Professional Responsibility

Copies of Transparencies on Analysts

Prof. Ingo Walter

Tuesday 12 February 2002
Research on Research

Four-dimensional role of research in new issues:

- Provide information and unbiased interpretation to investors.
- Solicitation of mandates
- Support due diligence process.
- Support sales effort.

Potential for conflicts of interest.

Pro-independence:
- Buy-side dealflow.
- Aggressive researcher-rating activity.
- Active market for researcher talent.
- Media commentary.
- Maintenance of a personal franchise.
- Role of Chinese walls.
WHAT INVESTORS REALLY WANT

As demonstrated in many of the individual reviews of top-ranked analysts, institutional investors crave insight and information above all else. When the voters for the All-America Research Team were asked again this year to rank eight attributes in order of importance in assessing the worth of a securities firm, industry knowledge topped the list, followed by written research. Stock selection dropped from the second most important virtue a year ago to fifth this year. The size of the portfolio does affect what the investor seeks. Managers of smaller portfolios put greater emphasis on stock selection and earnings estimates than those with more assets under management. Here are investors' preferences, both overall and by the size of their U.S. equity portfolios.

<table>
<thead>
<tr>
<th>Rank</th>
<th>Attribute</th>
<th>Overall Rank</th>
<th>$75 Billion or More</th>
<th>$30 Billion to $74.9 Billion</th>
<th>$10 Billion to $29.9 Billion</th>
<th>$5 Billion to $9.9 Billion</th>
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</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Industry knowledge</td>
<td>1</td>
<td>1</td>
<td>1</td>
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<td>1</td>
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<tr>
<td>2</td>
<td>Written reports</td>
<td>3</td>
<td>2</td>
<td>3</td>
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<td>2</td>
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<td>3</td>
<td>Special services*</td>
<td>2</td>
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<td>Servicing</td>
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<td>2</td>
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<tr>
<td>6</td>
<td>Earnings estimates</td>
<td>5</td>
<td>6</td>
<td>6</td>
<td>6</td>
<td>4</td>
<td>4</td>
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<td>Quality of sales force</td>
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* Company visits, conferences, etc.
As part of the reporting process for the All-America Research Team, we asked institutions to rate analysts in six of their primary activities: picking stocks, writing reports, estimating corporate earnings, acquiring knowledge of their industries, being responsive to clients' requests and initiating timely calls to investors. The leaders appear below in alphabetical order, along with the industries in which they are cited. The most diversified strength this year came from second-teamer Vivek Juneja, who tracks S&Ls & GSEs for J.P. Morgan Securities. He appeared on the accessibility, timely calls and earnings estimates lists. He was the only analyst to show up in more than two groups.

<table>
<thead>
<tr>
<th>Written reports</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Jeffrey Applegate</td>
<td>Lehman Brothers</td>
<td>Portfolio strategy, 3</td>
<td></td>
</tr>
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<td>Michael Goldstein</td>
<td>Sanford C. Bernstein &amp; Co.</td>
<td>Quantitative research, 2</td>
<td></td>
</tr>
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<td>Equity derivatives, 2</td>
<td></td>
</tr>
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<td>Economics, 1</td>
<td></td>
</tr>
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<td>Merrill Lynch</td>
<td>Equity derivatives, 1</td>
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</tr>
<tr>
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<td>Prudential Securities</td>
<td>Small companies, 1</td>
<td></td>
</tr>
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<td>Edward Nicostki</td>
<td>U.S. Bancorp Piper Jaffray</td>
<td>Technical analysis, RAU</td>
<td></td>
</tr>
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<td>William Pecorillo</td>
<td>Sanford C. Bernstein &amp; Co.</td>
<td>Beverages, 2</td>
<td></td>
</tr>
<tr>
<td>Satya Pradhuman</td>
<td>Merrill Lynch</td>
<td>Small companies, 3</td>
<td></td>
</tr>
<tr>
<td>Steve Scala</td>
<td>SG Cowen</td>
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</table>

