

How Corrupt Is Wall Street?

New revelations have investors baying for blood, and the scandal is widening

By Marcia Vickers and Mike France, with Emily Thornton, David Henry, and Heather Timmons in New York and Mike McNamee in Washington

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(PFD File)

When Debases Kanjilal, a Queens (N.Y.) pediatrician, picked up his phone in early 2001 to call lawyer Jacob H. Zamansky, he had no idea he would whip up a full-fledged hurricane on Wall Street. Kanjilal claimed he lost \$500,000 investing in Infospace Inc. ([INSP](#)), an Internet stock he says his Merrill Lynch & Co. ([MER](#)) broker urged him not to sell when it was trading at \$60 a share. By the time he sold, it was down to \$11. Zamansky filed a novel arbitration claim against Merrill in March, 2001, in which he argued that its star Net analyst, Henry Blodget, had misled investors by fraudulently promoting the stocks of companies with which the firm had investment banking relationships. That lawsuit led directly to an investigation by New York State Attorney General Eliot Spitzer, who stunned Merrill and its Wall Street brethren three weeks ago when he made public some shocking e-mail exchanges between Merrill analysts and bankers.

That was just the start. Now, Spitzer is investigating Salomon Smith Barney, Morgan Stanley Dean Witter ([MWD](#)), and at least three others. The Securities & Exchange Commission has launched a probe into practices at 10 firms, while the Justice Dept. is pondering an inquiry of its own. And plaintiffs' lawyers are advertising for clients and filing new suits daily.

The widening scandal has plunged Wall Street into crisis. The resulting furor is more thunderous than the one unleashed by Michael R. Milken's junk-bond schemes in the 1980s, the Prudential Securities limited-partnership debacle in the early '90s, or price-fixing on the Nasdaq later in the decade. In part, that's because many more individuals lost money in the recent market collapse than on earlier scandals.

But uproar over the relationships between analysts and their investment banking colleagues has also grown because it comes on the heels of several other scandals that raise big questions about how Wall Street operates. Already, probes are under way into Wall Street's shady initial public offering allocation practices, as well as its crucial role in setting up and selling the partnerships that led to Enron Corp.'s collapse. Worse, execs at many firms may have made a bundle investing in the partnerships, even as those same firms advised clients to hold Enron stock virtually until it went bankrupt. It all makes Wall Street seem rigged for the benefit of insiders as never before.

The damage goes way beyond the tattered reputations of the firms and their beleaguered analysts. The entire economy depends on the financial system to raise and allocate capital. And that financial system, in turn, is built on the integrity of its information. Should investors lose confidence in that information, it could deepen and prolong the bear market, as wary investors hesitate to put money into stocks. And it could easily put a damper on the economy if companies are less willing--or less able--to raise capital on Wall Street. "One of the precious things we have is the integrity of the financial markets. If that changes it could have dramatic repercussions on the dollar, on domestic inflation, on the economy," says Felix G. Rohatyn, former managing director of Lazard Freres & Co.

Wall Street has always struggled with conflicts of interest. Indeed, an investment bank is a business built on them. The same institution serves two masters: the companies for which it sells stock, issues bonds, or executes mergers; and the investors whom it advises. While companies want high prices for their newly issued stocks and low interest rates on their bonds, investors

want low prices and high rates. In between, the bank gets fees from both and trades stocks and bonds on its own behalf as well, potentially putting its own interests at odds with those of all its customers.

But in recent years, those inherent conflicts have grown worse, as the sums to be made by overlooking them have grown enormous. That's because since the repeal of Depression-era banking laws, megabanks such as Citigroup ([C](#)) and J.P. Morgan Chase ([JPM](#)) are allowed to do everything from trading stocks to lending money and managing pension funds.

