



**Comments on
Securities and Exchange Commission
Proposed Rule:
Regulation Analyst Certification**

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to the
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Regulation Analyst Certification
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The Securities and Exchange Commission's (SEC) proposed rule "Regulation Analyst Certification," along with other reforms adopted to date, imply an accurate diagnosis of what ails Wall Street: serious conflicts of interests that have distorted research reports issued by brokerage firms on public companies, with devastating consequences to investors. However, they fail to provide an adequate cure for several reasons:

Reason #1: The conflicts are more serious. The conflicts of interest and their consequences are both broader and deeper than previously believed.

Specifically:

- *Conflicts affect many more firms:* In our earlier paper submitted to regulators, entitled *Crisis of Confidence on Wall Street: Brokerage Firm Abuses and the Worst Offenders*, we show that, among brokerage and investment banking firms issuing stock ratings on companies that subsequently failed in 2002, a surprisingly large percentage – 94% – continued to maintain “buy” or “hold” ratings on the companies up until the day they filed for Chapter 11.¹
- *Conflicts have broader consequences:* In addition to their impact on the accuracy of ratings, documents just submitted to Congress by Citigroup's Salomon Smith Barney demonstrate that conflicts of interest may have also negatively influenced the fairness of allocation of shares in initial public offerings (IPOs), further harming investors.²
- *Similar conflicts may influence other investment vehicles including corporate bonds, municipal bonds, annuities, and life insurance.*³ Debt securities are addressed in the proposed rule, but not in recently adopted SRO rules. Meanwhile, annuities and life insurance are outside of the SEC's jurisdiction.

Reason #2: Certification has a fundamental flaw. The proposed mechanism – certification of analyst personal views and opinions – overlooks the cognitive dissonance principal.

The primary mechanism proposed is certification that the opinions expressed in research reports and public appearances accurately reflect the analysts' personal views about the securities and issuers.

¹Martin D. Weiss, *Crisis of Confidence on Wall Street: Brokerage Firm Abuses and the Worst Offenders*, presented at the National Press Club, Washington, D.C., June 11, 2002, revised July 24, 2002. (www.weissratings.com/crisis_of_confidence.asp)

² Gretchen Morgenson, “After Criticism, a Top Analyst Quits Salomon,” *New York Times* (August 16, 2002).
Ibid., “Ebberts Got Million Shares in Hot Deals” (August 28, 2002).

³ Martin D. Weiss, *The Ultimate Safe Money Guide*, John Wiley & Sons (2002), pp. 134-143, 194-201.

However, this proposal seems to overlook the principal of *cognitive dissonance*. In a nutshell, the principal holds that when individuals are confronted with a conflict between (a) what they believe personally and (b) what they are expected to say or write publicly, they are more likely to modify their personal views to justify their public statements than to modify their public statements. Only rarely do they modify their public statements in defiance of social and economic pressures.

This principal is valid even when the personal views are rooted in firmly held, fundamental, or religious beliefs, provided there is a consistent system that rewards the “correct” opinion, while punishing the “incorrect” opinion, typically through ridicule or ostracism.

Thus, the principal is certainly valid when personal views are based on a subjective weighing of positive and negative factors, a “gut” feeling about what’s important, plus some guesswork about what the future may bring, as is the case with research reports on stocks and issuers.

Indeed, with most Wall Street research, there is a shaky balance between positive and negative conclusions. In many cases, all it takes is a subtle outside influence to tip the delicate scale – not only biasing the public statements, but *also biasing the personal views of the analyst*. And, unfortunately, as recent investigations have revealed, the outside influences impacting research analysts are far from subtle. Wall Street society continues to maintain a consistent and powerful system of rewards (including rich compensation) for “correct” opinions and punishment (such as demotion, termination, and ostracism) for “incorrect” opinions.

It’s no wonder that analysts swear under oath that they “truly believed” everything they have ever written or said about companies that have since failed, such as WorldCom or Global Crossing. Almost all analysts will say they truly believe what they say and write, whether they do or not. Most actually do come to believe it, at some time during the report’s development or after its publication. Others may not have believed it at the time, but may find it very easy to modify, in retrospect, what they remember about their past beliefs. And some may simply be lying to protect their *current* interests.

In any of these situations, the SEC’s proposal – that they certify their reports are consistent with their personal views – does little to address the fact that it is human nature to modify one’s personal views to conform to one’s public statements.

Reason #3: Technical weaknesses. The Regulation Analyst Certification also suffers from several technical weaknesses.

There are some technical weaknesses in the SEC proposal, as follows:

- Signature does not seem to be required. If the purpose of the certification statement is to make the analyst think twice about disseminating false or misleading information, then the analyst should be required to personally sign the certification, much as CEOs and CFOs are being required to do to certify the accuracy of their firms’ financial statements.

