



**Comments on
NYSE and NASD Rulemaking:
Proposed Rule Changes
by the New York Stock Exchange, Inc.
Relating to Exchange Rules
344, 345A, 351 and 472
and by the National Association
of Securities Dealers, Inc.
Relating to Research Analyst Conflicts of Interest**

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to the
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Summary

In 2002, Weiss Ratings demonstrated that the ratings publicly available from 94% of 50 major brokerage and investment banking firms continued to recommend that investors should buy or hold shares in failing companies right up to the day those companies filed for bankruptcy. Further, in two follow-up studies, we revealed that despite widespread investigations by regulators, publicly available ratings from the majority of Wall Street firms continued to recommend bankrupt companies.

This phenomenon is a symptom of two serious problems: (1) a two-tiered communication network favoring an elite group of investors and (2) deeply ingrained conflicts of interest at a corporate level.

Although steps in the right direction, the proposed rules governing broker stock ratings and research do not address these two problems, leaving several significant loopholes that could undermine the Wall Street reform effort. To close these loopholes, we recommend the following measures:

1. Create a comprehensive stock ratings database and make it widely available to the public, enabling investors to compare the ratings and historical track records of research analysts and their firms.
2. Require firms to update their stock ratings on a regular basis and following any event that could materially impact a rated company.
3. Require firms to base analysts' incentive compensation exclusively on the accuracy of their research and ratings, eliminating all direct and indirect contributions from investment banking revenues.
4. Require firms to write all research reports in plain English, including specific disclosures regarding the nature of any remaining conflicts, explicitly pointing out how such conflicts could bias the research.
5. Require firms and their brokers to provide similar disclosures to investors when recommendations are communicated orally and to inform customers when ratings change or coverage is dropped.

With these added measures, we believe the proposed rules will go a long way to resolve the conflicts of interest that have plagued investors. Investment banking will be largely prevented from influencing most research, bias will cease to be a cornerstone of the industry, and investors will no longer be kept in the dark regarding critical ratings changes.

**Weiss Ratings' Comments on NYSE and NASD Rulemaking:
Proposed Rule Changes Relating to Exchange Rules 344, 345A, 351
and 472 and the National Association of Securities Dealers, Inc.**

Although they are steps in the right direction, the proposed rules are inadequate to remove pervasive and deeply ingrained conflicts of interest that continue to distort brokerage firm stock ratings and research reports available to the public. In this commentary, we

- review our recent research demonstrating symptoms of the continuing conflicts (Part I),
- identify critical loopholes in the new rules (Part II), and
- propose measures to close them (Part III).

I. Weiss Ratings' Research on Continuing Conflicts of Interest

June 11, 2002 White Paper

In a paper presented to the National Press Club on June 11, 2002, we demonstrated that the ratings publicly available from 94% of 50 major brokerage and investment banking firms continued to recommend that investors buy or hold shares in failing companies right up to the day those companies filed for bankruptcy.¹

Follow-up Studies October 7, 2002 and January 21, 2003

In two follow-up studies conducted in 2002 and 2003, we revealed that despite widespread investigations by regulators, a massive public outcry, and solemn promises by Wall Street to change its ways, publicly available ratings from the majority of Wall Street firms studied continued to recommend bankrupt companies.²

We believe this research exposes an egregious abuse of investors, representing a blatant symptom of continuing serious conflicts of interest in the industry.

¹ Martin 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 June 19, 2002. www.weissratings.com/crisis_of_confidence.asp

² Weiss Ratings, Inc., "46 Brokerage Firms Continue Pattern of Recommending Failing Companies Despite Intense Regulatory Scrutiny," October 7, 2002, and "Publicly Available Ratings From 66% of Brokerage Firms Continue to Recommend Failing Companies," January 21, 2003. www.WeissRatings.com, under News Releases, Brokerage Firms.

Reasons for broker recommendations of bankrupt companies

We have identified several reasons for this abuse, as follows:

- Ignoring major events. In many cases, the firms continued to recommend companies while ignoring significant events impacting the financial viability of the companies. For example, several major Wall Street firms continued to recommend Kmart, Global Crossing and McLeodUSA despite repeated downgrades and warnings of bankruptcy from the established credit rating agencies.³
- Stubbornly bucking the tide. In some cases, the firms issued new reports on the failing companies in the period shortly before their failure, urging investors to hold their shares or even buy more. Some even issued these new reports on the very day that the companies filed for bankruptcy.⁴
- Failing to update old ratings. In other cases, the brokerage firms never updated their earlier positive (“buy” and “hold”) ratings, taking no further action to either reaffirm or deny their current validity. Research reports are not normally published on a regular schedule. Therefore, in the absence of any notification to the contrary, investors seeking an opinion on these companies would have had no way of discerning whether they were current or not. Most investors would assume that the ratings were still valid until told otherwise.⁵
- Failing to inform of dropped coverage. In still other situations, the firms “dropped coverage” on the failing companies but apparently neglected to inform major public sources. Investors seeking an opinion would not have learned that the coverage was dropped.⁶

³ Martin D. Weiss, *ibid.*, pages 10-18. See especially “The Case of Kmart,” “The Case of Global Crossing,” and “The Case of McLeod USA.”

