ORAL TESTIMONY OF RONALD GLANTZ

Chairman Oxley, Chairman Baker, Ranking Members LaFalce and Kanjorski, and members of the committee, thank you for inviting me to testify on Wall Street's research practices.

My name is Ronald Glantz. I was in the investment business for 32 years before retiring last year. I began my career on Wall Street as an equity research analyst. Money managers polled by Institutional Investor Magazine selected me the top analyst in my field for seven consecutive years. I then became Director of Research, Chief Investment Officer, Director of Economics and Financial Markets, and a member of the Management Board of Paine Webber, one of the largest brokerage firms in the United States. I ended my career as a Managing Director of Tiger Management, one of the largest hedge funds in the world. This has given me a good perspective on how the role of analysts has changed over the last three decades.

When I began in the business, the top-rated equity research firm was named Laird. Within five years it failed. So did most of the other top-rated firms. What happened? When I began, the average commission was over 40 cents a share. A few years later, commissions paid by institutions such as banks, pension funds, and mutual funds became negotiated, almost immediately falling to less than 6 cents a share. The only way for research firms to survive was to merge with someone that could spread research costs over a larger base, usually brokerage firms whose main clients were individual investors. Retail commissions had remained fixed, and retail brokerage firms discovered that good research helped them gain retail clients and stock brokers. By the end of the 1970s, the largest number of top analysts were at Paine Webber, which had bought the top-rated research firm, and Merrill Lynch, which hired talent from failing research firms.

Companies pressure analysts to recommend their stock, since a higher price means:

- Fewer shares have to be issued when raising new funds or acquiring another company.
- They are less vulnerable to being taken over.
- Executives make more money when they cash in their options.
- Shareholders are pleased.

It is easy to reward favored analysts. They are given more access to management, “helped” in making earnings estimates, and invited to resorts for “briefings.” And, most important, their firm receives lucrative investment banking business.

Companies penalize analysts who aren’t sufficiently enthusiastic. Let me give you a personal example. When I was a brokerage firm analyst, I downgraded a stock. The company’s chief financial officer called my firm’s president to say that unless I recommended his stock, he would cease doing investment banking business with my firm and would order the bank which managed his company’s pension fund to stop doing business with my firm. I have seen top analysts removed from company mailing lists, their telephone calls left unreturned, and even physically barred from company presentations. Once I was doing a reference check on an analyst I was considering hiring. A CFO told me that the analyst was disliked so much that he was deliberately given misleading information.

In 1980, top analysts made just over $100,000 a year. Today, top analysts make up to $20 million a year. How is this possible, considering that institutional commissions have fallen even further and brokerage firms now discount retail commissions to avoid losing customers to such firms as Schwab and e-Trade?

What happened is that brokerage firms discovered that highly-rated research helped them gain investment banking clients. Soon the largest number of top analysts were at investment banking goliaths such as Morgan Stanley and Goldman Sachs. They could pay considerably more, because investment banking transactions were much more lucrative than trading stocks. The institutional commission on trading $300 million-worth of stock was only $300,000, of which less than $25,000 would go to the research department. This barely paid for printing and mailing research reports on that company. However, underwriting a similar dollar value of a new issue would bring in at least $10 million, and bankers thought nothing of giving a million dollar fee to the analyst responsible for the business. A merger or acquisition could bring in even more. Soon firms were including anticipated investment banking fees in the contracts they offered analysts. The huge fees earned by investment banking gives them the ability to influence and, in some cases, even control the equity research department. As we all know, whoever "pays the piper" names the tune.

Analysts used to view retail customers and investment managers as their clients. My first boss told me, "Widows and orphans depend upon you to give good advice." Now the job of analysts is to bring in investment banking clients, not provide good investment advice. This began in the mid-1980s. The prostitution of security analysts was completed during the high-tech mania of the last few years. For example, in 1997 a major investment banking firm offered to triple my pay. They had no interest in the quality of my recommendations. I was shown a list with 15 names and asked, "How quickly can you issue buy recommendations on these potential clients?"

