



Crisis of Confidence on Wall Street

Brokerage Firm Abuses and the Worst Offenders

Presented by

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Martin D. Weiss, Ph.D., chairman of Weiss Ratings, Inc., is among the nation's leading advocates for investor safety, helping hundreds of thousands of investors objectively discriminate between safe and risky brokerage firms, insurance companies, banks, S&Ls, brokers, HMOs, stocks and mutual funds. Dr. Weiss holds a Doctorate from Columbia University and is the author of the national best-seller, *The Ultimate Safe Money Guide*.

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Executive Summary

A crisis of confidence is shaking Wall Street to its core as investors, already shell-shocked by deep market declines, realize that a series of deceptions by many institutions they trusted may have played a significant role in their losses.

A deeper understanding of the crisis can be achieved through an analysis of “buy,” “sell,” and “hold” ratings issued to companies that have gone bankrupt this year — a total of 50 investment banking and brokerage firms issuing ratings to 19 companies that filed for Chapter 11 in the first four months of 2002. Among these, the results show that:

1. Ratings publicly available from 94% of the 50 firms continued to indicate that investors should buy or hold shares in failing companies right up to the day these companies filed for bankruptcy.
2. Among the 19 bankrupt companies, 12 continued to receive strictly “buy” or “hold” ratings on the date of bankruptcy filing.
3. In response to these and related investor abuses, a rapid rise is expected in the number of investor legal actions against brokers. Even before the latest revelations, the number of arbitration filings surged by 24.4% from 2000 to 2001, and by 17% in the first three months of 2002, as compared to the equivalent period one year earlier. Several brokerage firms, targets of the most legal actions between 1997 and 2001, are likely to be among the targets of the most frequent future legal actions as well.
4. Among the 20 largest brokerage firms, 13 may become financially vulnerable if their conditions deteriorate further, while seven have the financial wherewithal to withstand a severely adverse business environment. It is possible that failures in the brokerage industry could emerge as an important future challenge for investors, legislators and regulators.

To address these issues, the power and will of government is limited. Instead, the best regulators and dispensers of financial justice are investors themselves. They cannot exercise this function, however, in the current environment of uneven disclosure, secrecy, and even duplicity.

In order to help investors make constructive, informed decisions in the selection of a broker and brokerage firm, brokers should disclose significant data on stock ratings, past legal actions, and the financial stability of each firm. The disclosure must be accompanied by more complete education on the risks associated with specific investments and with the failure of a broker-dealer. Disclosure questionnaires and procedures are offered to help investors protect themselves against future abuses.

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Introduction

A crisis of confidence is shaking Wall Street to its core. Investors have suffered losses of as much as \$5 trillion since 2000. Now, adding insult to injury, they are learning that a complex series of deceptions by many institutions they trusted — major corporations, accounting firms and investment bankers — may have played a significant role in their losses.

The bankruptcy of large, well-respected companies in 2002 are a case in point. In the first four months of 2002, 87 publicly traded companies filed for Chapter 11, wiping out what was once a total of \$185 billion in investor wealth at peak market prices.

What steps, if any, did Wall Street firms take to warn investors of these bankruptcies? How will these and similar bankruptcies impact the brokerage industry in the future? What steps can be taken to improve the industry's ability to warn of future troubles?

In this paper, each of these questions will be answered based on a broad analysis of the nation's brokerage and investment banking firms, encompassing their stock ratings, history of investor abuses and financial stability.

Part I delves into the published stock ratings on the failing firms in order to evaluate the industry's track record in warning investors of impending troubles;

Part II delves into legal actions taken by regulators and investors against the largest firms as an indication of which firms are most likely to be targets of future actions; and

Part III provides proposals for remedial steps to help avoid future difficulties, while better protecting individual investors.

Each section is designed to help investors defend themselves with practical, user-friendly information, while providing guidelines for regulators and legislators.

Part I. Wall Street Firms Fail to Warn of Failures in 2002

Typically, only the largest or most interesting companies catch the attention of Wall Street research analysts. So it is not surprising that only 19 of the 87 companies failing in 2002 received ratings.

It is also typical that a relatively large number of brokerage and investment banking firms take an interest in the same company, and, in this case, there were 50 firms issuing ratings on at least one of the 19 failed companies.