⁴ For example, Kmart filed for Chapter 11 on January 22, 2002. On this date, S&P lowered its bond rating from CCC- to D, its lowest rating grade. However, also on this date, Bank of America, Bear Stearns and Salomon reaffirmed their “hold” ratings on the stock.

⁵ For example, on January 30, 2002, McLeodUSA filed for Chapter 11 bankruptcy. However, on that same date, major public sources continue to show “buy” or equivalent ratings from Hibernia Southcoast Capital, Lehman Brothers, Thomas Weisel, and William Blair.

⁶ In its complaint against Merrill Lynch, the New York State attorney general’s office put it this way: “In lieu of assigning reduced or sell recommendations to stocks they no longer favored, [they] instead merely quietly stopped covering the stock, without any announcement or meaningful explanation to the retail public.” Affidavit in Support of Application for an Order Pursuant to General Business Law Section 354 by Eliot Spitzer, Attorney General of the State of New York with regard to the acts and practices of Merrill Lynch & Co et al., submitted to the Supreme Court of New York County of New York, www.oag.state.ny.us/press/2002/apr/MerrillL.pdf.

- Failing to communicate ratings changes in public venues. Many of the firms do provide regular notification of ratings changes, including dropped coverage, but these notifications are communicated only to private information sources that are available exclusively to the firms' customers. Even wealthy individual investors willing to pay the high monthly subscription fees for these private sources would not be given access to the information. Publicly available information sources do pick up and post many of the ratings changes, but critical downgrades are occasionally missed, and notifications of dropped coverage are frequently missed. As a result, incorrect ratings often remain in the public domain, leaving investors with the false impression that the companies are still recommended.

For example, in early 2003, the leading private information source, First Call, posted the terms "dropped coverage," "suspending coverage," or "not rated" for the following bankrupt firms:

Adelphia Communications Corp.
Budget Group, Inc.
Metromedia Fiber Network, Inc.
NewPower Holdings, Inc.
Pinnacle Holdings, Inc.
U.S. Airways, Inc.
Versatel Telecom International, Inc.
WorldCom, Inc.
XO Communications, Inc.

However, at the same time, two leading public information sources, Briefing.com and Bloomberg, continued to display "buy" or "hold" ratings on these same bankrupt companies.

Who is to blame?

Most Wall Street firms disavow responsibility for these communication gaps, stating that it is beyond their control. The public sources, in turn, state that they rely on the firms to communicate changes and to take some initiative to monitor the accuracy and currency of the ratings posted for public consumption. Rather than assign blame, however, suffice it to recognize that:

- There are two communication networks on Wall Street – one for an elite group of customers that provides complete research and stock ratings data, and another for all other investors that provides incomplete and often deceptive information.
- Individual investors are the losers inasmuch as they are effectively told to hold shares that have long ago been abandoned by the same brokers who originally recommended their purchase.

Conclusions:

The firms *are* largely responsible for at least one of three behaviors:

- (1) They continue to recommend failing companies;
- (2) They quietly walk away from their earlier recommendations; and/or
- (3) They often neglect to take the appropriate steps to make sure the public is informed that their opinion has changed.

We believe each of these behaviors is

- (1) institutionalized in the form of various company procedures and practices that may persist despite any reforms in the decision-making processes of individual analysts,
- (2) related to the firm's deeply ingrained mandate to help protect a corporate client from scrutiny or to protect its shares from selling pressure by the public, and
- (3) driven by serious conflicts of interest on the corporate level.

Most important, we believe that any rule changes will tend to be ineffective unless they take into account all of these institutionalized obstacles to change.