Chinese walls--jargon for the strict separation of the different lines of business conducted under the same roof--were supposed to keep the bankers honest and free from corruption. But a series of scandals since the early 1980s has eaten away at those foundations. The final blow, however, was the tide of money that flooded over Wall Street during the great tech bubble. Between the last quarter of 1998 and the first quarter of 2000, the tech-heavy Nasdaq market index soared from 1,500 to more than 5,000. Many investors made out like bandits. So did the investment banks. During the same period, according to Thomson Financial/First Call, Wall Street earned \$10 billion in fees by raising nearly \$245 billion for 1,300 companies, many of them profitless tech outfits that later blew up. The bubble burst in the spring of 2000, wiping out more than \$4 trillion in investor wealth. "The fact is that a bubble market allowed the creation of bubble companies, entities designed more with an eye to making money off investors rather than for them," wrote famed investor Warren E. Buffett in his annual report to Berkshire Hathaway ([BRK.A](#)) shareholders last year.

Staking their claim in the gold rush, Wall Street firms ramped up in the late '90s, hiring hordes of analysts, many of them inexperienced. New investment bankers were hired as well. A feeding frenzy set in as rivals fought to grab a big share of the market to bring companies public. At the same time, a new cult of equities came to life, as individuals invested in stocks as never before. True, many investors ignored common sense. Still, as analysts applauded stocks, trumpeting their picks on CNBC and other media, investors bought. "Investors took everything at face value, which was understandable. There wasn't a lot of information, and it was of varying quality," says Michael E. Kenneally, co-chairman and chief investment officer at Bank of America Capital Management Inc.

Only now are the ugly details of the conflicts at play being laid bare. In some of the e-mail turned up by Spitzer, analysts disparage stocks as "crap" and "junk" that they were pushing at the time. The e-mails are so incendiary that they threaten to thrust Wall Street into the sort of public-relations nightmare that Philip Morris ([MO](#)), Ford ([F](#)), Firestone, and Arthur Andersen have endured in recent years. All the ingredients are present: publicity-hungry attorneys general, packs of plaintiffs' lawyers, and potential congressional hearings. "The last thing the industry wants is...the drip-drip-drip of new stories every week," says Howard Schiffman, a former SEC Enforcement Div. lawyer now practicing privately in Washington.

More explosive documents may be on the way. Both Spitzer and the SEC are seeking from more than a dozen firms papers and e-mail related to analysts' recommendations and their potential conflicts of interest. While nobody knows what evidence will emerge, other firms will have their own smoking guns. And analyst pay is likely to emerge as a hot-button issue. Zamansky, for instance, claims that he has seen contracts from investment banks promising analysts 3% to 7% of all the investment banking revenues that they help to generate.

That would be clear proof that analysts were being paid to help the firms' banking clients, often at the expense of investors who expected objective advice.

The financial implications of this mess are enormous. Based on the evidence that has already emerged, Merrill is facing potential fraud claims by every retail investor who purchased any stock that Blodget & Co. may have insincerely recommended. If analysts covering other industries at

the firm harbored similar doubts about the companies they hawked, the number of claimants will expand exponentially. Should other financial firms have similarly embarrassing documents in their files, Wall Street could easily be facing billions in potential liability. In a report released on Apr. 24, as the fiasco was unfolding, Prudential Financial analyst David Trone estimated the issue could cost Merrill alone \$2 billion.

Heads could roll, too. If prosecutors conclude that firms are guilty of systemic fraud--rather than harboring a small group of rogues--research directors and other high-ranking execs could be vulnerable. That's why the way analysts were paid is such an explosive issue. In egregious cases, criminal prosecutions are possible. Although regulators have never thrown an analyst in jail for fraudulently recommending a stock, experts say that could happen if public outrage flames high enough. Spitzer, whose tough New York securities statutes give him unusually broad power to file criminal suits, says he won't stop short of structural reform. "I'm continuing to negotiate [with Merrill]," he told *BusinessWeek* on May 1. "They've been fruitful discussions, but negotiations can break down over a range of things. At this moment, we have significant issues that have not been resolved."