<table>
<thead>
<tr>
<th>Earnings estimates</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
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<tr>
<td>Richard Bitetti</td>
<td>Morgan Stanley</td>
<td>Entertainment, RAU</td>
<td></td>
</tr>
<tr>
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<td>Dean Witter</td>
<td></td>
<td></td>
</tr>
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<td>Broadcasting/radio &amp; TV, 1</td>
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<td>Retailing/hardlines, 1</td>
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<td>Sanford C. Bernstein &amp; Co.</td>
<td>S&amp;Ls &amp; GSEs, 1</td>
<td></td>
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<td>J.P. Morgan Securities</td>
<td>Insurance/mortgage, 1</td>
<td></td>
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<td>Merrill Lynch</td>
<td>Specialty finance companies, 3</td>
<td></td>
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<td>J.P. Morgan Securities</td>
<td>S&amp;Ls &amp; GSEs, 2</td>
<td></td>
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<td>David Nadel</td>
<td>Bear, Stearns &amp; Co.</td>
<td>Education services, 2</td>
<td></td>
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<td>Richard Simon</td>
<td>Goldman, Sachs &amp; Co.</td>
<td>Leisure products/leisure time, 2</td>
<td></td>
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<td>Health care/medical supplies &amp; devices, R/U</td>
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**Industry knowledge**

<table>
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<tbody>
<tr>
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<td>Tobacco, 3</td>
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<td>S&amp;Ls &amp; GSEs, 1</td>
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<td>Telecom services/CLECs, 1</td>
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<td>Telecom services/wireline, 1</td>
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<td>Thomas Hanley</td>
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<td>Insurance/real estate, 1</td>
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<td>Faye Landes</td>
<td>Thomas Weisel Partners</td>
<td>Textiles/apparel/footwear, 1</td>
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<td>David Londoner</td>
<td>Schroder &amp; Co.</td>
<td>Entertainment, 3</td>
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<tr>
<td>Nikos Theodossopoulos</td>
<td>Warburg Dillon Read</td>
<td>Telecom equipment/wireline, 2</td>
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**Accessibility & responsiveness**

<table>
<thead>
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<tr>
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</tr>
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<td>Health care/managed care, R/U</td>
</tr>
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<td>PaineWebber</td>
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<td>Deutsche Banc Alex. Brown</td>
<td>Packaging, 2</td>
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<td>Technical analysis, R/U</td>
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<tr>
<td>Dana Telsey</td>
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</tr>
<tr>
<td>Paul Ting</td>
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</tr>
<tr>
<td>Ivy Zeiman</td>
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<td>Building, 1</td>
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<td>Jonathan Ziegler</td>
<td>Salomon Smith Barney</td>
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</tbody>
</table>

**Useful & timely calls**

<table>
<thead>
<tr>
<th>Name</th>
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<th>Industry/Interests</th>
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</thead>
<tbody>
<tr>
<td>Eric Berg</td>
<td>CIBC World Markets</td>
<td>Insurance/life, 3</td>
</tr>
<tr>
<td>Martin Feldman</td>
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<td>Tobacco, 1</td>
</tr>
<tr>
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</tr>
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<td>Schroder &amp; Co.</td>
<td>Oil/domestic, 2</td>
</tr>
<tr>
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<td>Washington research, 1</td>
</tr>
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</tr>
<tr>
<td>Daniel Niles</td>
<td>BancBoston</td>
<td>Electronics/semiconductors, 3</td>
</tr>
<tr>
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Research on Research

Four-dimensional role of research in new issues:

- Provide information and unbiased interpretation to investors.
- Solicitation of mandates
- Support due diligence process.
- Support sales effort.

Potential for conflicts of interest.

Pro-independence:
- Buy-side dealflow.
- Aggressive researcher-rating activity.
- Active market for researcher talent.
- Media commentary.
- Maintenance of a personal franchise.
- Role of Chinese walls.