II. Critical Loopholes

Weiss Ratings commends the NYSE and NASD for their initiative to establish registration, qualification, and continuing education requirements for analysts, and for their desire to ensure that analysts receive ethics and professional responsibility training. However, we are concerned that the funding to support these programs may be inadequate. Moreover, in light of the above, we have identified the following loopholes in the proposed rules:

1. **Two-tiered communication network:** The proposed rules require that when a firm drops coverage, it must provide a final recommendation or rating and make notice of these items “in the same manner as when research coverage was first initiated.” However, this rule is deficient in that it assigns no specific responsibility to any entity for distributing that notification to the public. As illustrated earlier, many firms currently distribute their research exclusively to private vendors. These, in turn, make only partial information available to the public, often excluding critical notification of downgrades or dropped coverage. As long as the communication mandated by the proposed rules is funneled through this two-tiered communication system, much of the information will likely fail to reach the intended audience, investors will remain in the dark, and the rules will not achieve the desired results.
2. **Outdated ratings:** The proposed rules contain no provisions regarding the minimum frequency of ratings reviews by analysts. Nor do they include any guidelines that would help define significant events that should mandate a ratings review. Therefore, there are no mechanisms that might prevent the stock ratings and research themselves from becoming outdated.
3. **Corporate-level conflicts of interest:** The proposed rules prohibit analyst compensation based on specific investment banking deals or on the analyst’s contribution to the firm’s investment banking business. However, this rule is deficient in that it overlooks conflicts of interest that occur on a corporate level, resulting in patterns of behavior that continue to result in investor deceptions. At the same time, the proposed rules can be fatally undermined by the firm’s continuing ability to base the analyst’s compensation on the overall performance of the firm, which, in turn, can be largely driven by investment banking revenues.
4. **Plain English:** There is no broad provision in the rules requiring that analyst reports and disclosures be written in plain English.⁷ As a result, even if all of the information reaches individual investors on a timely basis, it may often fail to achieve the goal of informing them of the conflicts and potential risks.

⁷ Recently adopted SRO and SEC rules on analysts require that mandated disclosures must be “clear, comprehensive and prominent” but do not require that these be written in plain English. To our knowledge, the only plain-English provision refers strictly to notifications of non-certification. Thus, there appear to be no plain-English requirements covering analyst reports themselves or even covering the disclosures they contain.

5. **Oral communications:** The proposed rules also do not cover broker communications to customers. Yet individual brokers continually use analyst recommendations to persuade their clients to make trading decisions, and those clients need the benefit of the required disclosures in order to fully assess the quality of recommendations and make informed investment decisions. Investors need to know when the ratings change or coverage is dropped on the securities they bought on the recommendations of their brokers.

III. Weiss Ratings' Recommendations to Close the Loopholes

In order to better protect investors from the widespread abuse to which they are being subjected, Weiss Ratings recommends the following additional measures:

1. Create a comprehensive Stock Ratings Database (SRD), making it widely available to the public.

Goals of the SRD

- To provide individual investors with a user-friendly database on the current and historical stock ratings issued by Wall Street analysts and firms, empowering investors to make informed decisions regarding the value of the advice.
- To provide third-party researchers the ability to freely obtain a relational database in its entirety, enabling them to develop comparative studies and commentary regarding the value of the advice to investors.

The aggregation of information on one website will allow the public to compare and measure the performance of analysts. This, in turn, will provide market-based incentives for analysts to compete based on the quality of their research.

The SRD will enable investors to view or compare the current ratings of each stock by various analysts, the track records of each analyst, and the performance of various analysts and firms over time. As such, the SRD will circumvent and overcome Wall Street's two-tiered communication network, which has left so many investors twisting in the wind and suffering monumental losses.

Creation and Maintenance of the SRD

Weiss Ratings recommends that regulators put the majority of the burden for creating and maintaining the database on the individual brokerage firms by requiring them to submit all of their analysts' stock recommendations in a standard format and via an automated upload. The procedure would populate the database with the relevant information. Firms supplying incomplete or erroneous information should be subject to penalties that would then go toward covering the cost of monitoring that firm's submissions in the ensuing year.

Contents of the SRD

Weiss Ratings has outlined suggestions for the precise fields and content of the SRD in order to provide all the basic information investors would require to make informed investment decisions regarding broker advice. (See Appendix)

Until such time as this system is in place, changes in ratings, including notification of dropped coverage, must be disseminated in such a way as to ensure that the public receives effective notice.

2. Require firms to update their stock ratings on a regular basis and following any event that could materially impact a rated company.

As discussed above, many firms fail to update their ratings despite significant changes. Some even reaffirmed their positive ratings despite events, such as major credit rating downgrades that adversely affect the companies.

We propose that firms be required to update ratings following any event—such as a debt downgrade—that could materially impact a rated company. In addition, at a minimum, ratings should be reviewed quarterly.

3. Base analysts' incentive compensation exclusively on the accuracy of their research and ratings, eliminating all direct and indirect contributions from investment banking revenues.