Over the long run, a risk bigger than legal penalties could be new restrictions that Spitzer or others place on the way investment banks do business. On May 8, the SEC is scheduled to approve new rules forcing analysts to limit and disclose contacts with investment banker colleagues. But there's good reason to question whether these steps will be enough to satisfy the industry's critics--some of whom seek a separation between investment banking and analysis. At the moment, such radical change is a long shot. But if the Democrat-controlled Senate latches on to the analyst issue, it could trigger embarrassing hearings or proposals for more stringent rules. "Other shoes will drop," says one securities-industry lobbyist. "If [Salomon's Jack] Grubman or [Morgan Stanley's] Mary Meeker turns up [in similar evidence], the sky is the limit" for this issue. "It has big legs."

It was never much of a secret that analysts who work at investment banks often work against investors. Sell ratings now make up less than 2% of analysts' recommendations, up from around 1% during the bull market, according to First Call. Analysts are under pressure from the companies they cover, as well as from big institutional clients who may own the stock, to give positive ratings. Michael Mayo, senior bank analyst at Prudential Financial, recently told the Senate Banking Committee that he had been exhorted to stay bullish throughout his career, from both his former employers and the companies he covers. Otherwise, he said, he doesn't get the same access that others do, which gives him a harder time making nuanced stock calls. "It's like playing basketball with one hand tied behind your back," says Mayo. Analysts also need to shine in surveys such as Institutional Investor's annual rankings, in which money managers vote for their favorite stockpickers, so they spend too much time lobbying clients rather than crunching numbers. "Analysts get focused on saying what they think the client wants to hear to win the vote," says Henry J. Herrmann, chief investment officer at Waddell & Reed Inc., a money manager.

The biggest factor now contaminating the system is compensation. To an ever-increasing degree, analysts' pay is tied to how much investment banking business they bring in. According to a Merrill memo released by Spitzer, Blodget detailed how he and his team had been involved in 52 investment banking transactions from December, 1999, to November, 2000, earning \$115 million for the firm. Shortly thereafter, Blodget's pay package shot up from \$3 million to \$12 million. Charles L. Hill, First Call's director of research, says that when he was a retail analyst 20 years ago, if he helped investment bankers with a new client, he would get a small reward at year's end: "But it was the frosting on the cake. Now, it is the cake."

It would be an exaggeration to say analysts alone are to blame for Wall Street's woes. There's a much deeper problem involving everyone from credulous investors to deal-happy investment bankers and execs looking to fatten their wallets. "It's finally dawning on people that this incentive system we've given managers based on the value of stock options has encouraged

management to puff up their companies a lot," says Robert J. Shiller, an economics professor at Yale University and author of the 2000 best-seller *Irrational Exuberance*.

Even so, experts say a lot of the corruption oozing from Wall Street has to do with an erosion in investment banking ethics and practices. It goes clear back to 1975, when fixed trading commissions were ended. Until then, investment banks had been able to make big bucks off pricey trading commissions. Slashed commissions meant the firms were forced to derive more revenues from investment banking business. "There's a real sense of sadness over what has happened in investment banking. It's not about what's right for a client, it's all about jamming a deal down a client's throat," says an ex-analyst who recently joined a hedge fund.

Consider Enron, which has paid \$323 million to Wall Street in underwriting fees since 1986, according to Thomson. Goldman, Sachs & Co. ([GS](#)) pocketed \$69 million of that, while Salomon made off with \$61 million, and Credit Suisse First Boston took \$64 million. Indeed, two of CSFB's investment bankers, after helping to design Enron's off-the-books partnerships, sat on one of the partnerships' boards. According to a complaint filed in Houston Federal Court on Apr. 8, investment bankers generated megaprofits from secretly investing in Enron's hidden partnerships. Meanwhile, many analysts continued recommending the stock to the bitter end: 11 out of 16 analysts who follow Enron had buys or strong buys less than a month before the company's bankruptcy filing.