- Individual is not personally responsible. In the SEC proposal, the primary burden of responsibility is on the firm, often relieving the individual of much of the responsibility.
- Penalties unclear. The SEC proposal outlines no specific penalties for an analyst's failure to comply. The firm itself would be subject to disciplinary action by the SEC, but that disciplinary action is not spelled out. In fact, if an analyst fails to submit a quarterly statement regarding his public appearances, the only remedy spelled out is that the firm would have to include a statement in all research reports disseminated over the next 120 days stating that one or more of its analysts had not complied with the certification requirements. We believe that is both too vague and too broad to be of benefit to investors or have any pre-emptive impact on the dissemination of research that may be conflicted.
- Potential for buried boilerplate. The proposed rule says that the analyst report certification must be displayed on the first page of the report or must be referenced from the first page of the report. We fear that this will lead to an entry in the table of contents or in a footnote on the first page that then leads to a statement buried in the boilerplate at the back. Further, we fear such a boilerplate may wind up saying something along the lines of "The views contained in this report accurately reflect the views of the analyst preparing the report. Said analyst has not received and will not receive any direct compensation for the opinions expressed in this report." We don't believe these statements will do much good to reassure investors or to hold research analysts responsible.

Reason #4: Disclosure alone may be inadequate. Most investors are now well aware of conflicts, and this awareness has not effectuated significant change.

The second mechanism proposed by the SEC is *disclosure* of conflicts of interest. Although more disclosure can only help, it is unlikely that this step by itself will be adequate to effect the desired changes.

The conflicts of interest have been well known in the industry for decades, and in the wake of recent revelations by the New York State attorney general, Congress and the press, they are now well recognized by average investors as well. Thus, for the most part, the public already *knows* that conflicts of interest are an integral aspect of business as usual on Wall Street. Telling the public that a particular report is conflicted does add some useful information to the investor, but it is unlikely to be enough.

If Wall Street's typical business model were based on independent, unbiased, conflict-of-interest free research, specific disclosure statements could have a very significant impact. However, in our current environment, where nearly all research is, as a rule, directly or indirectly conflicted, there is a real danger that the disclosures will become standardized and ubiquitous, appearing at the bottom of nearly all research reports. Investors will gloss over them, and little of substance will have changed.

Weiss Ratings' Proposals

Weiss Ratings is the only rating agency in the nation that covers brokerage firms, publishing a quarterly guide that covers more than 600 security broker-dealers. The Weiss Ratings' *Guide to Brokerage Firms* provides information on each firm's financial security, commissions, service, and history of legal actions filed against it.

Based on our knowledge of the industry gained from our surveys and studies of the brokerage firms, we believe that a focus on disclosure alone in lieu of structural changes may be tantamount to favoring *form over substance*. We believe that regulators must first address the sources and causes of the conflicts with more specific measures aimed at promoting a change in the structure of the investment banking and brokerage business. Disclosure requirements can then be positioned as a mechanism to reinforce or back up the structural changes.

Recent proposals that directly address analyst compensation tied to investment banking are a step in the right direction. However, even these skirt the fact that, in most cases, the *firm itself* is the primary entity in a conflicted position.

Hypothetically, assume a research analyst employed by a Smith Jones & Co., a large Wall Street broker-dealer and investment banking firm. Assume also that Smith Jones takes all the appropriate steps to ensure that the analyst's compensation is not directly or indirectly linked to investment banking results. Despite these efforts, however, the analyst is still a Smith Jones employee, still participates in the Smith Jones' pension or defined-benefit plan, may still receive compensation in the form of Smith Jones shares and/or options, and continues to derive job security, compensation and perks from the firm's overall financial stability, revenues, profits and prestige. To be a team player, the analyst will likely tend to work for, not against, Smith Jones' short and long-term interests. Since the firm has conflicts of interests, those conflicts are naturally passed from the firm to the analysts and other employees and on to the investing public.

In light of the above, we offer the following proposals:

Proposal #1: Prohibition of sales incentives. Brokerage or investment banking firms should never be allowed to tie the compensation of their research analysts to the success of investment banking or other sales.

Proposal #2: All firms should be urged to separate investment banking from brokerage operations through divestiture.

Proposal #3: Compensation tied to accuracy. All firms should be urged to tie a substantial portion of research analysts' compensation to the accuracy of analyses and recommendations.

It is anticipated that this incentive will help:

- Motivate the analyst to be as objective as possible in order to achieve the best possible track record.

- Help offset and, ideally, overcome internal pressures from the firm to bias the conclusions.
- Align the interests of the analyst with the interests of the investor.

Proposal #4: Disclosure. Firms that choose not to separate their operations through divestiture or tie compensation to accuracy should adhere to a strict certification and disclosure regime, as proposed by the SEC and enhanced by the recommendations below.

- Signature requirement.** The analyst should be required to personally sign the certification.
- Corporate and individual responsibility.** Both the firm and the analyst should be held responsible for ensuring the accuracy of the certification and its timely submission.
- Penalties for failure to comply.** Disciplinary action should be enforced for both the analyst and the firm for non-compliance.
- More than just standard boilerplate.** Disclosures written in plain English should be included as an integral part of all printed materials or communications.
- Implementation of NASD 2711.** The NASD proposal that larger firms include a rating history in all research reports showing any previous recommendations issued on the company along with the stock price as of the date of that recommendation should be required of all firms, large and small.