Thus, the scope of the analysis in Part I is restricted to the 19 failed companies and the 50 firms that covered them. It excludes companies that were not rated. It excludes brokerage firms that did not issue ratings on these failed companies. Plus, it excludes any ratings that were not available at four major public sources — Bloomberg, Yahoo.com, Zacks, and First Call. (A more detailed discussion of the definitions and scope of this study can be found in Appendix A.)

The analysis was undertaken from two perspectives, as follows:

- A. Ratings issued by 50 brokerage and investment banking firms. First, the analysis focused on the 50 firms issuing ratings on the failed companies, seeking to determine how many continued to overtly or tacitly recommend the shares of companies as they approached bankruptcy.
- B. Ratings issued on 19 failed companies. Second, the analysis focused on the 19 failed companies in order to determine how many of these companies still received “buy” and “hold” ratings even as they approached bankruptcy.

Perspective A. Track Record of the 50 Firms Issuing Ratings on Failing Companies

In reviewing the stock ratings available on major public sources, a careful analysis demonstrates that the brokerage firms displayed a consistent pattern of conscious neglect and even deliberate disdain for the individual investor, with few exceptions. It shows that:

1. Almost all firms continued to recommend failing companies until the very end. Among the 50 firms in this study, the ratings publicly available from 47, or 94%, of the firms continued to indicate that investors should buy or hold shares in failing companies right up to the day these companies filed for Chapter 11 bankruptcy.
2. Only 6% consistently warned of failure. Three firms, or 6%, avoided recommending bankrupt companies prior to their failure, while taking the initiative to warn investors about at least one of the impending bankruptcies.

3. Most ignored the obvious. Although the firms played an active role in recommending these companies, often with great fanfare and media attention, very few took the initiative to warn investors of the companies' impending demise even after it was blatantly obvious that bankruptcy was at hand. In some cases, the firms issued new reports reaffirming their recommendations for the shares, even as the companies' representatives were walking up the steps of the bankruptcy courts.

4. Firms failed to warn investors in several ways:
 - In some cases, the firms downgraded the companies from "buy" to "hold," "market perform," "neutral," or equivalent, apparently believing that these constituted adequate warning to investors. However, it is fair to assume that most of the investing public would not interpret such terms as warnings to avoid investing in the shares.

 - 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 same day that the companies filed for bankruptcy.

 - In other cases, the brokerage firms simply left their earlier positive ("buy" and "hold") ratings in the public domain, 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.

 - In still other situations, the firms "dropped coverage" on the failing companies, but apparently neglected to inform major public sources. Again, investors seeking an opinion would not have learned that the coverage was dropped. And even if they did, that alone would not have constituted a clear warning of impending troubles.

In *all* of the above situations, the firms either continued to recommend the failing companies, or they quietly walked away from their earlier recommendations, neglecting to inform the public that their opinion might have changed. 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.”¹

Many firms seek to shirk responsibility for this disparity of reporting by pointing fingers at the news media. However, in most cases, it appears that the firms are to blame. They often viewed their earlier “buy” ratings for failing companies as a source of embarrassment and a potential threat to their reputation. In addition, some may have feared that a public warning could hasten the demise of corporations to which they had loans outstanding. Therefore, although most made every effort to publicize the positive ratings, it appears they made little or no effort to publicize the withdrawals of those ratings or to notify major public sources.

In response to an inquiry about their policy for removing investment ratings, Bloomberg states:

“... We receive all analyst coverage directly from the analysts themselves and/or from the firm they represent ... As long as the analyst is actively covering a security and is still considered active at the firm they represent, we leave their coverage up on the system. Finally, we remove coverage from an analyst if they leave the firm they are representing or if they drop their coverage of the security.”²

However, by the date this analysis was completed, May 30, 2002, Bloomberg had not yet removed the ratings included in this analysis, implying that it had not received notification regarding a change in the employment status of the analysts or in the coverage status of the companies. Similarly, Yahoo.com continued to disseminate the ratings included in this study, with no indication of a change in their status.

Table 1 on the following page lists the 50 brokerage firms included in this analysis along with a breakdown of the ratings available from these firms through major public sources, at the date of failure and six months prior to failure.

