TESTIMONY

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THE ASSOCIATION FOR INVESTMENT MANAGEMENT AND RESEARCH
UNITED STATES SENATE
COMMITTEE ON GOVERNMENTAL AFFAIRS

Enhancing Analyst Independence and Improving Disclosure to Investors

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Ø **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^{Ò} (AIMR^{Ò}) and a holder of the Chartered Financial Analyst^{Ò} (CFA^{Ò}) 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.

Ø **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.

Ø **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.
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> 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.
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> 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.

Ø **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.

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