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Are Big Brokerage Firms Betraying Their Clients' Trust? (or) Is The Brokerage Industry's "Chinese Wall" Made of Swiss Cheese?

Although there are surely hundreds of honest, ethical analysts toiling away at major Wall Street firms, it seems that the overall process of brokerage firm recommendations is rife with corruption. "Chinese Walls" are supposed to be self-imposed separation of sales from research, and their purpose is to help maintain the integrity of Wall Street. For years now, people inside the industry knew that something was amiss. Woody Guthrie once wrote, "Some people rob you with a six-gun, others with a fountain pen." It looks like many major Wall Street firms are now circling their wagons, preparing for their own version of Enronitis.

One of the basic lessons that successful investors and businesspeople learn early on is that short-term greed usually leads to a situation where everybody loses. This differs from the basic desire for long-term gain, where everybody has the opportunity to win. It is a simple contrast: expedience, convenience, and quick profits versus patience, discipline and honesty. The moral of the story is a financial version of the Tortoise versus the Hare. Doing the right thing may have short-term consequences for business profitability, but the long-term benefits are clear: integrity and an unblemished reputation.

This lesson of the destructiveness of short-term greed was recently brought to the attention of our head of investment research, Chris Schreur, who co-authored this article, when New York's Attorney General, Eliot Spitzer, obtained a court order against Merrill Lynch, the largest investment bank in the United States. The order forced Merrill to disclose in any stock research report it publishes whether it has or is trying to get an investment banking relationship with the company covered in the report. For example, if a brokerage firm is strongly recommending that its customers purchase stock in Tyco and it is also the investment banker for Tyco, which means they are helping the company raise additional capital through a new stock or bond offering, then their customers will need to be made aware of the potential conflict of interest.

The court order, which is likely to be followed by some kind of executive action, was the result of a ten-month investigation, launched well before the Enron scandal. The government found that "[the investment analyst's] stock ratings were biased and distorted," and that the firm "often disseminated misleading information" to help corporate clients at the expense of individual investors. According to a press release issued by Spitzer's office, these actions were a "shocking betrayal of trust". Spitzer has called for "reform throughout the entire industry" and, as of the date of this article, other states may broaden the investigation to nearly a dozen major Wall Street firms.

New York State may yield on these matters to the S.E.C., who has yet to enter the fray. A recent appalling discovery was a series of internal e-mails that Spitzer released, in which Merrill Lynch's analysts disparaged, in very graphic terms, the same stocks they were

recommending to their retail customers. For example, Internet provider Infospace was dubbed “a powder keg” and “a piece of junk” while it got Merrill’s top 1-1 rating, and Internet portal Excite@Home, rated 2-1, was called “such a piece of crap.” A 1 (Buy) is Merrill’s highest rating on a scale of 1 to 5.

Most of the large brokerage firms have two main businesses: investment banking, which serves corporate clients, and investment management, which serves individual customers. These two businesses are supposed to operate independently, separated by a “Chinese Wall,” to avoid potential conflicts of interest. The Chinese Wall has come to resemble Swiss cheese these days, as investment analysts who are supposed to represent the interests of customers increasingly offer “Buy” recommendations in order to help their firms win or retain investment banking business. The internal e-mails released by Spitzer detailed this betrayal; analysts recommended stocks to their customers that they knew were bad ideas. Additional damaging evidence coming out of these investigations is that some analysts’ cash bonuses are dependent on whether they help close investment banking deals. This is a recipe for consumer indigestion!

The virtues of working for long-term gains should guide financial service professionals. Stock analysts should be encouraged to speak the truth about the companies they are reviewing. The brokerage firms and their competitors in the banking industry all might lose some investment banking business in the moment, but their base of retail customers would have saved billions of dollars. Clients would then have good cause to remain loyal to these huge firms because of the desire to associate with people of integrity. Now, the

entire industry is in a fight to preserve its reputation. Merrill Lynch's CEO, David Komansky, appeared on TV recently to publicly apologize to their customers but it is interesting to note that only one Merrill analyst has been fired over the incident so far.

In an interview, Eliot Spitzer, the head lawyer for New York, said that he wants major structural changes in the way Wall Street firms provide stock research. One proposal is the possibility of forcing firms to separate their research units from their investment banking departments. Spitzer is also considering filing criminal charges against firms he believes purposely mislead investors by hyping stocks through research.

Thomas Brown, a former research analyst at Donaldson Lufkin & Jenrette (DLJ), now part of Credit Suisse First Boston (CSFB), believes that Spitzer's investigation "should be fabulous news to anyone interested in restoring ethics to Wall Street research." Mr. Brown says he was fired by DLJ in 1998 because he refused to issue positive research reports on companies that were current or prospective investment-banking clients.

This kind of ongoing soap opera is giving small investors a chronic headache. The market may be attractive on a fundamental basis, but this kind of unfolding news furthers the lack of confidence most people feel about the basic way stocks are traditionally sold. The end result is yet another level of overhanging skepticism. Until the moral crisis on Wall Street is dealt with straight on, it is unlikely that the general public will regain an appetite for common stocks.

Rob Rikoon is Chief Executive Officer (rrikoon@aol.com), and Chris Schreur is Chief Investment Officer (riaschreur@aol.com) of Rikoon-Carret Investment Advisors, located at 510 Don Gaspar, Santa Fe, NM, Tel. 989-3581.

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