On the date the companies filed for Chapter 11, there were six “buy” ratings from Lehman Brothers, as well as eight “hold” ratings from Salomon Smith Barney. There were also “buy” ratings from Bank of America Securities, Bear Stearns, CIBC World Markets, Dresdner Kleinwort Wasserstein, Goldman Sachs, Prudential Securities, and many other firms. Only the ratings from Credit Agricole Indosuez Cheuvreux, Edward Jones and HSBC Securities excluded any positive ratings on failing companies, while at the same time, including at least one “sell” rating at the time of failure.

¹ 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.

² Email communication from Bloomberg to Weiss.

1. Brokerage Firm Ratings on Companies Filing Bankruptcy in 2002

Brokerage Firm	Weiss Safety Rating	# of Companies Rated at Time of Bankruptcy Filing			# of Companies Rated 6 mos. before Bankruptcy Filing		
		Buy	Hold	Sell	Buy	Hold	Sell
A.G. Edwards Inc.	A-		1	2	1	1	1
ABN Amro Incorporated	C		1		1		
Bank of America Securities LLC	B-	1	2		2	1	
BB&T Capital Markets	U	1			1		
Bear Stearns & Co.	C	2	2		3	1	
BlueStone Capital Securities Inc.	C	1			1		
BMO Nesbitt Burns Corp.	B	1			1		
Buckingham Research	U	2	1		2	1	
CIBC World Markets Corp.	B+	1	3		2	2	
Credit Agricole Indosuez Cheuvreux	U			1			1
Credit Lyonnais Securities (USA) Inc.	A-		1	1	2		
Credit Suisse First Boston Corp.	C-		6		4	2	
Deutsche Bank Alex. Brown Inc.	B-		5		1	4	
Dresdner Kleinwort Wasserstein LLC	C+	1	1		1	1	
Edward D. Jones & Co. LP	B+			1		1	
Fahnestock & Co. Inc.	A-	1	1		1	1	
First Union Securities Inc.	C		2			2	
Friedman, Billings & Ramsey & Co.	A-		2		1	1	
Gerard Klauer Mattison & Co. Inc.	A-	1	2		1	2	
Goldman Sachs & Co.	C	1	2		1	2	
Granite Financial	U	1			1		
HD Brous & Co. Inc.	B-	1			1		
Hibernia Southcoast Capital	U	1			1		
HSBC Securities (USA) Inc.	C+			1			1
ING Barings LLC	B-	1			1		
JP Morgan Chase & Co.	C-		3		1	2	
Janney Montgomery Scott LLC	A-	2	1		2	1	
Kaufman Brothers	U	2			2		
Ladenburg Thalmann & Co. Inc.	B+	1			1		
Legg Mason Wood Walker Inc.	B+		1			1	
Lehman Brothers Inc.	C-	6	2		6	2	
McDonald Investments Inc.	B+		2		1	1	
Merrill Lynch Pierce Fenner & Smith	C-		5	2	2	5	
Midwest Research	U		1			1	
Morgan Keegan & Company Inc.	B+		1			1	
Morgan Stanley Dean Witter & Co.	B-		3		1	2	
Pacific Growth Equities	U	1			1		
Prudential Securities Inc.	B	1	1	2	3		1
RBC Capital Markets (Canada)	U		2			2	
RBC Dain Rauscher Inc.	B+		2			2	
Robert W. Baird & Co. Inc.	B+		2		1	1	
Robertson Stephens Inc.	B		1		1		
Roth Capital Partners LLC	B	1			1		
Salomon Smith Barney Inc.	C		8		5	3	
Sanford C. Bernstein	U		1			1	
Thomas Weisel	U	2			2		
U.S. Bancorp Piper Jaffray	B	2	1	1	3	1	
UBS Warburg LLC	C-		3		1	1	1
William Blair & Co. LLC	B+	2			2		
Wit Soundview Corporation	A	1			1		

Weiss Safety Rating A=Excellent, B=Good, C=Fair, D=Weak, E=Very Weak, F=Failed, U=Unrated. "Buy" = "strong buy," "buy," "recommended list," "accumulate," and "attractive." "Hold" = "hold," "hold/neutral" and "market perform." "Sell" = "reduce" and "sell."

