against his or her own recommendation, purchasing pre-market shares in companies and then issuing positive research reports on those companies, or allowing analyst compensation to be tied directly to the success of investment banking accounts in which they are involved.

The reality is that conflicts will never be erased and that no "Chinese Wall" will ever effectively separate research from investment banking as long as investment banking pays the bills. The goal for NASD Regulation should be to create incentives (through disclosure of their success rate, for example) that help to counter-balance those conflicts and to arm investors with clear and meaningful information about the conflicts that may bias recommendations. To supplement improved disclosure, NASD should work with the SEC and others to educate investors about the limitations of Wall Street research. Finally, the SROs must work with the SEC to take effective enforcement action against the Wall Street version of the pump and dump scheme, when analysts issue "booster shots," for example, just before the end of a lock-up period and then sell their holdings while encouraging the investing public to buy. Only a multi-faceted approach of this type will begin to restore some balance to the recommendations made by Wall Street analysts.

We appreciate the opportunity to comment on this proposal. Please feel free to call Barbara Roper if you have any questions about our comments or would like to discuss these issues further.

Respectfully submitted,

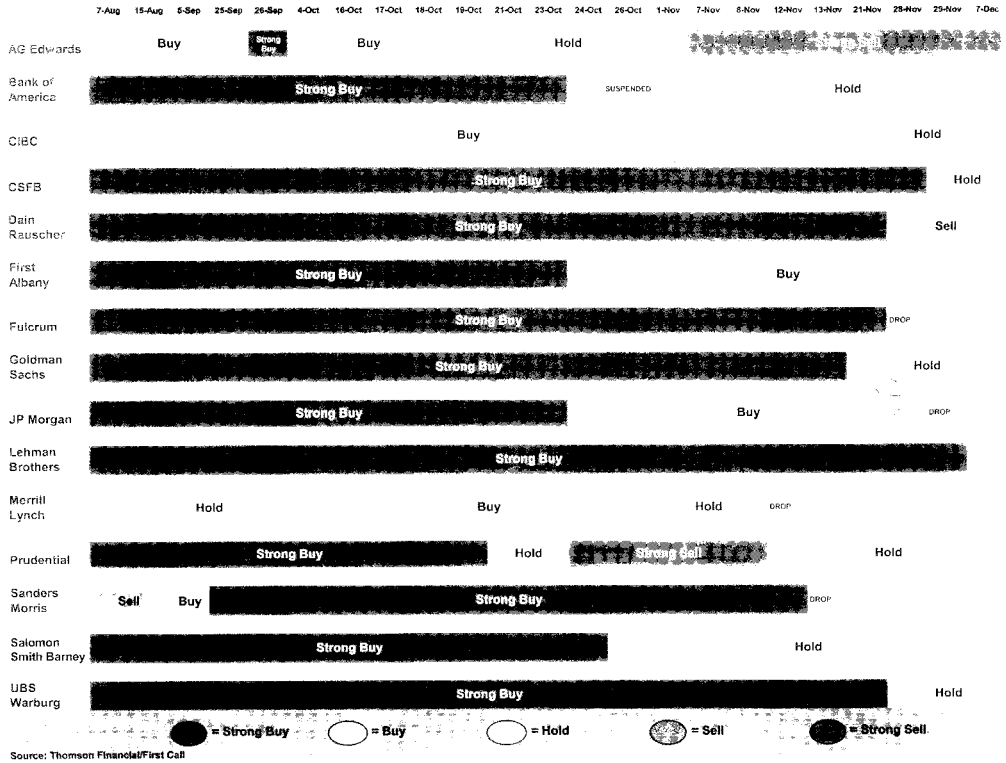
Barbara L. N. Roper
Director of Investor Protection
Consumer Federation of America