Let me pause here to assure you – most analysts still want to give good advice. Not only is it the right thing to do, it helps their reputation, which brings in investment banking business. Nevertheless, the pressures are enormous.

When I was Director of Research, analyst compensation was based upon the performance of his or her recommendations, commissions generated, and ratings by institutional clients and the retail system. Today, name analysts are given guaranteed contracts, whether or not their recommendations are any good. Every year *The Wall Street Journal* lists the analysts who have provided the best investment advice. These analysts are rarely the best paid in their field. Why is that? Investment banking. It is an open secret that "strong buy" now means "buy," "buy" means "hold," "hold" means that the company isn't an investment banking client, and "sell" means that the company is no longer an investment banking client. Less than 1% of all recommendations are "sell." Some analysts call their best clients and tell them that their real opinion differs from their published opinion, even though this is illegal.

But what about the individual investor? No one told my 86-year-old widowed aunt that the Internet stocks she was buying in 1999 had no hope of ever earning any money, that the analyst recommending purchase was being paid by investment banking.

Investment banking now dominates equity research:

- Bankers often suggest and are usually asked to approve hiring analysts from other brokerage firms.
- Investment banking provides the bulk of proven analysts' pay package.
- Some analysts report directly to investment banking.
- Analysts routinely send reports to the companies and to bankers for comment before they are issued.

- Three years ago, Tiger was able to hire the top rated analyst in his field. He had consistently been negative on one company, a major source of investment banking fees because of its many acquisitions. Then his firm hired an investment banking team from another brokerage firm. As reported in *The Wall Street Journal*, the analyst was fired so that a "more compliant" analyst could be hired, one who would recommend potential investing banking clients. Disillusioned, the analyst moved over to money management, where the quality of recommendations was still more important than the quality of relationships with potential buyers of investment banking services.

To give one of many personal examples, four years ago, I came up with some extremely negative information on a company, including bribery, defective product, accounting irregularities, and serious pollution problems. I called the three most visible analysts recommending the stock, one of them the top-rated analyst in his field, and gave them my evidence. Everyone continued to recommend the stock. Why? This company was an investment banking client.

The genie has been let out of the bottle. As long as investment banking is the most profitable part of the firm, then investment bankers will find a way to pay analysts who bring in business. Money managers can hire their own analysts. But my elderly aunt will never know whether the advice she is receiving is unbiased or not. That's not only bad for the average investor, it undermines one of the primary reasons for having a stock market – the efficient allocation of investment dollars.

My proposals can only address part of the problem. At the least:

1. Brokerage firms should list in large type on the first page of all buy recommendations any investment banking business they have had with the company over the last three years and

any equity ownership by the analyst, members of his or her immediate family, or the firm.

2. No buy recommendation should be permitted if the analyst, members of his or her immediate family, or the brokerage firm purchased stock or options for their own account in the month preceding the report, nor should they be permitted to sell stock until three days after a sell recommendation is issued.

3. Any shares purchased of a new issue by the analyst, members of his or her immediate family, or a money management arm of a brokerage firm should be held for a minimum of one year.

Thank you.

Resume

Ronald A. Glantz

Born and raised in Baltimore, Maryland, Mr. Glantz graduated *cum laude* from Harvard in 1962 and received his M.A. from The Fletcher School in 1963. After serving as an economist on the staff of the Secretary of the Treasury, he received his M.B.A. from Harvard in 1966. Following two years as a consultant with Booz-Allen and Hamilton, Mr. Glantz joined Laird as chief economist and security analyst in 1968. He moved to Mitchell Hutchins in 1972, which merged with Paine Webber, where he was Director of Research, Chief Investment Officer, Director of Economics and Financial Markets, and on the Management Board. Mr. Glantz joined Montgomery Securities as a general partner in 1985 and moved to Dean Witter in 1990, where he was Director of West Coast Research. He was on *Institutional Investor's* All-American Research Team for 17 years, including seven as top automobile analyst. Mr. Glantz joined Tiger Management, one of the two largest hedge funds in the world, as a Managing Director in 1997 and retired in 2000.