Anti-independence:
- Compensation structure (research budget allocation to corporate finance, e.g. 40%).
- Superior information access via due diligence role.
- Sales role and "booster-shots."
- Underwriter blacklisted by client.
- Analyst fired or put in corporate penalty box.
Analyst Recommendations
(27,000 Recommendations in-place on 29 December 2000)

Strong buy 33.3%
Hold 28.5%
Buy 37.2%
Sell 0.8%
Strong sell 0.2%

Source: First Call
In an increasingly significant sector... Telecommunications stock underwriting deals as a percentage of all U.S. stock underwriting

- Telecom
- Other

Salomon Smith Barney

1999: 49.3%
2000*: 59.5%

17.1%

Merrill Lynch

23.4%
35.5%

Lehman Brothers

Goldman Sachs

27.9%
32.8%

19.8%

Morgan Stanley

24.5%

*Year-to-date

An off recommendation
Daily closing price of AT&T shares

$70

Salomon wins role in AT&T wireless IPO

...and weak IPO performance
Aftermarket performance of telecom initial public offerings led by managers with five or more such IPOs; for IPOs issued 1999-present

C.S. First Boston - 87.8%
Lehman Bros. - 28.9%
Bear Stearns +41.4%
Morgan Stanley D.W. +40.5%
D.J. +24.3%
Deutsche Bank +25.1%

-11.2% FleetBoston Finl.
-12.0% Goldman Sachs
-27.5% Salomon S.B.
-31.7% Merrill Lynch

Sources: Thomson Financial Securities Data; Datastream
Conseco Fires Merrill Lynch As Underwriter
($800MM debt offering)

Conseco Inc. fired Merrill Lynch & Co., its lead underwriter on a newly announced debt offering, shortly after a Merrill analyst downgraded Conseco's stock.

Conseco, which is trying to raise money to finance its pending acquisition of Kemper Corp., insisted the firing of Merrill Lynch is unrelated to the analyst's unfavorable comments. But people on Wall Street familiar with the situation said the two events are linked and that Conseco Chairman Stephen Hilbert phoned to fire Merrill Lynch shortly after the news of the downgrade hit the newswires Monday morning.

Merrill Lynch declined to comment on specifics, but defended its research department. "There may be times when a research opinion conflicts with a business transaction, but our practice is that our research department remains independent," a Merrill Lynch spokesman said.

While unusual, retribution for negative research reports isn't new. New York developer Donald Trump threatened a "major lawsuit" against a Philadelphia brokerage firm, Janney Montgomery Scott Inc., unless it issued an apology or fired an analyst who predicted tough times for one of Mr. Trump's casinos. The firm fired the analyst, though he later won a $750,000 arbitration award against the firm.

Other companies have stopped trading securities through a particular brokerage, a practice known as "being in the penalty box," following an analyst downgrade. At the same time, some brokerage firms have been accused of writing favorable research reports in return for getting a role in a securities underwriting.

Cold Calls: AOL May Be Snubbing Merrill

AOL Chief Financial Officer Mike Kelly denies the two top-ranked analysts were deliberately shunned. He says no one from Merrill's research department has called him or AOL's investor-relations department since the day of the downgrade, and he doesn't know of any canceled meetings. If they call, "we will deal with them," he says. "It's not in our best interest to shut people out." Susan McCabe, a spokeswoman for Merrill Lynch, declined to comment.

AOL Time Warner's daily closing share price since shortly before the two companies' Jan. 10, 2000, merger announcement.

At any rate, this much is undisputed: Mr. Kelly reacted angrily to the downgrade, which cited concerns about revenue and earnings shortfalls at the America Online unit. The analysts' action came less than two hours after the company announced third-quarter earnings Oct. 17, but before a conference call with analysts.