Frank Torres
Legislative Counsel
Consumers Union

Kenneth McEldowney
Executive Director
Consumer Action

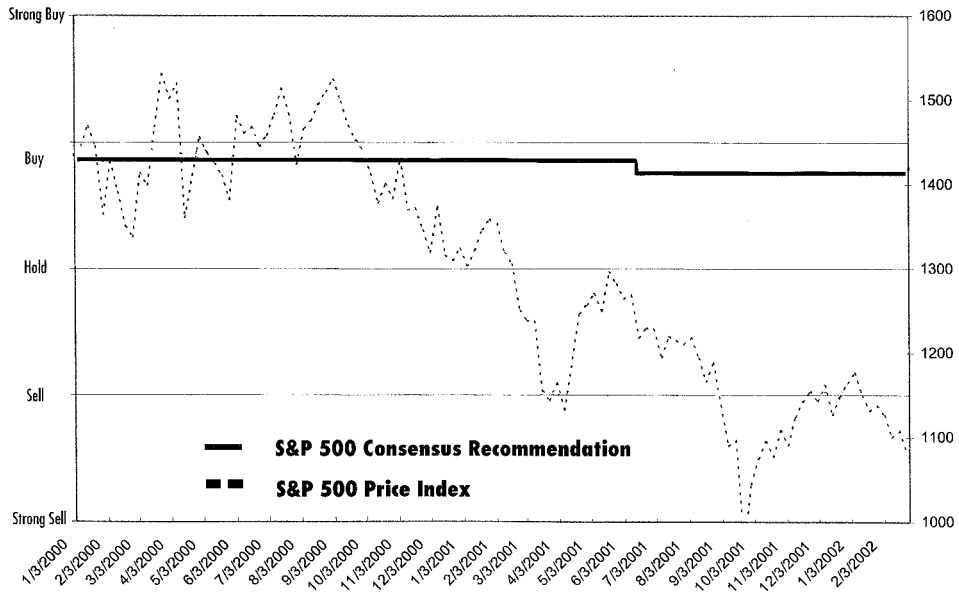
Enron Stock Recommendations by Broker

Aug 7 - Dec 7, 2001

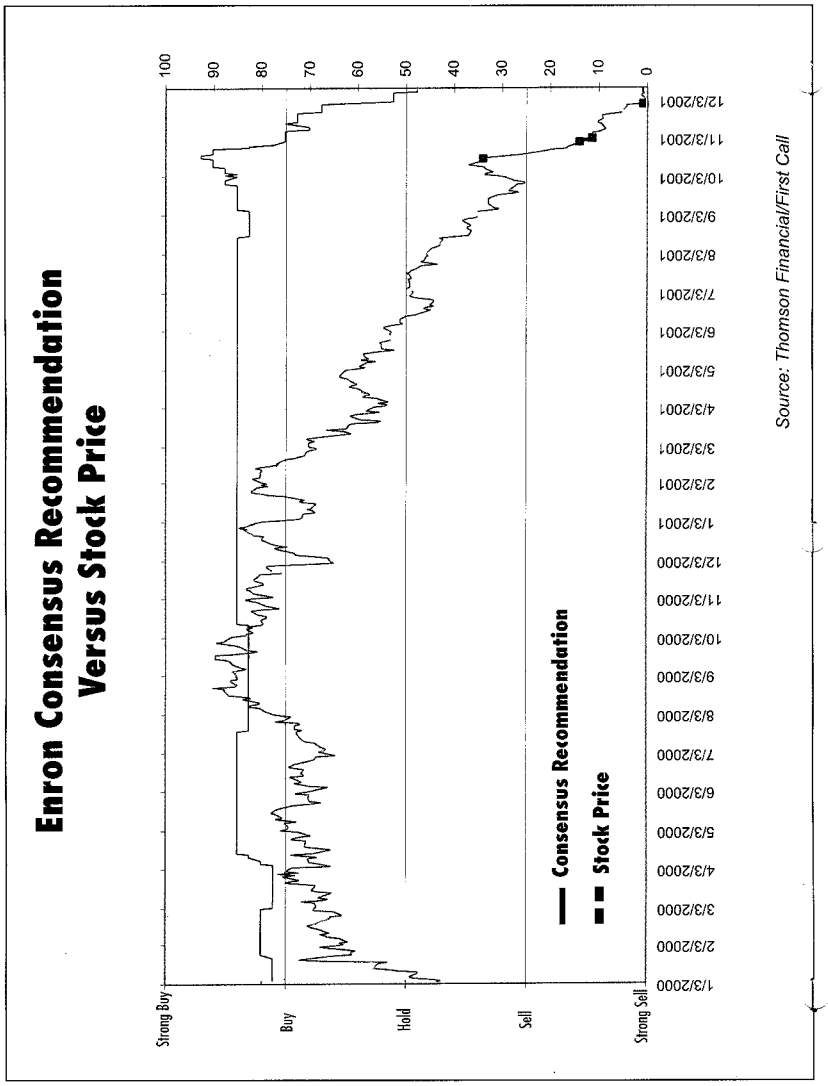


Source: Thomson Financial/First Call

S&P 500 Price Index Versus S&P 500 Consensus Recommendation



Source: Thomson Financial/First Call


Enron Consensus Recommendation
Versus Stock Price
Strong Buy
Buy
Hold
Sell
Strong Sell
100
90
80
70
60
50
40
30
20
10
0
1/3/2000
2/3/2000
3/3/2000
4/3/2000
5/3/2000
6/3/2000
7/3/2000
8/3/2000
9/3/2000
10/3/2000
11/3/2000
12/3/2000
1/3/2001
2/3/2001
3/3/2001
4/3/2001
5/3/2001
6/3/2001
7/3/2001
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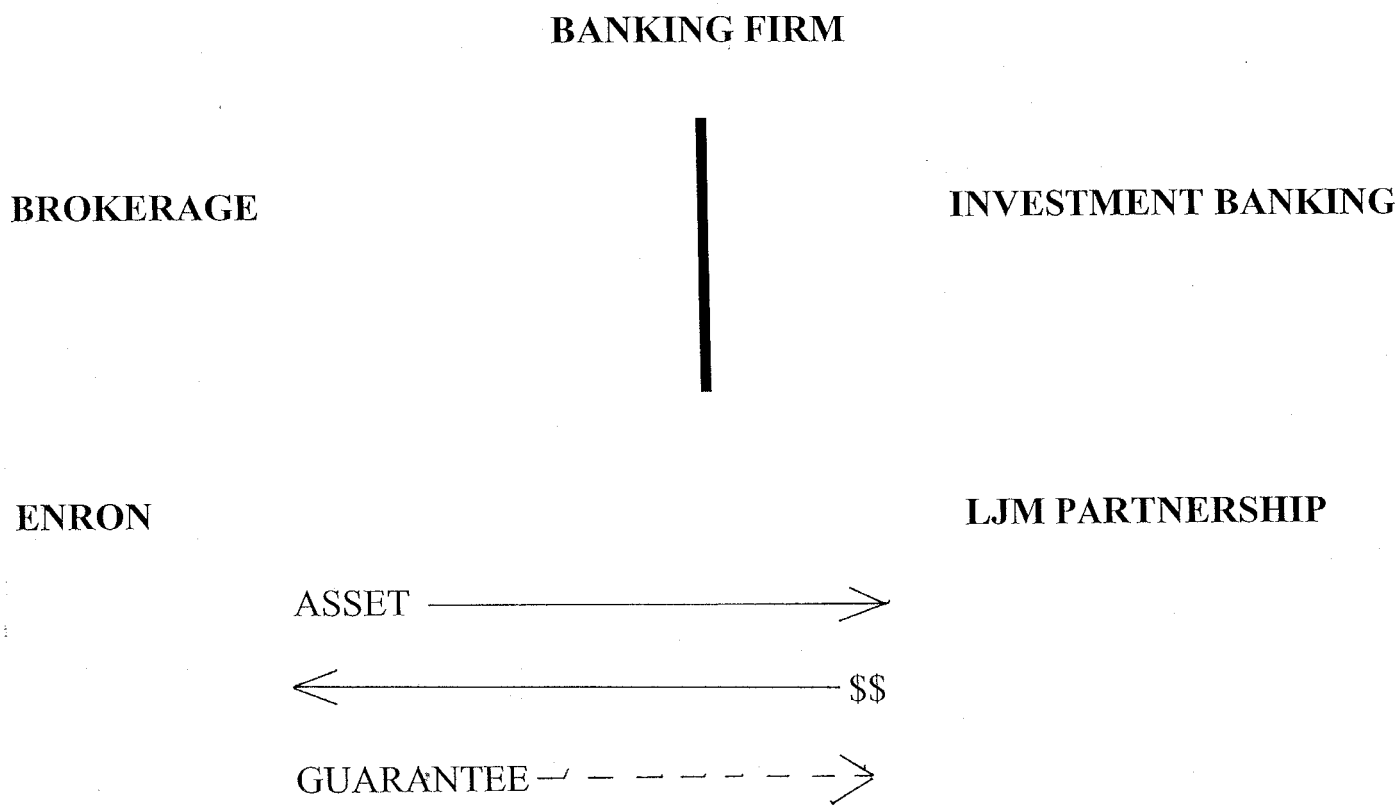
Consensus Recommendation
Stock Price
Source: Thomson Financial/First Call


BANKING FIRM
BROKERAGE
INVESTMENT BANKING
ENRON
LJM PARTNERSHIP
ASSET
$$
GUARANTEE

RESPONSE FROM THOMAS BOWMAN
TO REQUEST FOR INFORMATION FOR THE OFFICIAL RECORD

"The Watchdogs Didn't Bark: Enron and the Wall Street Analysts"

February 27, 2002

AIMR Standards of Professional Conduct pertaining to Gifts

Standard IV (A.3), Independence and Objectivity, of the AIMR Standards of Professional Conduct states that "members shall use reasonable care and judgment to achieve and maintain independence and objectivity in making investment recommendations or taking investment action." The AIMR Code of Ethics and Standards of Professional Conduct are provided on the AIMR web site at: http://www.aimr.org/pdf/standards/english_code.pdf. This standard governs the receipt and acceptance of gifts by members. In addition, the AIMR Standards of Practice Handbook (Eighth Edition, 1999) provides the following additional guidance and commentary on the subject of gifts:

"External sources may try to influence the investment process by offering analysts and portfolio managers a variety of 'perks.' Corporations may be seeking expanded research coverage; issuers and underwriters may wish to promote new securities offerings; brokers typically want to increase commission business. The perks may include gifts, invitations to lavish functions, tickets, favors, job referrals, and so on. One type of perk that has gained particular notoriety is the allocation of shares in oversubscribed IPOs to investment managers for their personal accounts. This practice affords managers the opportunity to make quick profits and may not be available to their clients. Such a practice is prohibited under Standard IV (A.3). Modest gifts that do not exceed US$100 and entertainment are acceptable, but special care should be taken by member analysts and investment managers to resist subtle and not-so-subtle pressures to act in a manner possibly detrimental to their clients.

"Gifts from clients can be distinguished from gifts given by entities seeking to influence a member to the possible detriment of clients. In a client relationship, the client has already entered some type of compensation arrangement with the member or the member's firm. A gift could be considered supplementary compensation. The potential for obtaining influence to the detriment of other clients, while present, is not as great as in situations where no compensation arrangement exists. Therefore, members may accept "bonuses" or gifts from clients but must disclose to their employers gifts from clients exceeding US$100 in value. Disclosure allows a member's employer or clients to make an independent determination about the extent to which the gift may impinge on the member's independence and objectivity." (Standards of Practice Handbook, 1999, pages 79-80.)

Procedures for Compliance

Members should follow certain practices and should encourage their firms to establish certain procedures to avoid violations of Standard IV (A.3):

Limit gifts. Members should limit the acceptance of gratuities and/or gifts to token items. US$100 is the maximum acceptable value for a gift or gratuity. Standard IV (A.3) does not preclude customary, ordinary, business-related entertainment so long as its purpose is not to influence or reward members. (Standards of Practice Handbook, 1999, pages 84-85.)

RESPONSE FROM THOMAS BOWMAN
TO REQUEST FOR INFORMATION FOR THE OFFICIAL RECORD

"The Watchdogs Didn't Bark: Enron and the Wall Street Analysts"

February 27, 2002

Association for Investment Management and Research (AIMR)
Survey on Accounting for Stock Options

In September 2001, the Association for Investment Management and Research (AIMR) sent an electronic survey to more than 18,000 AIMR members worldwide to gauge their response to a proposed agenda topic of the International Accounting Standards Board that could require companies to report the fair value of stock options granted - including those to employees - as an expense on the income statement, which would have the effect of reducing reported earnings.

A total of 1,944 AIMR members responded to some or all of the survey. Seventy-five percent of respondents were from North America, 13% from Europe and 10% from the Asia-Pacific region. Following are the questions asked and a summary of respondents' answers:

(1) Select one of the following position titles that best describes your work.

Total Respondents: 1.944

Equity Analyst, buy-side: 19%

Equity Analyst, sell-side: 13%

Debt Analyst, buy-side: 7%

Debt Analyst, sell-side: 2%

Portfolio Manager, corporate: 2%

Portfolio Manager, institutional investor: 24%

Portfolio Manager, individual investor: 14%

Other: 19%

(2) Select the appropriate regional jurisdiction(s) or domicile(s) of the firms that you currently monitor or evaluate.

Total Respondents: 1,929

Australia: 9%

Canada: 22%

France: 15%

Germany: 16%

Japan: 12%

South America: 7%

United Kingdom: 21%

United States: 73%

Other Asian Countries: 15%

Other European Countries: 18%

Other: 4%

(3) Do you consider share-based (or stock option) plans to be compensation to the parties receiving the benefits of these plans?

Total Respondents: 1,934

Yes: 88%

No: 6%

It Depends: 6%

(4) Do firms you evaluate and monitor have share-based (or stock option) plans that grant shares of the firms' stock?

Total Respondents: 1,926

Yes: 85%

No: 6%

Not sure: 9%

(5) If you answered YES to question 3, please select the industry or industries in which the firms would be included.

Total Respondents: 1,502

Total Selections: 8,472

Automotive: 27% of selections

Food & Beverage: 33%

Chemicals: 26%

Computers & Electronics: 55%

Computer Systems & Software: 38%

Entertainment: 38%

Energy & Utilities: 37%

Extractive Industries: 25%

Financial Services: 59%

Hospitality: 22%

Internet: 44%

Pharmaceutical: 39%

Retail & General Merchandising: 34%

Telecommunications: 5%

Textile & Apparel: 19%

Transportation: 26%

Other: 13%

(Comment: Analysts may follow several industries. Portfolio managers may "follow" all industries in that their investment strategies may require diversification across industries.)