Enron may be an extreme example. Still, in the past, tradition and ethics played a large role in keeping investment bankers loyal to their corporate clients. Indeed, Wall Street itself used to have much more of an interest in guarding its reputation. Says Jay Ritter, a finance professor at the University of Florida: "These days, bankers are far more focused on short-term profits than on their long-term reputations."

That's likely to get worse as investment banking business continues to dry up. The amount being raised in initial public offerings is way off its 2000 highs. Now there are far fewer mergers and follow-on offerings taking place. Because of this, it's unlikely that Wall Street, after all its hiring during the tech bubble, can sustain its profitability. Goldman Sachs estimates that five of the top investment banks on Wall Street will have to get by on \$2 billion less than the \$16 billion in net revenues they racked up in 1999. If investment banks roll back to 1999 staffing levels, Putnam Lovell Securities estimates that banks will have to shrink their payrolls by 5%--putting over 13,000 out of work.

But no matter how much Wall Street shrinks, its credibility must grow again. Firms have already taken some steps, such as eliminating direct reporting by analysts to investment bankers. But the Street and the SEC still must hammer out a solid, enforceable code of conduct. And if strong reforms in how analysts are compensated aren't pursued, focusing on increased disclosure will do little to end the abuses. Beyond that, regulators may need to go after the firms' top brass--the folks who set the procedural as well as ethical tone. And the Street should take great pains to monitor itself in an effort to restore investors' confidence. "If Wall Street knows what is good for it and what is good for this country, it will very definitely clean up its act," says Rohatyn. Adds George H. Boyd III, head of equities at New York's Weiss, Peck & Greer: "This is an industry of trust; it's one of its key assets. If [Wall Street] loses it, it is going to have to invest in getting [that trust] back and putting in the controls to rebuild it. Without that trust, there's nothing."

Merrill Lynch apparently knows this. At its annual shareholder meeting on Apr. 26, Chairman and CEO David H. Komansky took an unprecedented stand on the analyst debacle, saying: "We have failed to live up to the high standards that are our tradition, and I want to take this opportunity to publicly apologize to our clients, our shareholders, and our employees." Other apologies may follow, as firms desperately try to assuage potentially litigious investors and unyielding regulators. But for Wall Street, just saying sorry at this stage may prove to be too little, too late.

How Analysts' Pay Packets Got So Fat

By Mara Der Hovanesian, with Louis Lavelle and Tom Lowry in New York

It has been a frustrating 15 months for Daniel Peris, an analyst at Argus Research Corp. in New York. His efforts to cover AOL Time Warner Inc. ([AOL](#)) have hit one brick wall after another. Unlike analysts at big-name investment banks, Peris was one of the few bearish voices on the stock for much of last year. He has been yelled at by AOL's investor-relations reps for spouting off in the press, he has been granted scant contact with senior management, and his calls seeking basic information are returned by low-level employees--often weeks later. "I'm sitting here in obscurity," he says. His consolation: Clients who followed his advice did better than those who followed more bullish calls.

What sets Peris apart from peers is that he works for an independent research firm that doesn't trade or do investment banking. And that means he has also missed out on the big bucks raked in by most other high-tech analysts. While AOL admits it gives priority to bigger firms, the company says it returns all analysts' calls, regardless of banking ties. Since the mid-'90s, those ties earned many Wall Street analysts fat paychecks by helping investment bankers win lucrative business, such as underwriting or merger deals. "The analysts who brought in deals drove huge changes in research compensation," says Joan Zimmerman, partner at New York's Rhodes Associates, an executive search firm.

Salaries for Wall Street's researchers skyrocketed with the surging stock market. Fueled primarily by the tech and initial-public-offering boom, equity analysts' pay jumped fourfold in a decade--and with it, all pretense that research was being written to benefit the investor. Because analysts' pay is tied so closely to the banking business, the Chinese Walls intended to keep them apart crumbled. "Technology drove a higher percentage of investment banking revenues, and [pay packages] started going up at a much faster pace as well," says C. David Bushley, a financial-services consultant at Buck Consultants Inc.