Mr. Kelly says he was "disappointed at the downgrade," but "we were more upset with the process," that is, that the analysts didn't wait until the company's earnings conference call was completed to change their stock recommendation. "Before we even had our call with the analysts ... they had already downgraded the stock," he says, adding that AOL didn't have a chance to talk to the analysts to argue its point of view.

In a telephone call later that morning with Merrill's team, Mr. Kelly spoke harshly, using an expletive at one point. He says he told the analysts that he wouldn't be answering questions from them at that particular day. He says his comments were to this effect: "We're not going to deal with you because we are going to deal with other folks. We will deal with your questions in due course." He says he wanted to talk first to other analysts who were "still formulating their opinion about the results." On that day, the shares dropped 18% to $30.61.

Double Whammy

HEARD
ON THE STREET

By JULIA ANDWIN
And MARTIN PERSEI
Staff Reporters of THE WALL STREET JOURNAL

NEW YORK—Have top Merrill Lynch analysts Henry Blodget and Jessica Reif Cohen been loganed off from AOL Time Warner?

During the two weeks since the pair downgraded the shares of the giant media company to "neutral" from "buy," multiple phone calls to AOL placed by them and their research assistants haven't been returned, according to people the analysts have spoken to and others familiar with the matter. At least one scheduled meeting between Merrill analysts and AOL management has been canceled, one such person says.

A few lost phone messages and a coincidental cancellation?

The analysts don't think so, according to people familiar with the situation. They think they have been put in the penalty box as a result of the downgrade, a move that would make them the latest example of an unpleasant aspect of Wall Street: Those analysts bold enough to downgrade stocks often must brace themselves for a company's angry reaction.

Jessica Reif Cohen

Source: Thomson Financial/Firstcall
Investment Banks Must Soothe Asian Sensibilities

By MARK LANDLER

HONG KONG, March 11 — Investment banks have always struggled to reconcile their roles as tough-minded analysts and smooth-talking salespeople. Nowhere is this truer than in Asia, where the lines between government and business can be blurry and the opportunities to offend both are legion.

The regional division of Goldman, Sachs & Company has become the latest to stumble in this minefield. The investment firm recently felt obliged to apologize to Thailand after one of its reports drove down the shares of the nation’s largest bank and angered the Finance Minister.

“All of us at Goldman Sachs deeply regret the controversial media attention that our ‘Market Flash’ dated February 8th subsequently generated in the Thai press,” said the president of Goldman Sachs Asia, Philip Murphy, in a letter last month to the Finance Minister, Tarrin Nimmanhaeminda.

In that report to clients, Goldman’s chief Asian banking analyst, Roy Ramos, said that Mr. Tarrin viewed Bangkok Bank as the “biggest risk factor in Thailand’s banking system.” After Mr. Tarrin denied saying that, Mr. Ramos conceded that the characterization was his own.

Like most of its competitors, Goldman has hastened to make amends, rather than risk losing business from either the government or private companies, which are loath to use a bank that is in disfavor.

Eugene K. Galbraith, former head of research at ABN Amro in Hong Kong, remarked, “Since the nexus of government and business is so much closer in Asia than in Europe or the U.S., the consequences of offending the Government are much greater.”

While officials can be thin-skinned in any Asian country, bankers feel this most acutely in dealings with China. Almost every major firm here can tell of a chill wind from Beijing after they published reports critical of the economy or of politically connected companies.

In one of the most prominent examples, Morgan Stanley ran afoul of Beijing when the firm’s chief strategist, Barton M. Biggs, advised clients in October 1997 to steer clear of the Hong Kong stock market. (He had unkind words for some other Asian markets, too.)

The report outraged Wang Qishan, who was then chairman of a leading Chinese bank that played a role in the sale of shares in China Telecom. Mr. Wang is now the executive vice governor of Guangdong province.

Last May, Shandong International Power Development, a Government-controlled company, dismissed Morgan Stanley as its investment banker. A spokesman for the investment bank said he doubted that there was a direct link between the Biggs report and the bank’s action, though he confirmed China’s hard feelings.
Mayo Fired -- Coincidence or Business Decision?