(6) For firms that have share-based plans, how is the information and data provided in regards to these plans? Select all that apply.

Total Respondents: 1,769

Recognized and displayed as compensation expense on income statement: 17%

Recognized and displayed as a liability on the balance sheet: 11%

Disclosed in a note to the financial statements: 81%

Disclosed in a supplementary report: 22%

Disclosed in a regulatory filing: 37%

Other: 7%

(Comment: Exceeds 100% of respondents because they could select more than one option.)

(7) Do you use this information and data in your evaluation of a firm's performance and determination of its value?

Total Respondents: 1,840

Yes, use this information whether recognized in the income statement or disclosed in the notes to the financial statements or other sources: 66%

Yes, use this information only when it is recognized as compensation expense in the income statement: 15%

No: 19%

(8) Do the current accounting requirements for share-based payments need improving, in particular, for those plans covering employees?

Total Respondents: 1,836

Yes: 74%

No: 26%

(9) Should the accounting method for all share-based payment transactions (including employee share option plans) require recognition of an expense in the income statement?

Total Respondents: 1,868

Yes: 83%

No: 17%

AIMR reported the above information in a press release dated Nov. 19, 2001. See http://www.aimr.org/pressroom/01releases/01stockopt_survey.html.

TESTIMONY OF DAMON A. SILVERS

ASSOCIATE GENERAL COUNSEL, AFL-CIO

BEFORE THE SENATE COMMITTEE

ON GOVERNMENTAL AFFAIRS

FEBRUARY 27, 2002

This testimony is being submitted on behalf of the American Federation of Labor and Congress of Industrial Organizations. The AFL-CIO believes this Committee's hearing on Enron Corporation and the marketing of its stock is a vital contribution to the efforts to both bring to light the causes of Enron's collapse and protect the public and our economy against future events of this kind.

Directly and indirectly, America's working families are the ultimate customers in our securities markets. Defined benefit pension funds that provide benefits to the AFL-CIO's 13 million members have approximately $5 trillion in assets. These plans include thousands of pension plans sponsored by AFL-CIO member unions, public employee pension plans, and single employer pension plans subject to collective bargaining. Since the passage of ERISA in the 1970's, these funds have increasingly invested in equities. 401-k and other defined contribution plans, employee stock ownership plans, and union members' personal savings account for further extensive investments in equity markets by America's union members.

Enron's collapse devastated some workers' retirement security. The Committee has heard from some of those workers at prior hearings and their words speak for themselves. But the collapse of Enron also took money out of the retirement savings of practically every worker in America fortunate enough to have retirement savings.

Most pension funds and institutional investors held some Enron stock. Many of the most popular mutual funds held Enron stock. Every S&P 500 index fund lost money in Enron-- probably about half a percent of their total assets in that fund. And these are index funds-- funds designed to cheaply mitigate the risks of investing in any single company.

Billions of dollars were lost by Enron that were going to fund pension benefits for working families-- for the public employees we are counting on to protect us during this period of national crisis, for the iron workers who are clearing the rubble at Ground Zero, for the firefighters who stand ready to give their lives to save ours. Because of the way that our retirement system has become increasingly interwoven with the capital markets, practically every American fortunate enough to be able to save for retirement in any form was hurt by the collapse of Enron.

Indexed investing is very attractive to both institutions and individual investors. Indexed investing essentially means you buy the whole market, and do not make judgments about whether any given stock is underpriced at any given moment. Indexed investing entails very low fees and guarantees substantial diversification. But it does assume that the market prices for securities are roughly reflective of the real values of those securities in light of the information known at any given time. The indexed investor is very vulnerable to fraud perpetrated on the markets, because the indexed investor is essentially a price taker. Because of the popularity of indexed investing among institutional investors, when a company artificially inflates its stock price by withholding information from the

markets or putting out false information, the victims are not only the unsophisticated individual investors, but some of the largest and most sophisticated funds in the country, investing on behalf of hundreds of thousands of individual investors.

While no one has as of today been literally indicted, the AFL-CIO believes that a number of responsible parties have emerged. These parties include the senior management of Enron, the board of directors, Arthur Andersen, the outside auditor, the sell-side analyst community, and perhaps some money managers. These people and organizations made up the web of parties with obligations to Enron, its investors, and the public at large. These are the people and institutions that failed to ensure that Enron's assets were used to benefit the company and that the investing public had the information necessary to make fully informed decisions about whether to invest in Enron and if so at what price.

The AFL-CIO has done considerable analysis of the behavior of Enron's officers and directors. I have attached to this testimony letters we and the Amalgamated Bank, a large manager of worker pension funds, sent to Enron's board in early November laying out the details of some of the transactions that led to Enron's collapse and explaining the undisclosed conflicts of interest that in our view crippled Enron's board.

The AFL-CIO also has been a longtime supporter of efforts undertaken by Arthur Levitt when he was chairman of the Securities and Exchange Commission to rein in conflicts of interest affecting auditor independence. Pension funds affiliated with the building trades

unions have for several years submitted shareholder proposals seeking to ensure companies they invest in hire truly independent auditors. We submitted a rulemaking petition to Harvey Pitt, Arthur Levitt's successor at the SEC, asking him to act to end the types of conflicts of interest that appear to have compromised Arthur Andersen's ability to carry out its duties as Enron's public auditor. That petition is also attached.

But the Committee has asked for the AFL-CIO's views on the role specifically of investment analysts. The remainder of this testimony focuses on the analysts' role in the collapse of Enron. As we will discuss in further detail below, in light of the inadequate response from the self-regulatory organizations and the Securities and Exchange Commission to the problems of analyst independence, there is a continuing need for Congressional involvement to protect investors, particularly individual investors, from the danger of conflicted investment analysis.

Sell-side analysts work for full-service investment houses. Full-service firms underwrite securities, they make markets in securities, they give investment banking advice to companies, they manage money on behalf of clients, and often they trade on their own accounts in the securities markets. Since the rise of integrated mega-financial service firms after the repeal of Glass-Steagall, these firms also make bank loans to companies.

One of the services these full-service firms provide to their clients who trade securities through their brokers is access to research reports written by their research analysts.

These analysts are called "sell-side analysts" because their firms do a substantial business selling securities to their clients, and fundamentally the research is paid for by the brokerage fees generated by the firm's sales and trading activity. The research itself is not sold. This business model means that sell-side analysts are eager to share their work with investors generally, through their reports, and through appearances on television, radio and the internet. As a result, sell-side analysts shape investor opinions out of proportion to their numbers.

Sell-side analysis is widely available to market participants, both directly through the brokerage houses and through services like First Call and Investext. While firms try and keep the most up to date reports available only to clients, relatively recent sell-side analyst reports are widely available at a relatively reasonable price.

Few union members or other individual investors are in a position to master the raw data that informs the financial markets, and even fewer have routine access to insiders in the companies they invest in. Most union members, and the trustees of their pension funds, for that matter, rely on a variety of professionals for their information about the equity markets. Sell-side analyst reports are likely to be the most detailed, critically analytical information the typical small investor has to consult in making investment decisions. For that reason, America's working families have an enormous stake in the honesty of the investment information they receive from the analyst community.

Analysts are investment advisors subject to the Investment Advisors Act of 1940. Under the Act, analysts have a fiduciary duty to their clients. They are not mere marketers, serving the needs of their firms' underwriting business. They owe a duty of loyalty and of care to the investors they advise.

Unfortunately, in recent years the structure of the securities industry has shifted in ways that appear to have compromised sell-side analysts. 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 the issuer. That is the conclusion of a 1999 study by Roni Michaely of Cornell University as well as a 1997 study by Hsiou-wei Lin of National Taiwan University and Maureen McNichols of Stanford Business School.[1] CFO Magazine reported last year that analysts who work for full-service investment banks have 6% higher earnings forecasts and close to 25% more buy recommendations than analysts at firms without such ties.[2]

The comments of analysts in the financial press are even more telling than the statistics. In the last few months, analysts have been quoted by name saying such things as "a hold doesn't mean it's ok to hold the stock" and "the day you put a sell on a stock is the day you become a pariah."[3]

It should not be surprising that this is true given that issuers pick underwriting firms based on their ability to bring effective positive analyst coverage to their businesses. This

is the conclusion of a soon to be published paper on why firms switch analysts by Laurie Krigman of the University of Arizona, Wayne Shaw of Southern Methodist University and Kent Womack of the Tuck School Business at Dartmouth College.[4]

In addition, the data cited by CFO Magazine suggests several quite disturbing things. First is that it is not just existing relationships that are affecting analyst recommendations, but also the prospect of future business. The result is a systematic positive bias affecting recommendations across the board. Second, the response from the securities industry that analyst involvement in underwriting helps ensure that the firms only do quality deals at the right price is simply inadequate to explain the distortion in the data affecting all recommendations.

