TESTIMONY OF DAMON A. SILVERS

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AMERICAN FEDERATION OF LABOR AND

CONGRESS OF INDUSTRIAL ORGANIZATIONS

BEFORE THE HOUSE SUBCOMMITTEE ON CAPITAL MARKETS,

INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISE

ON

ANALYZING THE ANALYSTS—ARE INVESTORS GETTING UNBIASED

RESEARCH FROM WALL STREET

JUNE 14, 2001

Good morning, Mr. Chairman. My name is Damon Silvers, and I am an Associate General Counsel of the American Federation of Labor and Congress of Industrial Organizations. The AFL-CIO believes today's hearing on investment analyst independence is of vital importance to working families and their pension funds, and would like to thank the Subcommittee for its efforts in this area.

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 programs, and union members' personnel savings account for further extensive investments in equity markets by America's union members.

However, few union members either have the time or the skills 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 funds, for that matter, rely on a variety of professionals for their information about the equity markets. For that reason, America's working families have an enormous stake in the accuracy and honesty of the investment information they receive from the analyst community.

Recent trends in equity investing have increased the importance of the analyst community for workers' retirement funds. Increasingly, large institutional investors have placed the majority of their equities in index funds. Leading funds like the California Public Employee Retirement System and the Operating Engineers National Pension Fund have over 70% of their equity portfolio in index funds.

Indexed investing both minimizes fees and reflects a sound understanding of the difficulty of large funds outperforming the market as a whole. However, at the same time it puts these funds at the mercy of overall market pricing. If the investors who are trading are following conflicted analyst advice, indexed investors will purchase shares at inflated prices and eventually receive lower returns on their equity portfolios. Essentially, the funds who invest in index funds are placing their trust in the transparency and honesty of our markets, and have no defense against systematic distortions such as those created by conflicted analysts.

In that context, what are we to make of Thomson Financial's survey of December, 2000 that 71% of all analyst recommendations were "buy" and 2.1% were "sell," with the remaining 28% hold? In the remainder of my testimony I would like to suggest that what has happened here is the collapse of what used to be called the Chinese Wall between underwriting and analysis, and that only regulatory action can rebuild it.

The large firms that produce analyst reports for public consumption have always been in a number of distinct businesses within the securities industry. They underwrite securities issues, for which they receive a fee from the issuer. They run trading desks, where they earn commissions on trades for clients toward whom they have fiduciary duties.

There is substantial statistical evidence that analysts' decisions whether or not to recommend that investors buy a stock is 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]

In some ways what we find more persuasive than the statistics are the comments of analysts in the financial press. 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]

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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.

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. Secondly, 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.

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[4] Why do Firms Switch Underwriters? Wayne H Shaw, Kent Womack, Forthcoming, Journal of Financial Economics.

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, 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 service 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. I'm not suggesting the committee revisit the repeal of Glass-Steatgall, but rather that the sub-committee look closely at the consequences of that repeal, and what additional protections investors need in light of the new business realities the repeal has created.[5]

At the same time, issuer executive compensation has been linked to issuer stock price, and 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 market making operations lead to a buildup of inventory in particular issuers' securities. However, the addition of firms investing significant capital

[5] Ibid.

in proprietary trading makes the risk of senior executives aware of the positions taken in proprietary trading encouraging research departments to prop up demand for certain securities.

Recognizing that there is a problem, the securities industry is currently at work on codes of best practices that attempt to address some of the issues raised at this hearing. We would however urge the Committee to look closely at any such code to see if it leaves room for continued linkage of analyst compensation to underwriting activity, or continued participation by analysts in marketing securities underwritten by the analysts' firm. The decay of the so-called "Chinese Wall" is driven by extremely powerful financial pressures and it will not be halted or reversed by either general statements of a desire to be honest or subtly crafted principles that on closer examination leave room for a continuation of business as usual.

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. As the SEC recognized when it promulgated Regulation FD, 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.

Despite the improvements wrought by Regulation FD, we believe that there is a need for this Subcommittee to work with the Securities and Exchange Commission to develop new regulatory approaches. Some measures the Subcommittee should raise with the Commission include bars on linking analyst compensation in any measurable way to the financial performance of the underwriting and M&A businesses of their firms, and bars on analyst participation in marketing underwritten offerings, including attending road shows. The Subcommittee should also consider whether in view of the tensions at work here whether a more blanket approach comparable to that used to protect plan participants under the fiduciary scheme in ERISA may be the only solution. Such an approach would block firms from issuing analyst reports on companies while they were acting as underwriters of those same companies. In our view this approach would be more consistent with the role analysts play as fiduciaries for their clients.

Working with the Commission on these new initiatives will take time. In the meantime, we believe the Subcommittee has an immediate task. As we all know, Regulation FD was quite controversial when it was adopted, and we soon will have a new Chairman at the SEC. We think this Subcommittee would do a great deal to protect investors and the analyst community if, at a minimum, it used its influence with the Commission to protect Regulation FD and ensure it continues in place.

In conclusion, the AFL-CIO believes the question of analyst independence is vital for the retirement security of America's working families. We urge this Subcommittee and the full committee to work closely with the SEC, NASD, and the National Exchanges to address the concerns you have heard today. While we do not have specific regulatory language, we think it is high time rulemaking was begun to address the industry’s apparent tolerance of the collapse of the “Chinese Wall.” We look forward to working with the Subcommittee further on this important issue.

Disclosures required by clause 2(g) of Rule 11 of the House and Rules of the Committee on Financial Services

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4. Neither I nor the AFL-CIO have received any Federal grants or contracts, including any sub-grants and sub-contracts, since October 1, 1999.

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Damon A. Silvers is an Associate General Counsel for the AFL-CIO. His responsibilities include issues involving corporate, securities and bankruptcy law, benefit fund investment policy, and mergers and acquisitions. Mr. Silvers works closely with the AFL-CIO's Office of Investment and the Center for Working Capital. Mr. Silvers has represented the AFL-CIO and the Trade Union Advisory Committee to the Organization for Economic Cooperation and Development at the OECD's Corporate Governance Taskforce, has testified before the House and Senate Judiciary Committees on bankruptcy law, and has addressed the National Association of Corporate Directors on corporate governance issues.

Prior to working for the AFL-CIO, Mr. Silvers was a law clerk at the Delaware Court of Chancery for Chancellor William T. Allen and Vice-Chancellor Bernard Balick. Mr. Silvers has previously worked in the Mergers and Acquisitions Department at Credit Suisse First Boston, for the law firm of Cravath, Swaine & Moore, the Enforcement Division of the United States Securities and Exchange Commission, Monitor Company, a management consulting firm, and in the General Counsel's office at the International Brotherhood of Teamsters. Mr. Silvers has also been the Assistant Director of the Office of Corporate and Financial Affairs for the Amalgamated Clothing and Textile Workers Union, and the Research Director for the Harvard Union of Clerical and Technical Workers, AFSCME.

Mr. Silvers received his J.D. with honors from Harvard Law School and an M.B.A. with high honors from Harvard Business School. Mr. Silvers is a graduate of Harvard College, summa cum laude, and has studied history at Kings College, Cambridge University.