Michael Mayo, the Credit Suisse First Boston analyst who made waves on Wall Street by urging investors to sell bank stocks, is being dismissed following the investment bank's decision to merge with Donaldson Lufkin & Jenrette.

Because both investment banks have well-regarded research departments, it was expected some analysts would be fired after the purchase of DLJ by Credit Suisse, CSFB's parent.

However, Mr Mayo's dismissal has at least symbolic importance for Wall Street because of his very public role as a bank-stock bear.

Investment bank analysts rarely issue reports urging investors to sell stocks. This has led to criticism that banks refrain from recommending sales so they can win corporate finance deals from companies they follow.

In this environment, Mr Mayo - and CSFB - stood out. On May 24 1999, Mr. Mayo issued a celebrated report that lowered his ratings on Bank One, Citigroup, Chase Manhattan and JP Morgan to a sell.

Despite Mr. Mayo's stance, CSFB remained an important adviser on mergers and acquisitions involving US commercial banks. So far this year, CSFB has ranked third on such deals, up from fifth last year, according to Thomson Financial Securities Data.

Mr Mayo, 37, also ranked second among regional bank analysts in last year's Institutional Investor poll. However, he was criticized by some fund managers for exacerbating the slide in prices of bank stocks.

CSFB declined comment.

Morgan Stanley Internal Memo

"Our objective ... is to adopt a policy, fully understood by the entire firm, including the Research Department, that we do not make negative or controversial comments about our clients as a matter of sound business practice."

Credit-rating agencies

AArgh!

Were he alive today, John Moody, a railway-bond enthusiast and the founder of Moody's Investors Service, a big American rating agency, would be horrified. Last week it emerged that America's justice department is investigating possible breaches of antitrust rules in the rating-agency business. By Moody’s own admission, the firm appears to be the chief focus of the investigation.

Like all credit-rating agencies, which publish their opinions on the creditworthiness of the companies and governments that borrow in the world's bond markets, Moody's depends for its livelihood on its reputation among investors for objectivity and accuracy. Over time, its judgments and those of other big agencies, such as Standard & Poor's (S&P), have proved remarkably accurate.

Why all the fuss, then? The justice department, says Moody's, is worried about the agency's practice of issuing "unsolicited", or "hostile", ratings. These involve it judging the creditworthiness of companies' bonds even though it has not been asked to do so. In its defence, Moody's has cited its right to free speech under America's constitution. If it genuinely believes that other agencies have got a rating wrong, why should it not say so?

That, say Moody's rivals, is hardly the point. Agencies earn their keep by charging fees to those who issue bonds, not to the investors who use the ratings. This, they claim, can create perverse incentives. By giving borrowers a low, unsolicited rating, the big agencies may force unwilling issuers to pay for their services in the hope of getting a better one.

When The Economist asked Moody's whether it sometimes invoices borrowers for its services, regardless of whether they have requested that they be rated, the agency at first denied it, but then acknowledged that it did. Accompanying letters to such invoices (circulated by a rival agency) appeal to wavering companies to "reflect on the propriety of failing to pay for the substantial benefits that the issuer reaps from our efforts."

One borrower has begun to attack Moody's in the courts. Last October, Jefferson County School District, a local authority in Colorado, filed a lawsuit accusing Moody's of "fraud, malice, and willful and wanton conduct". Moody's, alleged the district, had published a "punishment" rating on its bonds because it had not hired the agency to rate them. Moody's will not comment on the pending litigation. It is contesting the case vigorously.

According to industry sources, the justice department may also be investigating whether big agencies use their muscle with borrowers to squeeze smaller rivals, such as Fitch, out of the market. The investigation is believed to be confined to two such niche markets: that for bonds issued by municipalities, and the market in bonds backed by assets such as consumer loans and mortgages. Fitch says that 65% of its revenues are earned in these two markets. As a private company, Fitch does not release details of its profits, but it is believed to have had a particularly tough time last year.