But these conflicts are exacerbated by the ways in which analysts are used and compensated. It has become a common practice for analysts to accompany teams from the corporate finance department on underwriting road shows, and most importantly, analyst compensation has become tied at many firms to analysts' effectiveness at drawing underwriting business.

In addition, the consolidation of the financial services industry, and in particular the repeal of Glass-Steagall, has created a wide array of further potential conflicts. Issuers are 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. This leverage is particularly powerful when the issuer is itself a financial services company. For example, CFO Magazine reported last year that the troubled financial services giant First Union cut off all bond trading business with Bear Stearns in response to negative comments by their analyst, and Bear Stearns ordered the analyst to be more positive.

At the same time, issuer executive compensation has been linked to issuer stock price, often in ways that give incentives to executives to manipulate short term movements in stock prices. The result is that issuer executives have tremendous personal incentives to use the resources of their companies to pressure analysts into issuing conflicted reports.

The rise in the importance of proprietary trading at major firms also creates further possible conflicts of interest for analysts. A version of this problem has always existed when firms' trading operations and market making operations lead to a buildup of inventory in particular issuers' securities. However, the addition of firms investing significant capital in proprietary trading creates a risk of senior executives aware of the positions taken in proprietary trading encouraging research departments to prop up demand for certain securities.

Finally, among the most lucrative business areas for full-service firms is providing investment banking advice to companies going through large mergers and acquisitions. Such deals are typically dependent on shareholder approval or effectively dependent on

the price of the stocks of the companies involved remaining within a certain range. These circumstances can give a full-service firm that is advising a participant in a deal a substantial interest in trying to encourage investors to behave in ways that support the transaction closing.

There has been some good news though in the effort to protect analyst independence. Much of the literature in the 1990's on securities analysts' behavior noted the ability of issuers to reward and punish analysts by providing and withholding information. This power meant that analysts who were doing their best to be loyal to their customers could not provide customers with the timely information that is the minimum requirement of the job without tilting their recommendations so as to ensure they weren't on the losing end of the business of selective disclosure.

Earlier this year the SEC promulgated Regulation FD barring selective disclosure. In doing so the Commission recognized selective disclosure not only harmed those not privy to the selective disclosure, it gave issuers power that resulted in warping the behavior of those who *were* the recipients of the selectively disclosed information. The adoption of Regulation FD marked an important step toward restoring analysts' independence. However, Harvey Pitt has at various times suggested he is not an enthusiastic supporter of this rule. Regulation FD is an important step toward restoring analyst independence and deserves Congress' continuing support.

The story of the collapse of Enron illustrates the consequences of these conflicts of interest on the larger market environment. Enron was throughout the late '90's a high-flying stock, trading at up to 70 times earnings. Even though its earnings growth as shown in pre-restatement numbers was around 5% per year from 1998 to 2000, Enron's stock price quadrupled over the same period.

During the spring and summer of 2001, Enron's stock price was falling, apparently due to the normal reasons stock prices fall-- deteriorating conditions in certain of Enron's markets, and trouble with certain large projects. However, in addition, some journalists were raising concerns that Enron was both opaque and overvalued.[5]

What is noteworthy about this is that during this period Enron executives were engaged in extensive selling of Enron shares. At the same time Enron's CFO was telling the press "We don't want anyone to know what's on those books. We don't want to tell anyone where we're making money." During this period, according to First Call, which surveys sell-side analyst reports, there was clearly insufficient transparency to Enron's financial disclosures to allow an analyst to be able to give an opinion as to whether the company's stock was a good investment.[6] Nonetheless, as one might expect from the general data we have surveyed, out of 11 sell-side firms tracked by Briefing.Com there were no downgrades of Enron from May 11, 1999 until August 15, 2001.[7]

Compare this record to the independent investment newsletters surveyed by Forbes Magazine.[8] Of the eight Forbes looked at, six were advising their subscribers to sell Enron, four before May 1st, and two in October. One of the eight advised subscribers to sell until the price hit $9, then went to a buy, and only one of the eight maintained a consistent buy during the period of Enron's collapse.

On August 15, following the sudden resignation of Enron's CEO Jeffrey Skilling, Merrill Lynch's analyst, downgraded Enron from Near Term Buy/Long Term Buy to Near Term Neutral/Long Term Accumulate. This may sound like a modest downgrade. But compare it to the firms that were underwriters for Enron. The earliest downgrade among this group appears to be J.P. Morgan-Chase, which went from Buy to Long-Term Buy on October 24, 2001. Strangely enough though, J.P. Morgan-Chase appears never to have downgraded Enron below a Long-Term Buy in the weeks that followed. In fact of the twenty seven firms we could find that covered Enron, the only sell-side firm that actually downgraded Enron to a Sell was Prudential, which downgraded Enron twice in the week that followed the announcement of the $1.2 billion charge to earnings on October. These results of our research parallels a Forbes Magazine study that looked at 13 sell-side firms and found as of the end of October, two weeks after the initial announcements of the charge to equity and the SEC investigation, only one firm recommended Sell, one firm recommended Hold, and the remaining eleven still had various forms of buy recommendations.

In late October and November, as Enron attempted to sell itself to Dynegy, key firms with an interest in the transaction maintained what appeared to be positive ratings. JP Morgan Chase and Citigroup were Enron's advisors and stood to earn large fees. These fee arrangements have not been disclosed but are likely to have been in excess of $50 million per firm. Citigroup lent Enron more than $500 million, monies in part that came from federally insured commercial bank deposits. Citigroup's analyst at Salomon-Smith Barney maintained a Neutral-Speculative rating. JP Morgan Chase lent Enron $400 million, while its analyst rated the stock a Long-Term Buy all the way through November. Lehman Brothers, the advisor to Dynegy on the Enron purchase, also stood to earn a similarly large fee if the deal closed. Lehman kept a Strong Buy rating on Enron throughout the fall.[9]

What can be concluded from this record. First, though Enron's financials included somewhat cryptic references to the partnership structures Enron's management used to hide liabilities and pass interests in company assets to executives, no analyst appears to have paid any attention to these items until they became widely known in October. Second, with one notable excep[illegible]n in Merrill Lynch, no analyst took action based on Skilling's resignation. Finally, with the exception of Prudential, no analyst thought it worthwhile to actually recommend their clients sell the stock. Interestingly, neither Prudential nor Merrill Lynch were underwriters for Enron or had any part in advising or lending money to either Enron or Dynegy.

One can observe in the analysts' treatment of Enron many of the problems critics of analyst conflicts pointed to before the Enron debacle. These include the linkage between analyst behavior and the investment banking, and now commercial banking, interests of their firms; the use of codes by analysts, where Long-Term Buy may mean Sell, and Hold certainly means Sell; the reliance on company projections and the failure to either look deeply into company financials or to consult outside sources. Taken together, these conflicts seem to have converted the analysts from providers of analysis with a fiduciary duty to their investor clients to simple salesmen for their firms' investment banking clients. And when the investment banking client is defrauding the investor client, too often the analyst, like the auditor, becomes a part of the fraud.

The AFL-CIO believes strongly that Congress, the regulatory agencies, and the self-regulatory agencies need to act in a coordinated fashion to protect the independence of analysts. In particular, we believe that what used to be called the Chinese Wall between research and investment banking in full service houses needs to be rebuilt. The AFL-CIO has submitted shareholder proposals to several full-service financial services companies seeking to have those firms make such changes on their own. In response to these proposals, several prominent firms have committed to making changes in their practices, including most recently Goldman Sachs' announcement last week that it would bar its analysts from holding the securities they analyze and would make research directly report to Goldman's management committee. However, we believe that industry wide short-

term competitive pressures are likely to lead to the continued violation of analysts' fiduciary duties unless regulatory action is taken.

Two weeks ago, the National Association of Securities Dealers and the New York Stock Exchange announced new rulemaking initiatives to address the problems with analyst independence. While we had hoped based on early reports that this initiative would meaningfully rebuild the wall between investment banking and research, the initiative appears to perpetuate the formula come up with by the Securities Industry Association last summer that allows analysts to be compensated based on investment banking performance. In the face of all that has happened in the last year the failure of the self-regulatory organizations to act independently of the Securities Industry Association on this critical point, and the willingness of the SEC to uncritically endorse a proposal that leaves the problem of conflicted analysis unaddressed is a powerful argument for the need for Congressional action.

Prior to the release of the SRO's proposal earlier this month, the AFL-CIO had taken the position that reform in this area was best accomplished by the SRO's. We still believe that as an institutional matter they and the Commission are better suited for this sort of detailed regulation than Congress. However, if the SRO's and Commission insist on promoting sham reforms than allow the current unacceptable conflicts to continue, we believe Congress has a responsibility to insert itself into the process by amending the

Investment Advisors Act to bar analyst compensation based directly on investment banking performance.

Currently, as a result of pervasive conflicts of interest, our capital markets are treacherous places for the unwary. Enron is only the most recent and most dramatic example of this unfortunate fact. This is in part why the labor movement strongly believes that America's working families need retirement security that rests on three legs-- Social Security, a defined benefit pension plan and personal savings, only one of which should be directly at risk in the capital markets.

