Attacking Wall Street with a Blunt Instrument
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The recent announcement by securities regulators and Eliot Spitzer, New York attorney-general, of a Dollars 1.4bn (Pounds 870bn) settlement with 10 prominent securities groups for misconduct is a disturbing event for those who seek clarity and fairness in stock market regulation.

The settlement purports to punish leading investment banks for engaging in systematic exploitation of investors and to provide needed reform by tighter regulation of the relationships between analysts and investment bankers, by changing public underwriting practices and by requiring Dollars 450m in subsidies for independent research to be provided to retail customers. But the settlement has been extracted by threats of criminal prosecution by Mr. Spitzer and by continued public exposure to embarrassing staff e-mails and other leaked communications. The 10 groups were divided into different tiers of culpability and put under pressure to pay up (two smaller companies refused to settle and were deferred). The companies did not admit to any violation of laws or regulations and the records of the case will presumably be sealed from further public view. The government has greatly disproportionate power over Wall Street groups in confrontations such as this and can impose a solution that may not be fair. Indeed, this global settlement invites the thought of companies being rounded up in the midst of a public scandal because of where they rank and then all lumped together under bright lights for a show trial.

As in a number of cases last year - the Securities and Exchange Commission against Credit Suisse First Boston and the state of New York against Merrill Lynch - this settlement does not make clear what the groups did that might have been in violation of existing laws or regulations. How do you prove that a research report is fraudulent rather than wrong? While it is clear that during the years in question the market experienced the biggest bubble in history, and some analysts were taken in by their clients and/or were poorly supervised and given excessive inducement to bring in new banking clients, it is not clear that the effort was systemic or that the attributable level of harm and injury to retail customers in particular rises to the level of a Dollars 1.4bn fine.

On the face of it, a fine of Dollars 1.4bn would suggest an egregious, clear and deliberate breaking of existing rules simultaneously by 10 leading investment banks. Could all of these - in fierce competition with each other - have knowingly issued false research recommendations to gain business? Would not their more sophisticated corporate and institutional clients have learnt of it and objected?

If it can be shown that what was done was against the law, the individuals concerned and their companies - when appropriate - should be punished accordingly. If that cannot be shown, a forced group settlement for conduct that is not clearly in violation of law or regulation is unfair to the banks.
The reform measures of the settlement are unnecessary and expensive. Mr. Spitzer, the central figure in securing the settlement, has no business affecting details of federal securities laws. These are administered and enforced by the SEC and SEC rules already cover most of the ground that Mr. Spitzer's reforms address. True, the SEC has been headless and dysfunctional for some time. But that does not give Mr. Spitzer a licence to insist on new regulations to reform the markets, particularly only a month or two before the new SEC chairman takes office.

Each effort to layer more regulation on the market has a cost and that cost is ultimately born by market users. In addition to huge fines and the likely need for further settlements with the ever-present plaintiff bar, the added costs of providing subsidised independent research and other provisions of the settlement begin to add up. At some point issuers and investors may find that regulatory costs are much greater in the US than elsewhere.

America’s markets work well because information flows effectively and relatively inexpensively. Companies value broad distribution of new issues to include institutions and individuals alike, both of which require post-offering information about the companies. Their bankers require expert analysis of private companies before taking them public. Analysts are the people who supply this information to the market; if they were not needed, they would not exist.

We do not want reforms to damage the efficient flow of information or to ignore the cost of additional regulation to the users of the market. Group settlements for the sake of establishing scapegoats are not the way to regulate a complex, sophisticated global securities industry.