The industry's minnows, retort the bigger agencies, are hardly saints themselves. They accuse them of sometimes offering companies and governments overly generous ratings. One study by Richard Cantor and Frank Packer, two economists at the Federal Reserve Bank of New York, notes that borrowers rated by the two big agencies on the borderline of "investment grade" (a category that means that many big investors can buy their bonds) often try the services of a third, smaller rating agency. And more often than not, the borrower will duly be awarded an investment-grade rating.

Inevitably, much of the mud now flying between agencies is also being hurled for commercial reasons. Since all of them trade on their reputations, the best way for competitors to hurt them is to besmirch these. The smaller agencies, which have less to lose than the behemoths, have sharper tongues. If the industry is not, in the agencies' own jargon, to be downgraded, they might all have to learn to be more polite.
Research on Research

Four-dimensional role of research in new issues:

- Provide information and unbiased interpretation to investors.
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- Support due diligence process.
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Potential for conflicts of interest.

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- Buy-side dealflow.
- Aggressive researcher-rating activity.
- Active market for researcher talent.
- Media commentary.
- Maintenance of a personal franchise.
- Role of Chinese walls.

Anti-independence:
- Compensation structure (research budget allocation to corporate finance, e.g. 40%).
- Superior information access via due diligence role.
- Sales role and “booster-shots.”
- Underwriter blacklisted by client.
- Analyst fired or put in corporate penalty box.

What evidence is there?
- Anecdotal.
- For IPOs U/W “buy” recommendations underperform non-underwriters “buy” recommendations by 4.9% after one month and 17.7% after one year. (McAfee, & Womack, 1996)
What to Do?

- Corporate actions
- Name and shame
  Investment in buy-side research
- Civil litigation
- Regulatory intervention.
Should analysts own the stock they cover?

Good

Analyst Recommendation

Bad

Analyst Ownership
<table>
<thead>
<tr>
<th>Firm</th>
<th>May analyze purchase stocks they cover?</th>
<th>Do any restrictions apply?</th>
<th>Are pre-IPO investments allowed?</th>
<th>How are positions disclosed?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Suisse First Boston</td>
<td>Yes</td>
<td>Transactions must be preapproved by research and compliance officials. Minimum six-month holding period (30 days for stocks outside sector). Trading must be consistent with company ratings. Shorting permitted only if stock rated sell</td>
<td>Yes, with preapproval of research and compliance officials</td>
<td>General disclaimer that firm and its employees may own the stock</td>
</tr>
<tr>
<td>Deutsche Bank Alex. Brown</td>
<td>Yes</td>
<td>Transactions must be preapproved by research director and compliance officer. No trading within two days of ratings or estimates changes. No trading between close of company's fiscal quarter and earnings announcement. No trading for two days after company makes SEC filing. Six-month holding period (30 days outside sector). No shorting</td>
<td>Yes, with preapproval of research director and compliance officer</td>
<td>Reports specifically names analyst and states that he owns the stock</td>
</tr>
<tr>
<td>Goldman, Sachs &amp; Co.</td>
<td>Yes</td>
<td>Approval of research management required. Minimum 30-day holding period. May only buy stocks on recommended list or those rated trading buy. May not sell unless stock downgraded to below trading buy. No trading within 24 hours of commenting on company. Shorting allowed (positions must be held for 30 days)</td>
<td>Yes, on a case-by-case basis. Investments in firm-sponsored funds typically distributed in cash. Share distributions subject to the restrictions at left.</td>
<td>General disclaimer</td>
</tr>
<tr>
<td>Lehman Brothers</td>
<td>Yes</td>
<td>Research management must preapprove transactions. Sixty-day minimum holding period (14 days outside sector). No trades not consistent with recommendations. No shorting</td>
<td>Yes, with preapproval of research management</td>
<td>General disclaimer</td>
</tr>
<tr>
<td>Merrill Lynch &amp; Co.</td>
<td>Yes</td>
<td>All transactions must be preapproved by compliance. No trading within 24 hours of issuing comments on a company. No sales without negative rating on stock. No shorting</td>
<td>Yes, but must be preapproved by compliance department</td>
<td>General disclaimer with case-by-case exceptions</td>
</tr>
<tr>
<td>J.P. Morgan</td>
<td>Yes</td>
<td>All trades must be approved in advance by research director and compliance officer. May not sell unless stock is rated market perform or underperform. May not sell until 24 hours after downgrade to the ratings. Minimum 30-day holding period. No shorting</td>
<td>Yes, as part of employee private equity fund or as co-investments, with approval from research director and compliance officer. May not sell for six months after IPO</td>
<td>Reports specifically names analyst and states that he owns the stock</td>
</tr>
<tr>
<td>Robertson Stephens</td>
<td>No</td>
<td>Not applicable</td>
<td>Yes, with preapproval of research and compliance directors. IPO shares must be sold or put in a blind trust before analyst initiates coverage.</td>
<td>General disclaimer</td>
</tr>
<tr>
<td>Salomon Smith Barney</td>
<td>Yes</td>
<td>Minimum six-month holding period (30 days for investments outside sector). May only buy if stock rated neutral or higher. May only sell if rated underperform or lower. No shorting</td>
<td>No</td>
<td>General disclaimer</td>
</tr>
</tbody>
</table>