In conclusion, the AFL-CIO believes that systematic problems with the ways in which information flows to and in the capital markets contributed to both Enron's collapse and the severity of the impact of its collapse. While analyst conflicts were not the cause of the collapse of Enron, they contributed to a climate in which Enron's shares were artificially inflated and in which the conduct of management at Enron remained hidden long after it could have been brought to light. Finally, it appears that these conflicts contributed to a false optimism about the success of the Dynegy deal, an optimism that allowed Enron executives to continue to withhold vital information from the markets about Enron's liabilities and demands on its cash until the final collapse of the Dynegy deal.

We commend this Committee for taking up the issue of analyst independence as part of its broad inquiry into the collapse of Enron. We urge both this Committee and all involved: in Congress, the SEC, the Department of Labor, and the Justice Department to continue to investigate both the actions of particular individuals and firms and the larger structural arrangements that led to the collapse of Enron and the loss of so many peoples' savings. On behalf of the AFL-CIO, we look forward to continuing to work with the Committee on this vital matter.

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[1] Conflict of Interest and Creditability of Underwriter Analyst Recommendations. Michaely, Roni and K Wolmak Review of Financial Studies 1999 vol 12 no 4 653-686; Underwriting Relationships and Analyst Earning Forecasts and Investment Recommendations. Lin, Hsiou-Wei and McNichols, Maureen. Journal of Accounting and Economics vol 25 (1) pp 101-127 1997.
[2] What Chinese Wall?, Barr Stephen, CFO, March 1, 2000.
[3] Wall Street's Secret Code Spoils Investors' Aim, Noelle Knox USA Today, December 21, 2000; CFO, ibid.
[4] Why do Firms Switch Underwriters? Wayne H Shaw, Kent Womack, Forthcoming, Journal of Financial Economics.

[5] "Is Enron Overpriced?", by Bethany McLean. *Fortune*, March 5, 2001, Pg. 122.

[6] Testimony of First Call CEO before Joint Hearing of House Subcommittees on Capital Markets and Investigations, December 12, 2001.
[7] The data that follows regarding shifts in ratings by sell-side firms comes from Briefing.com, "Analyst History for Enron Corp.," http://biz.yahoo.com/c/e/ene.html.
[8] "Enron: An Unreported Triumph For Investment Letters." Forbes.com, December 7, 2001.

[9] "Assessing the Role of the Financiers," by Patrick McGeehan, New York Times, December 2, 2001, Section 3, page 11.

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December 11, 2001

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

Re: Petition for rulemaking

Dear Mr. Katz,

The American Federation of Labor and Congress of Industrial Organizations (the "AFL-CIO") hereby petitions the Securities and Exchange Commission (the "Commission") to undertake a rulemaking proceeding to amend the rules governing auditor independence to revise the definition of an independent auditor and limit the services accounting firms may provide to their audit clients. We also ask the Commission to require additional proxy statement disclosure regarding the role of the audit committee in approving both audit engagements and non-audit consulting agreements with the audit firm. As shown by the scandal currently unfolding at Enron Corporation, investor confidence in the U.S. capital markets requires that auditors be, and be perceived as, truly independent from their clients.

The AFL-CIO is a federation of trade unions that represent 13 million working men and women who participate in the capital markets as investors through defined benefit and defined contribution plans as well as through mutual funds and individual accounts. Our member unions sponsor benefit plans with over $400 billion in assets, and our members are participants in public employee and collectively bargained single-employer plans with over $5 trillion in assets. Our union-sponsored funds alone are the beneficial owners of approximately 3.1 million shares of Enron stock, through both actively-managed and passive (or indexed) portfolios.

Background

Independent auditors occupy a central position in promoting confidence in the integrity of the financial reporting system and U.S. capital markets. Because the Commission requires that financial information filed with it be certified or audited by independent auditors, auditors are, as the Commission recently stated, the "gatekeepers" to the public securities markets.[1] Auditors work not only for their clients, but also for the investing public.

The role of the independent auditor is once again in the spotlight, as it was following relevations of accounting fraud at Sunbeam, Cendant and Waste Management. Now, the stunningly rapid failure of Enron Corporation, where there is evidence that Enron's auditor, Arthur Andersen, knew about and identified accounting errors but did not insist on their timely correction, focuses attention on the factors that might lead a company's auditor to sign off on misleading financial statements. Foremost among these is a dependence on a company and its management that can serve to undermine an auditor's objectivity.

Independence can be compromised in various ways. The provision of certain kinds of non-audit consulting services to audit clients may create economic incentives that can lead a firm to devalue the audit services and focus on retaining the client, even at the cost of making inappropriate audit judgments. In 2000, Arthur Andersen received more non-audit fees than audit fees from Enron. A "mutuality of interest" not conducive to independence may develop from the provision of certain kinds of non-audit services or from the employment by an audit client of former employees of the auditor. Certain services result in the auditor acting as management or an employee of the client. Finally, auditors may not be able to audit objectively work performed by the audit firm itself under a consulting agreement.

Over the past several decades, the proportion of audit firms revenues derived from non-audit services, such as internal audit, information technology, financial advisory and appraisal and valuation services, has grown steadily. At the five largest public accounting firms, revenues derived from non-audit services grew from 13% of total revenues in 1981 to half of total revenues in 2000.[2]

The 2000 Commission Rulemaking

Citing these threats to independence and their potential effect on capital formation, as well as the increased pressure on companies to make or surpass analyst earnings estimates, the Commission undertook last year to revise its rules governing auditor independence. With respect to the provision of non-audit services to audit clients,

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[1] Revision of the Commission's Auditor Independence Requirements, Exchange Act Release No. 43602 (Nov. 21, 2000) (adopting release).

[2] Revision of the Commission's Auditor Independence Requirements, Exchange Act Release No. 42994 (June 30, 2000) (proposing release).

the Commission solicited comment on three alternative approaches: banning the provision of such services altogether, imposing limits on the provision of those non-audit services deemed most likely to impair independence, and requiring only additional disclosure.[3]

Although a number of commenters and those testifying at the Commission's public hearings favored a ban on non-audit services, there was also significant opposition, mainly from the accounting profession, to any substantive reform. As a result, the final regulations reflected a compromise in which auditors could provide those non-audit services that posed a danger to independence, but only under certain circumstances. (The proposed limitation on providing expert testimony were dropped in its entirety.) A compromise was also reached regarding the additional disclosure required of registrants regarding the non-audit services provided by their auditors and the involvement of their audit committees with respect to auditor independence issues.

In light of subsequent developments, however, we ask the Commission to revisit some of the issues raised in the 2000 rulemaking, and to consider some new reforms, in order to strengthen its auditor independence safeguards. As discussed more fully below, both substantive reform and additional disclosure are necessary to preserve confidence in our capital markets.

The Rules on the Provision of Non-Audit Services Should be Strengthened

We believe that the Commission's final rules give too much flexibility to audit firms to provide non-audit services that could compromise the firms' objectivity and create economic incentives that may undermine the effectiveness of audits. A December 5, 2001 Washington Post article highlighted the pressures on individual auditors to "cross-sell" non-audit services to audit clients, recounting a case in which a Coopers & Lybrand accountant's performance review varied according to the amount of such services he was able to sell. That case involved Phar-Mor, which later filed for bankruptcy protection following revelations of accounting fraud; a jury found that Coopers, Phar-Mor's auditor, had committed fraud.

We believe that in some cases the sheer amount of the consulting services may create perverse incentives. During testimony in connection with the 2000 rulemaking, much was heard about the "loss leader" phenomenon, in which firms submitted artificially low bids, not consistent with providing high quality audit services, as a way to establish a relationship with a client and sell audit services. The audit then makes up an even smaller proportion of the total revenue stream from the client. And here, the danger not only lies in the auditor's impaired judgment. Anecdotal evidence suggests that executives of some companies encourage audit firms to undertake non-audit consulting as a way of obtaining leverage for the company over the audit process.

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[3] See id.

Certain non-audit services pose a more significant threat to an auditor's independence than others. The Commission recognized this in the 2000 rulemaking, when it prohibited firms from providing certain services, like bookeeping services. However, the Commission determined that audit firms could continue to sell information technology and internal audit consulting services to audit clients, as long as certain requirements, designed to lodge ultimate responsibility for the systems with the client, are satisfied. We believe this was a mistake.

The provision of information technology and internal audit services raise several serious problems. First, in cases where an information technology project is unsuccessful, a company may not be permitted to capitalize the costs of the project on the balance sheet (thereby creating an asset), but rather is required to expense them, thus reducing income. An accounting firm that botched the consulting job will be less likely, we think, to be assertive with management about the need to expense the item.

Similarly, if the auditor discovers, during the course of an audit, a theretofore undiscovered problem with software or an internal audit system the auditor designed and installed, the auditor is in the uncomfortable position of having to inform the client about the audit firm's own error. Finally, in a real sense the audit firm is auditing it own work because assessing the reliability of the numbers generated by an information technology or internal audit system is a part of the audit function.

We believe that the conditions imposed on audit firms in connection with information technology and internal audit consulting services are easily manipulated and do not mitigate the danger that the auditor and client will come to view the auditor as an extension of management and that the auditor will experience difficulty in vigorously auditing its own work.