Senior analysts had no trouble pulling in a million in 2000, the blowout year. Those with a decade of experience tripled that by contributing heavily to the deal flow. A few hotshots at each firm earned anywhere from \$12 million to \$24 million. Even neophytes easily earned six-figure paychecks.

So how exactly are Wall Street analysts compensated? Increasingly, by yearend bonuses. A fixed portion of income is related strictly to old-school research duties, but the more that analysts are in fee-generating businesses, the higher their take-home pay. "The sales part of analysts' jobs became huge," says compensation consultant Alan Johnson of Johnson Associates Inc.

Wall Street denies there's any direct link between pay and deals. "There isn't anything you can track in a statistical, quantifiable way," says Lehman Brothers Inc. ([LEH](#)) spokesman William Ahearn. Goldman, Sachs & Co. ([GS](#)) and Merrill Lynch & Co. ([MER](#)) also insist they have never paid analysts directly for generating investment banking business. "Their compensation is based on the overall profitability of the firm," says Merrill spokeswoman Susan McCabe. "They've never done a deal and gotten a check."

True, it's a bit more subtle than that. New York State Attorney General Eliot Spitzer found that in the fall of 2000, Merrill Lynch asked its analysts to tally up all the investment banking deals on which they had helped. In an Oct. 13 memo from Merrill's Equity Research Director Deepak Raj, the company was "once again surveying...contributions to investment banking during the year." Superstar Internet Analyst Henry Blodget replied, listing his team's involvement in generating about \$115 million in revenue from 52 deals, including an IPO pitch for Pets.com. Blodget's compensation jumped from \$3 million in 1999 to \$12 million in 2001. He resigned in December, citing a "lifestyle change."

Attorney Jacob J. Zamansky, who has already sued two investment banks on behalf of investors, says he has seen employment contracts for analysts that promised specific compensation related to the volume of investment banking deals they pulled in. Specifically, he says, he saw confidential contracts that promised a \$2 million bonus to analysts if they brought in \$30 million in banking fees, and others that promised 3% to 7% of investment banking revenue. Banks such as Credit Suisse First Boston, PaineWebber, before merging with UBS, and Donaldson, Lufkin & Jenrette have paid analysts up to 2% of the banking fees generated at the peak of the market. The idea was an incentive to produce sales and to lure talent from the competition.

The banks insist that analysts' pay is based on complex formulas. Part hinges on the accuracy of analysts' stock recommendations and earnings estimates, part depends on "votes" about their value from investors. Sometimes they'll earn a premium if the sector they cover is viewed as key to the firm, or if they cover the largest industries. Analysts are graded for how much access they have to top brass at companies, and for getting inside scoops.

It's very different from the old days when analysts' compensation was linked to the trading commissions their stock picks generated. That world changed for good when the fixed-commission system was swept away in 1975, forcing banks to find other ways of bankrolling expensive research staffs. Now, compensation experts are scratching their heads over how regulators could sever the ties between deals and analysts' pay. It's not as if the two sides of the bank would stop talking to each other, points out Michael I. Franzino, senior practice managing partner at headhunters Heidrick & Struggles: "Is the head of investment banking going to go over to equities research and say, 'We need a little help here'? Yes."

Franzino may be right. Research departments once generated enough money to pay for their own bonuses. They earned it from investors willing to pay for objective info. Now that the advice is "free," investors are getting exactly what they pay for.

Commentary: A Sorry Legacy the Street Can't Shake

The pattern: A disgrace, a crackdown, then little real change

By Gary Weiss

It made headlines around the country. The New York State Attorney General took action against an entrenched practice on Wall Street--illegal conduct involving the stocks of the leading companies of the day. Wall Street seethed with resentment at what appeared to be politically motivated grandstanding.