In order to better align the interests of analysts with those of investors, Weiss Ratings proposes that each analyst's incentive compensation be based exclusively on the accuracy of the analyst's research. Under no circumstances should the analyst's compensation be driven by investment banking revenues, either directly or indirectly.

This step is needed in order to establish a firm counterweight to the conflicts of interest that are bound to persist on a corporate level as long as research and investment banking are under the same roof.

4. Require that all research reports be written in plain English, including disclosures regarding the nature of any remaining conflicts, explicitly pointing out how such conflicts could bias the research.

Research and disclosures of any remaining conflicts must not only reach individual investors, but it must also be clearly understandable to those investors.

The term “disclosure,” however, is often misused. Many firms will seek to provide opaque disclosures that state a fact but fail to inform investors why the fact is important or how it could bias the opinion of the researcher. Typically, such opaque disclosures become standard, investors learn to dismiss them, and the firms become free to go about business as usual. Or, sometimes industry leaders consent to broader, jargon-filled disclosures, but then overwhelm investors with reams of unintelligible information.

These roadblocks can only be overcome with very specific, plain English disclosures regarding the actual relationships and potential conflicts between each firm and its clients.

5. **Require firms and their brokers to provide similar disclosures to investors when recommendations are communicated orally and to inform customers when ratings change or coverage is dropped.**

It is especially important that individual investors understand the analysis in the report, the nature of any conflicts, and how such conflicts could bias the analysis. When brokers relay an analyst's recommendations orally, they should be required to provide investors with the disclosures contained in the research report and a brief review of the accuracy of the analyst's past recommendations. Further, when ratings change, brokers should be required to inform their clients that bought the stock on their recommendation. Once the SRD is in place, brokers should educate their customers regarding its goals, usage, and contents.

If the NYSE and the NASD truly wish to protect investors from the widespread abuse to which they are being subjected, these additional reforms must be addressed either in the context of the proposed rules or in subsequent rulemaking.

Appendix

Proposed Contents of Comprehensive Stock Ratings Database (SRD)

Weiss Ratings recommends that the SRD be made available to the public through an Internet website, with fields such as:

- Brokerage firm name
- Research analyst name
- An indication as to whether the firm or the analyst is independent or has conflicting business relationships
- Company name and ticker symbol of stock being rated
- A chronology of all ratings on this company
 - by the same firm
 - by the same analystwith dates and closing stock prices at time of each rating change
- Current rating, using standard classifications:
 - Buy
 - Sell
 - Hold
 - Dropped coverage

Note: For the purpose of tracking performance, dropped coverage is considered identical to a “sell” rating.
- Date of first “buy” rating, if any
- Closing stock price on date of first “buy” rating
- Position Open/Closed, wherein
 - the position is defined as “open” if no “sell” or dropped coverage rating has been issued
 - the position is defined as “closed” as soon as a “sell” or dropped coverage rating has been issued

On open positions:

- Most recent closing price
- Price appreciation or depreciation of the stock to date
- Total hypothetical accumulated dividends to date (assuming investors bought and sold at the closing prices)
- Total hypothetical return to date
- Number of calendar days from first “buy” recommendation to date
- Annualized total hypothetical return to date

On closed positions:

- Date position closed
- Closing price on date position was closed
- Price appreciation or depreciation on recommendation

- Total hypothetical accumulated dividends to date (assuming investors bought and sold at the closing prices)
- Total hypothetical return
- Number of calendar days from first “buy” recommendation to date position closed
- Annualized total hypothetical return

Application of the SRD:

The stock ratings database would allow each investor to sort or select the data by:

- stock,
- firm, or
- analyst.

Sorting or selecting by stock, the investor would be able to review and compare:

1. The current rating for the stock by multiple firms.
2. The current rating for the stock by multiple analysts.
3. The annualized total hypothetical returns achieved for the stock by multiple firms.
4. The annualized total hypothetical returns achieved for the stock by multiple analysts.

Sorting or selecting by analyst, the investor would be able to review and compare:

1. Current ratings issued by the analyst on multiple stocks.
2. Historical ratings issued by the analyst on multiple stocks, with total returns for each.
3. Overall total returns achievable by following the analyst’s advice from inception.
4. Total returns achieved by various analysts.

Sorting or selecting by firm, the investor would be able to review and compare:

1. Current ratings issued by the firm on multiple stocks.
2. Historical ratings issued by the firm on multiple stocks, with total returns for each.
3. Overall total returns achievable by following the firm’s advice from inception.
4. Total returns achieved by various firms.