Attention should be focused on another kind of consulting service, one that was not raised in the 2000 rulemaking but that has been brought to the fore by the Enron debacle. Enron's restatement of several years' worth of financial statements stemmed in part from the acknowledgment by Enron that the financial results of off-balance-sheet special purpose entities ("SPEs") set up by Enron—and in some cases managed by Enron officers—should have been consolidated with Enron's own results. In one case, Enron conceded that consolidation was necessary because the SPE had been inadequately capitalized when it was established.

Enron paid Arthur Anderson $27 million in 2000 for non-audit consulting services, including fees for "business process and risk management consulting." We are concerned that this category may include consulting regarding the transactions pursuant to which one or more of the erroneously non-consolidated SPEs were established. Such an arrangement would, we think, create an unacceptable conflict of interest, requiring Arthur Andersen's audit personnel to question the judgment of its consultants on a matter which could—and eventually did—have a major impact on Enron's financial results. We urge the Commission to consider amending Rule 2-01 of Regulation S-X to provide that

an independent auditor may not design and/or structure a transaction the audit firm must pass on in connection with the audit.

Auditors Should be Rotated

Currently, audit firms must rotate the audit engagement partner every seven years, in order to remove the risk of over-familiarity with the client. However, the engagement partner may remain in a relationship management position with respect to the client, which mitigates the effect of partner rotation.

We believe a more sensible approach is to require mandatory rotation of audit firms every seven years. Such rotation would provide a number of important benefits. First, a new audit firm would bring to bear a skepticism and fresh perspective that a long-term auditor may lack. Second, auditors tend to rely excessively on prior years' working papers, including prior tests of the client's internal control structure, particularly if fees are a concern.[4] Relatedly, longtime auditors may come to believe they understand the totality of the client's issues, and may look for those issues in the next audit rather than staying open to other possibilities. Finally, an auditor may place less emphasis on retaining a client relationship even at the cost of a compromised audit if it knows the engagement will end after several years.

In our opinion, the benefits to shareholders, lenders and the investing public from requiring rotation of auditors outweighs the additional cost that may be entailed in connection with a new auditor becoming familiar with the client. We urge the Commission to consider revising Rule 2-01 of Regulation S-X to provide for mandatory auditor rotation.

Additional Disclosure Should be Required

We also think that additional disclosure regarding the involvement of the audit committee in entering into the audit engagement and pre-approving non-audit consulting arrangements would enhance the effectiveness of audit committees and provide valuable information to investors. The Commission originally proposed in 2000 to require disclosure of whether the audit committee, before any disclosed non-audit service was rendered, approved and considered the effect on independence of such service. Only the latter disclosure was included in the final rule.

Requiring disclosure about the audit committee's role with respect to both the audit engagement and non-audit consulting contracts would advance important goals. Disclosing whether the audit committee, rather than the registrant, entered into the audit engagement would give investors information about whom the auditor views as its audit

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[4] See Richard G. Brody & Stephen A. Moscove, "Mandatory Audit Rotation," The National Public Accountant 32 (May 1998).

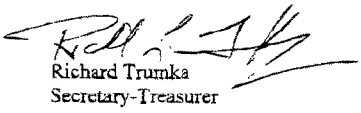
client. Commentators have noted that an auditor that views a registrant's management as its client is less likely to challenge that management in the context of an audit.

Similarly, investors would be better informed about the extent of the audit committee's involvement if the Commission required disclosure regarding audit committee pre-approval of consulting arrangements. The Panel on Audit Effectiveness organized by the Public Oversight Board, which was convened on the request of the Commission and issued its report last year, recommended that audit committees pre-approve non-audit services that exceed a threshold arrived at by the committee. Disclosure will assist investors in determining whether a registrant has implemented that recommendation.[5]

We urge the Commission to consider taking the steps proposed herein as soon as practicable. It is vital, we think, in light of recent events, to assure the investing public of the integrity and reliability of the audited financial statements of U.S. public companies. We believe that the reforms we propose to the auditor independence and audit committee disclosure rules can be an important step in that direction.

If you have any questions regarding this petition, please do not hesitate to contact Damon Silvers at 202-637-3953. We look forward to discussing this with you further.

Very truly yours,



Richard Trumka
Secretary-Treasurer

[5] The Panel on Audit Effectiveness Report and Recommendations, sec. 5.30 (Aug. 31, 2000).

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Clyde Rivers

December 12, 2001

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

Re: Petition for rulemaking

Dear Mr. Katz,

The American Federation of Labor and Congress of Industrial Organizations (the "AFL-CIO") hereby petitions the Securities and Exchange Commission (the "Commission") to undertake a rulemaking proceeding to amend Items 401 and 404 of Regulation S-K to require more proxy statement disclosure regarding conflicts of interest on the part of directors and director nominees. We believe that recent events at Enron Corporation have made plain that the existing disclosures are simply inadequate to ensure that shareholders are informed of all relevant information about director conflicts of interest.

Background

Our system of corporate governance relies heavily on independent directors to act as vigorous monitors of management behavior and to represent shareholder interests. For example, a committee of independent directors is often constituted to evaluate potential transactions or litigation involving a company. Similarly, the tax code requires that incentive compensation in excess of the $1 million cap on deductibility be awarded by a compensation committee composed of independent directors. Many institutional investors, following on that requirement, take compensation committee independence into account when voting on pay packages and deciding whether to withhold votes from director candidates.

One of the most important functions entrusted to independent directors is oversight of the financial reporting process, which is of vital importance both to a company's shareholders and the markets in general. To that end, listing standards of both the New York

the Nasdaq market require listed companies of a certain size to maintain audit committees composed of independent directors, and the Commission requires companies to disclose information regarding the mandate, membership and functioning of the audit committee.

Current Disclosure Requirements

The Commission's rules also, in essence, define independence by requiring disclosure in the proxy statement of certain relationships between directors (or director nominees) and the registrant (and in some cases its executive officers) that could compromise the director's objectivity. These requirements focus on employment, family, and business relationships. Currently, the following relationships involving directors and director nominees must be disclosed:[1]

1. Current or past employment by the registrant;

2. Family relationships between the director or nominee and the registrant's executive officers;

3. Transactions with the registrant or any subsidiary in which the amount involved exceeds $60,000 and in which the director or nominee has a direct or indirect material interest;

4. Indebtedness to the registrant or any subsidiary in an amount in excess of $60,000;

5. The ownership of certain equity interests in, or service as an executive officer of, a business or professional entity (a) that is a significant customer of the registrant, (b) that is a significant supplier of the registrant, or (c) to which the registrant is indebted in an amount exceeding a threshold;

6. Status as a member of, or of counsel to, a law firm that the registrant has retained during the last fiscal year or proposes to retain during the current fiscal year, subject to a minimum threshold;

7. Status as a partner or executive officer of an investment banking firm that has performed certain kinds of services for the registrant during the last fiscal year or that the registrant proposes to have perform services during the current fiscal year, subject to a minimum threshold; and

8. Any other relationship similar in scope and nature to the relationships listed above.

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[1] These disclosure requirements are set forth in Items 401 and 404 of Regulation S-K.

Enron Corporation

As you are no doubt aware, Enron Corporation recently filed the largest bankruptcy case in U.S. history, precipitated by a massive crisis of investor and customer confidence. Enron has already announced plans to lay off or put on leave 7,500 workers, and the value of Enron stock held in employees' 401(k) retirement accounts has declined by $1.3 billion since the beginning of 2001. The market capitalization of Enron, which was the seventh largest company in the Fortune 500, plunged from over $60 billion at its peak last year to under $1 billion last week. Enron's inclusion in the S&P 500 index until shortly before the bankruptcy filing means that the broader market and the many investors who index their equity holdings are also suffering as a result of Enron's failure.

The AFL-CIO is a federation of trade unions that represent 13 million working men and women who participate in the capital markets as investors through defined benefit and defined contribution plans as well as through mutual funds and individual accounts. Our member unions sponsor benefit plans with over $400 billion in assets, and our members are participants in public employee and collectively bargained single-employer plans with over $5 trillion in assets. Our union-sponsored funds alone are the beneficial owners of approximately 3.1 million shares of Enron stock, through both actively-managed and passive (or indexed) portfolios.

Enron's meltdown was caused by a number of factors, among them a cavalier attitude toward disclosure, inadequate internal controls and an approach to accounting that at best can be characterized as careless and at worst constituted a conscious effort to mislead investors and the public about the profitability of Enron's operations. These problems point to an abject failure by Enron's board, especially its finance and audit and compliance committees, in the discharge of its monitoring duties. We believe that the lack of independence on Enron's board and key committees contributed to this failure.

At first glance, Enron's board and key committees appear to be composed primarily of independent directors. According to Enron's 2001 proxy statement, of the 14 directors nominated for reelection at the 2001 annual meeting,[2] eight, or nearly two-thirds, lacked disclosable relationships with Enron. Of members of the audit and compliance committee, which was responsible for reviewing the effectiveness of internal controls and the application of accounting principles, only one, John Wakeham, has disclosable ties to Enron, in the form of a $72,000 per year consulting arrangement. A majority of members of the finance committee, which oversaw Enron's risk management activities, are similarly independent.