The above event was taken right from the headlines--of Jan. 5, 1978. The attorney general was Louis J. Lefkowitz, not Eliot Spitzer, and his target was the American Stock Exchange, not analysts.

It's scandal time on Wall Street. Again. If brokerage industry scandals seem to happen over and over again--the names of the players changed, but the playbook intact--there's a good reason. They do. And that's important to keep in mind as the daily headlines unfold over Wall Street's latest moral crisis. Recurrent scandals are a part of the fabric of the Street, a product of halfhearted regulation and deeply ingrained industry practices that often go unchecked for years.

Historians say a distinct pattern has evolved since the 1930s: scandal, usually a byproduct of a bull market, followed by a sometimes overzealous crackdown, followed by a return to business as usual under the eyes of lax regulators. "What you have here is an institutionalized structure feeding on itself--slippage between the rules as written and the rules in practice," says Dale A. Oesterle, a University of Colorado law professor and critic of Wall Street's regulatory structure. In this view, the securities industry's system of self-regulation feeds the scandal-crackdown cycle.

It's surely no secret that there are no new Wall Street scams--just dusted off old ones. That is evident by perusing Wall Street tell-all books that have long since turned yellow with age. One of them that could have been written yesterday--but was published in 1932--was *High and Low Financiers*, an exposé of "some notorious swindlers and their abuses of our modern stock-selling system." The book recounts one instance in which the long-defunct brokerage Hadley & Co. took a huge position in the shares of an aircraft company and then issued the 1929 version of a strong buy--with 1990s-style price targets. Alas, "the actual condition of the company while these glowing descriptions were being broadcast was rather sad," said the authors. Sound familiar?

In reaction to such abuses, lawmakers passed the Securities Act of 1933 and the Securities Exchange Act of 1934. The 1934 act, which created the self-regulation system in effect to this day, was a compromise between New Deal reformers and the Street. The newly created Securities & Exchange Commission was in overall charge, but most regulation and rulemaking was left in the hands of the exchanges.

The system has worked well--when the Street wants it to work well. But all too often, "abuses of our modern stock-selling system" go undetected and unpunished until it is too late. Critics say industry regulators are far too reactive and don't effectively prevent scandal. "The regulators have been slow to anger. They don't jump up and take action until there's a reason to notice," said John Herzog, a veteran Wall Street exec and chairman of New York's Museum of American Financial History.

Wall Streeters have a way of shrugging off the best their regulators have to offer. A good example can be found in the controversy that arose in the '90s concerning price-fixing on the Nasdaq Stock Market. After years of complaints that market-makers colluded to fix prices, the Justice Dept. brought suit. One result was a set of new order-handling rules designed to get customers fairer prices. But an SEC study in 2000 found what then-Chairman Arthur Levitt called an "alarming failure" to abide by those rules.

Other examples abound of Wall Street thumbing its nose at regulators. Penny stock scandals of the 1980s resulted in an uproar--and passage of sales practice rules governing shares trading at less than \$5. But the rules were evaded or ignored, and the microcap scandals of the 1990s were the result. In the end, federal prosecutors--not the regulators--proved the undoing of the microcap crooks.

Law enforcement also brought down the other scoundrels of the 1980s. The insider trading scandals, and the prosecution of Mike Milken, generated daily headlines and destroyed Drexel Burnham Lambert. But insider trading continues to dog the markets. Likewise, the Lefkowitz assault on Amex traders was quickly forgotten, and new scandals beset the Amex and NYSE in the late 1990s.

A cycle of scandals doesn't have to be a permanent feature of the Wall Street landscape. Not if the SEC more actively enforces securities laws and relies less on the self-regulatory organizations, often justly criticized as too sympathetic to the Street. And if the SEC won't step in--well, there's always the state regulators. Spitzer is following a tradition that may result in feelings of déjà vu--but that doesn't make it any less necessary.