*New policy, September 2008.

Source: The firm

April 2001

Institutional Investor
Wall St. and Its Analysts Get Warning From S.E.C.

Increased Scrutiny on Advice to Investors

By GRETCHEN MORGENSON

The nation's top securities regulator put Wall Street firms on notice yesterday, saying that the activities of their research analysts and the potential for conflict in the stock recommendations they make to investors will come under increased scrutiny.

Laura S. Unger, the acting chairwoman of the Securities and Exchange Commission, used the issue of analyst independence as the focus of a speech yesterday before the Northwestern University School of Law. She warned brokerage firms to "reinvigorate public confidence" by resolving the "blatant conflicts" their analysts face.

"This is an area that people have been grumbling about for some time," Ms. Unger said in an interview after the speech. "Given the current market conditions, preserving the integrity of information is more important than ever."

Specific conflicts raised in Ms. Unger's speech included the widespread practice of paying analysts based upon the investment banking fees generated when their firms raise money for the companies the analysts follow. Such an arrangement encourages an analyst to be overly positive to keep investment banking fees coming in.

Another concern of Ms. Unger's are analysts who own shares in the companies they follow or who receive discounted shares in a company before the shares are offered to the public. She also criticized brokerage firms that acquire a stake in a start-up company in exchange for helping it raise money from the public. After the stock has come public, Ms. Unger said, some firms have issued favorable research reports, what she called "a booster shot," which propelled the stock price higher and allowed the firm to sell its stake into an inflated market.

While she called on Wall Street firms to resolve the conflicts themselves, Ms. Unger said that the S.E.C. inspections of firms in coming months would focus on areas of potential conflict. One focus will be the so-called Chinese wall that is said to separate investment banking departments from their counterparts in research but that many critics suspect has been demolished.

Brokerage firm practices relating to analysts will also come under the microscope in Washington next month at hearings planned by Representative Richard H. Baker, a Republican of Louisiana. Mr. Baker, chairman of the House subcommittee on capital markets, is concerned that individual investors may not know how biased the advice coming from analysts can be.

Among the conflicts Mr. Baker plans to address at the hearings are analysts' personal ownership of stocks and the temptation to use upbeat research reports to help generate investment banking fees for their firms and for themselves.

Michael DiResto, press secretary to Mr. Baker, said the idea for the hearings, which have not yet been scheduled, grew out of the congressman's fears that his constituents were plunging into the stock market without fully understanding the ways of Wall Street. "It's high time that everybody is aware of how things actually work," Mr. DiResto said.