However, further research reveals that several of the eight ostensibly independent directors, including two who serve on the audit and compliance committee and one who serves on the finance committee, actually have relationships with Enron or its senior executives that could interfere with those directors' ability to be objective and to challenge company decisions and policies.[3]

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[2] One of those directors, then-CEO Jeffrey Skilling, resigned from both his executive and director positions in August 2001.

[3] We raised these concerns in a letter to Enron's special committee, which is attached to this petition.

- Audit committee member John Mendelsohn is the president of the University of Texas M.D. Anderson Cancer Center. The Cancer Center has received contributions from Enron, and Enron chairman and CEO Kenneth Lay was part of what the Houston Chronicle characterized as a "coalition" to lobby the Texas legislature for $20 million worth of infrastructure improvements to support the development of the Southeast Texas BioTechnology Park, which will be built on University of Texas land and house the Cancer Center's Life Sciences Center. Compensation committee chairman Charles LeMaistre is the Cancer Center's president emeritus and serves on its Board of Visitors.

- According to Enron's 2001 proxy statement, directors Norman Blake and John Duncan own common units of EOTT Energy Partners, L.P. ("EOTT"), a limited partnership whose general partner is a wholly-owned subsidiary of Enron. Enron thus exercises significant control over EOTT, which could affect the economic return available to Messrs. Blake and Duncan. Mr. Blake serves on Enron's finance committee; Mr. Duncan is a member of the audit and compliance committee.

- Wendy Gramm, a member of the audit and compliance committee, is director of the Mercatus Center at George Mason University. According to a December 10, 2001 article in Time magazine, Enron contributed $50,000 to the Mercatus Center.

Uncovering the relationships described above was neither easy nor inexpensive. An investor thus cannot evaluate the independence of the board and key committees at all or even a substantial number of the companies in its portfolio without expending significant funds. Because of the economics involved in undertaking such research, even proxy voting and research services such as the Investor Responsibility Research Center—which exploit economies of scale in assembling corporate governance data—rely solely on the disclosures set forth in the proxy statement when evaluating boards and key committees. Accordingly, we believe that additional proxy statement disclosure regarding relationships between directors and director nominees, on the one hand, and registrants and their senior executives, on the other, is vital in enabling investors to select investments wisely, monitor companies in which they have invested and cast informed votes in director elections.

Specifically, we urge the Commission to amend the rules to require disclosure of:

1. Relationships between the registrant or any executive officer of the registrant and any not-for-profit organization on whose board a director[4] or immediate family member[5] serves or of which a director or immediate family member serves as an officer or in a similar capacity. Disclosable relationships should be defined to include contributions to the organization in excess of $10,000 made by the registrant or any executive officer in the last five years and any other activity undertaken by the registrant or any executive officer that provides a material benefit to

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[4] For the sake of simplicity and readability, "director" also refers to director nominees.

[5] "Immediate family member" should be defined to include a person's spouse, parents, children, siblings, in-laws and first cousins.

the organization. "Material benefit" should be defined to include lobbying efforts such as those engaged in by Mr. Lay on behalf of the M.D. Anderson Cancer Center as well as fundraising activities undertaken by the registrant or any executive officer on the organization's behalf.

2. Relationships in which the registrant or any executive officer exercises significant control over an entity in which a director or immediate family member owns an equity interest or to which a director or immediate family member has extended credit. Significant control should be defined with reference to the contractual and governance arrangements between the registrant or executive officer, as the case may be, and the entity. For example, in most cases, a general partner exercises significant control over a partnership, while a limited partner may exercise significant control depending on the terms of the partnership agreement.

It may be necessary to provide that the existence of significant control may depend, in part, on the overall ownership structure of the entity and not just the stake held by the registrant or executive officer. For example, the owner of less than a majority of a corporation's stock may nonetheless exercise significant control if the other stockholders are numerous and fragmented.

3. Joint ownership by a registrant or executive officer and a director or immediate family member of any real or personal property.

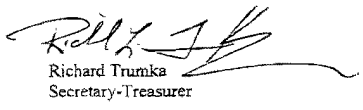
4. The provision of any professional services, including legal, financial advisory or medical services, by a director or immediate family member to any executive officer of the registrant in the last five years.

We understand that in 1998 the Council of Institutional Investors ("CII") filed a petition for rulemaking relating to disclosure of director conflicts of interest and that the Commission has not responded to that request. Although CII's proposed language is more general, we believe that our request covers many if not all of the conflicts that were of concern to CII.

We urge the Commission to take up these important issues immediately. Investor confidence in the United States capital markets depends in large measure on their transparency. Full disclosure of director conflicts of interest will improve transparency and enable investors to assess more accurately the quality of companies' governance structures.

If you have any questions regarding this petition, please do not hesitate to contact Damon Silvers on 202-637-3953. We look forward to discussing this with you further.

Very truly yours,



Richard Trumka
Secretary-Treasurer

Amalgamated Bank
America's Labor Bank

November 2, 2001

William Powers, Jr.
Chairman, Special Committee
Enron Corp.
University of Texas School of Law
727 E. Dean Keeton Street
Austin, TX 78705

Kenneth Lay
Chairman of the Board and Chief Executive Officer
Enron Corp.
1400 Smith Street
Houston, TX 77002

Dear Messrs. Powers and Lay,

We are writing to you in your respective capacities as chairman of the special committee of Enron's board of directors reviewing certain related-party transactions and chairman of Enron's board. Our institutions are shareholders of Enron. We have been deeply troubled by the events of the past two and a half weeks, in which Enron disclosed large losses and a $1.2 billion reduction in shareholder equity, accompanied by a fall in Enron's stock price to a nine-year low this week. While we applaud the decision to appoint a special committee of the board (the "Special Committee"), we are concerned that the mandate of the Special Committee is too narrow. This letter details a comprehensive program of corporate governance reforms we believe the Special Committee must take up if investor confidence in Enron is to be restored.

The constitution of the Special Committee demonstrates that Enron's board understands the urgent need for leadership by Enron's outside directors to restore transparency and confidence in the company and the information it provides to investors. We are also confident that Enron's board recognizes that the Special Committee must be accountable to, and communicate with, Enron's shareholders.

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Lack of Transparency

Most importantly, we are concerned that Enron has, in general, not been responsive to calls by shareholders and analysts for greater transparency, both in its accounting practices and its SEC filings. One analyst was quoted in a Wall Street Journal article as stating that lack of transparency is "a long-standing Enron hallmark." For example, Enron's practice of releasing only earnings data in its quarterly release and providing the balance sheet and statement of cash flows up to a month later impairs shareholders' ability to analyze Enron's financial position and creates the impression that Enron has something to hide.

Limited Agenda of Special Committee

We believe the perception of the company as unresponsive to shareholders' need for comprehensive transparency will be exacerbated by the apparently limited agenda of the Special Committee. The Special Committee appears to be focused exclusively on reviewing past transactions, rather than on ensuring that improper arrangements do not recur. To restore investor confidence the Special Committee should also seek to identify the weaknesses in Enron's policies and corporate governance structures that allowed the current situation to develop.

Additionally, it is unclear whether the Special Committee is empowered to examine all related-party transactions, not just the ones involving the two limited partnerships established and operated by Enron's recently-departed chief financial officer, Andrew Fastow (the "Fastow Partnerships"). The Wall Street Journal has uncovered a similar entity run by Michael Kopper, a managing director in Enron's Global Equity Markets Group—who has since left the company—that also did business with Enron. Because Enron must disclose in SEC filings only transactions involving directors and executive officers, there may be still more related entities of which shareholders are not aware.

Conflicts of Interest

Similarly, it has been reported that at least one transaction between Enron and one of the Fastow Partnerships involved Enron's own stock and some have speculated that other special purpose vehicles engaged in similar transactions, which we think create grave conflicts of interest. The Wall Street Journal reported that one of the Fastow Partnerships wrote put options committing it to buy Enron stock at a set price for six months, then renegotiated the transaction early, before a decline in Enron's stock price that could have forced the partnership to buy Enron shares at a loss of as much as $8 per share. We believe that the Special Committee must be given broad latitude to investigate all transactions with entities in which Enron employees or directors hold an interest and all transactions with special purpose vehicles involving Enron stock.

Transactions Involving Enron Stock

It appears that Enron's Compensation Committee and perhaps the board as a whole viewed arrangements like the Fastow Partnerships as a legitimate form of compensation. Charles LeMaistre, chairman of the Compensation Committee, was quoted in the Wall Street Journal as

saying that he "viewed the partnership arrangement partly as a way of keeping Mr. Fastow at Enron. 'We try to make sure that all executives at Enron are sufficiently well-paid to meet what the market would offer.'"

Aside from the Fastow transactions, compensation paid to Enron's five most highly-paid executives, reported in its 2001 proxy statement, totaled over $119 million.[1] This amount included compensation worth over $30 million each paid to Mr. Lay and former CEO Jeffrey Skilling, who resigned in August in unexplained circumstances. Though this is very generous compensation, it is dwarfed by the apparent size of Enron's transactions with the Fastow Partnerships. In addition, the failure to disclose compensation received by Mr. Fastow as a result of transactions between Enron and the Fastow Partnerships may have violated SEC disclosure requirements.

Independence of Committee Members

It appears that members of the key board committees responsible for setting company policy in the compensation and financial reporting areas of Enron's operations may not be independent. We believe that these relationships may impair the ability of these committee members to deal objectively with the crucial issues that are within the purview of these committees.

Specifically, Compensation Committee members Norman Blake and John Duncan hold partnership units in EOTT Energy Partners, L.P., a Delaware limited partnership whose managing general partner is a wholly-owned subsidiary of Enron, and Mr. Duncan serves on that general partner's board. Compensation Committee chairman Charles LeMaistre and Mr. Duncan are both members of the University of Texas' M.D. Anderson Cancer Center's Board of Visitors. The Cancer Center has received contributions from Enron and has recruited Mr. Lay as a member of what the Houston Chronicle described as a "coalition" to lobby the Texas legislature for $20 million worth of infrastructure improvements to support the development of the Southeast Texas BioTechnology Park, a project that will be built on University of Texas land and house the M.D. Anderson Cancer Center's Life Sciences Center.

Likewise, Audit and Compliance Committee member John Wakeham has a contract to provide consulting services to Enron and its affiliates on matters relating to European business operations. Member John Mendelsohn is president of the M.D. Anderson Cancer Center, whose ties to Enron are detailed above.

Composition of the Special Committee

Finally, we are concerned about the composition of the Special Committee. Initially, we believe that it is problematic to ask three Enron directors who, according to Mr. Lay, were informed of and approved the Fastow Partnerships and presumably other related-party dealings, to second-guess their original decisions. Consideration should be given to appointing additional

[1] This figure was arrived at by adding together all components of direct compensation, including the value on the grant date of stock option grants, using the more conservative 5% rate of return assumption.

new directors to both Enron's board and the Special Committee to ensure effective committee functioning.

We are also concerned that Special Committee member Herbert S. Winokur, Jr. is affiliated with National Tank Company ("NATCO"), a privately owned company that does significant business with Enron subsidiaries. Finally, in the interest of restoring investor confidence through greater transparency, we ask that Mr. Powers immediately disclose to investors the information that a director would typically disclose in Enron's proxy.

Recommendations

Specifically, we ask the Special Committee recommend the Board adopt the following governance reforms:

- Expand the mandate of the Special Committee to empower it to (a) examine all transactions with entities in which Enron employees or directors hold an interest and all transactions with special purpose vehicles involving Enron stock; (b) identify policies and corporate governance structures that contributed to the loss of investor confidence and to any improper related-party arrangements, other than the ones specifically set forth in this letter; and (c) recommend changes to those policies and structures.

- Adopt a policy that Enron will release all quarterly and annual financial statements simultaneously.

- Consider whether Enron's external auditor, Arthur Andersen, should be replaced.

- Adopt the independence standard formulated by the Council of Institutional Investors ("CII"), and amend the charter of the Audit and Compliance Committee to reflect that change; and act to ensure that the Audit and Compliance and Compensation Committees are composed solely of directors who are independent under the CII definition.

- Adopt a policy prohibiting related-party transactions involving securities issued by Enron, other than those involved in the normal course of executive compensation.

- Adopt procedures for reviewing the suitability of investments where either employees or directors are participants in the investment. Such procedures should include the review of such opportunities by outside directors with access to their own outside legal counsel and investment banking resources.

- Commence an extraordinary review of executive compensation policies and compensation granted to executives so far this year in light of the drastic reversals in Enron's fortunes in recent months.

- Provide comprehensive disclosure of (a) all relationships among Enron, its officers and directors and the M.D. Anderson Cancer Center and the financial interests, if any, of any officer or director of Enron in any venture related to the Southeast Texas BioTechnology Park; (b) all investments made by Enron directors in EOTT Energy Partners and any other entity controlled by Enron or its officers, including the circumstances under which such investments came to be made.

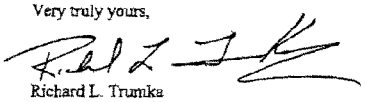
- Provide comprehensive disclosure of any relationship that would disqualify Mr. Powers from being considered independent under the CII definition.

The AFL-CIO is a federation of trade unions that represent 13 million working men and women who participate in the capital markets as investors through defined benefit and defined contribution plans as well as through mutual funds and individual accounts. Our member unions sponsor benefit plans with over $400 billion in assets, and our members are participants in public employee and collectively bargained single-employer plans with over $5 trillion in assets. Our union-sponsored funds alone are the beneficial owners of approximately 3.1 million shares of Enron stock. The AFL-CIO is also itself a shareholder.

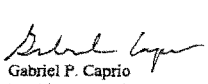
The Amalgamated Bank's LongView Funds are collective investment trusts managing equity assets on behalf of workers' pension funds. The LongView Funds currently hold 251,304 shares of Enron.

We would very much appreciate your giving institutional shareholders a prompt opportunity to meet with you and the other members of the Special Committee to discuss the matters we have raised in this letter. We have asked William Patterson, the director of the AFL-CIO's Office of Investment to arrange a meeting. Thank you.

Very truly yours,



Richard L. Trumka
Secretary-Treasurer
AFL-CIO



Gabriel P. Caprio
President and CEO
Amalgamated Bank

cc: Enron Board of Directors

Amalgamated Bank of New York
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MEMBER FEDERAL DEPOSIT INSURANCE CORPORATION

November 9, 2001

William Powers, Jr.
Chairman, Special Committee
Enron Corp.
University of Texas School of Law
727 E. William Keeton Street
Austin, TX 78705

Kenneth Lay
Chairman of the Board and Chief Executive Officer
Enron Corp.
1400 Smith Street
Houston, TX 77002

Dear Messrs. Powers and Lay,

We understand that Enron is now in talks with Dynegy Inc. regarding that company's possible acquisition of Enron. Given the lack of adequate financial disclosure to date and serious conflicts of interest on Enron's board of directors, we are deeply concerned that sufficient disclosure will not be forthcoming to stabilize the market for the company's stock and allow shareholders to properly evaluate a proposed transaction with Dynegy or some other suitor. We therefore call upon you to immediately elect additional outside directors to join William Powers, the only current director not exposed to derivative litigation, on a special committee to oversee both disclosure to shareholders and negotiations concerning a possible merger or sale.

As noted in our letter of November 2nd, our institutions are substantial shareholders of Enron that are deeply troubled by the events of the past three weeks. Enron shareholders are eager to consider any transaction that stabilizes Enron's weakened financial condition or provides us with fair value for our investment. But we are not prepared to allow the current

crisis to force a fire sale at a price below Enron's fair value in a climate in which the market for Enron's shares is driven not by information but by uncertainty.

Unfortunately, Enron has yet to provide sufficient disclosure of its complex off-balance sheet financing mechanisms to allow shareholders to properly value our investment. These off-balance sheet transactions could expose the company to material contingent liabilities. Moreover, Enron's Form 8-K filed today with the Securities and Exchange Commission raises additional questions, including the possibility that Enron inflated its historical earnings as a result of selling assets to off-balance sheet, but related entities. We are deeply concerned that full disclosure of these off-balance sheet arrangements, which is essential for valuing our investment, will not be provided to shareholders given the serious conflicts of interest on Enron's board.

The fact is that, with the exception of William Powers, Enron's current directors have serious conflicts of interest that could prevent them from fairly representing shareholders in connection with the sale of the company. As you know, most of Enron's directors have already been named as defendants in numerous derivative lawsuits arising from the company's transactions with certain related parties. In addition, the SEC is formally investigating these same transactions, which were approved by the board, and this investigation could result in civil or criminal charges against certain Enron officers and directors. Against this backdrop, Enron's directors have little incentive to provide the level of disclosure that shareholders will require to fairly evaluate a proposed transaction.

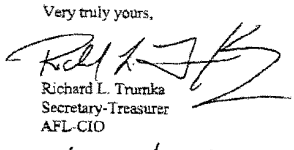
The purpose of the recommended committee, therefore, would be to oversee all aspects of disclosure to shareholders as well as the negotiation of any sale or merger transactions. This committee could operate as a subcommittee of the Special Committee of the Board established on October 31, but it should not include any incumbent directors other than Mr. Powers. Rather, it should be comprised of highly qualified individuals with global reputations and unimpeachable credibility in the capital markets. We are prepared to propose specific candidates for you to consider.

The AFL-CIO is a federation of trade unions that represent 13 million working men and women who participate in the capital markets as investors through defined benefit and defined contribution plans as well as through mutual funds and individual accounts. Our member unions sponsor benefit plans with over $400 billion in assets, and our members are participants in public employee and collectively bargained single-employer plans with over $5 trillion in assets. Our union-sponsored funds alone are the beneficial owners of approximately 3.1 million shares of Enron stock. The AFL-CIO is also itself a shareholder.

The Amalgamated Bank's LongView Funds are collective investment trusts managing equity assets on behalf of workers' pension funds. The LongView Funds currently hold approximately 250,000 shares of Enron.

We look forward to your timely response. If you would like to discuss possible outside director candidates, please contact William Patterson, the director of the AFL-CIO's Office of Investment, at (202) 637-3900. Thank you.

Very truly yours,



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cc: Enron Board of Directors

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