Ratings disseminated by major public sources from another five firms — A. G. Edwards, Credit Lyonnais, Merrill Lynch, Prudential Securities, and U.S. Bancorp Piper Jaffray — included “sell” ratings by the date of the bankruptcy filing but also included at least one positive rating on other bankrupt companies.

Table 2 below summarizes the data listed in Table 1.

2. Ratings Issued by the Brokerage Firms on Companies Filing for Bankruptcy

Ratings Issued	<u>On Date of Bankruptcy Filing</u>		<u>6 Months Before Bankruptcy Filing</u>	
	# of Ratings	%	# of Ratings	%
“Buy” or equivalent	38	31.4%	67	55.4%
“Hold” or equivalent	72	59.5%	49	40.5%
“Sell” or equivalent	<u>11</u>	<u>9.1%</u>	<u>5</u>	<u>4.1%</u>
Total	121	100.0%	121	100.0%

Of the 121 ratings available from major public sources six months prior to failure, 95.9% were “buy,” “hold” or equivalent, while only 4.1% were “sell” or equivalent. By the date of failure, the percentage of “buy” and “hold” ratings available from major public sources had declined to 90.9%, while the percentage of “sell” ratings had risen to 9.1%. However, given the many warning signs and news announcements that foretold of impending bankruptcy, the change in the ratings distribution over the six-month period is surprisingly small.

Perspective B. The 19 failing companies and the ratings they received

At the time of their failure, hundreds of thousands of individual investors owned shares in the 19 failing companies covered by the brokerage and investment banking firms, either directly or through mutual funds and other institutions. Many of these investors used major public sources to locate research and recommendations available on the companies. Moreover, when using these sources, it is fair to assume that they typically vest a high level of trust in the firms that produce the research, especially those with well-respected names and reputations. This confidence is further reinforced when more than one analyst or firm provides positive recommendations. Like a patient consulting various doctors and specialists, investors’ confidence tends to be higher when second and third opinions are mutually supportive and even higher when they can find few or no dissenting opinions.

Indeed, an analysis of the investment ratings available through major public sources and issued to the 19 bankrupt companies reveals that unanimity and mutually reinforcing opinions were the most common situation: among the 19 failing companies for which ratings were available, 12 continued to receive strictly positive ratings on the date of bankruptcy filing. Thus, even diligent investors who sought out possible dissenting opinions on their shares would have run into a virtual stone wall of unanimous, “don’t-sell” advice from the firms.

For example, on the day the company filed for Chapter 11, Global Crossing still boasted five “buy” ratings, nine “holds” and no “sells” at major public sources. Adelphia Business Solutions still received two “buys,” three “holds” and no “sells.” In addition, 10 other failing companies received exclusively positive ratings. In contrast, only one company received exclusively a negative (“sell”) rating. The balance, six companies, received a mix of positive and negative ratings.

Table 3 lists the 19 failing companies for which ratings were available through major public sources at the date of bankruptcy and six months prior. Table 4 summarizes the data from Table 3.

4. Ratings Received by 19 Companies Prior to Bankruptcy

Companies Receiving:	On Date of Bankruptcy Filing		6 Months Before Bankruptcy Filing	
	# of Cos	%	# of Cos	%
“Buys” and “Holds” only	12	63.1%	15	78.9%
“Buys,” or “Holds” and “Sells”	6	31.6%	3	15.8%
“Sells” only	<u>1</u>	<u>5.3%</u>	<u>1</u>	<u>5.3%</u>
Total	19	100.0%	19	100.0%

Six months prior to bankruptcy, 78.9% of the companies received exclusively positive ratings, while 21.1% received at least one negative rating. On the date of failure, the percentage of companies receiving exclusively positive ratings declined to 63.1%, while those receiving at least one negative rating rose to 36.9%.

As stated earlier, however, given the many warning signs and news announcements that foretold of impending troubles, the weakening of Wall Street’s unanimously positive support for the companies is surprisingly modest. Moreover, even when companies received a mix of positive and negative ratings, typically the positive ratings represented the overwhelming majority. Thus, the portrait painted for investors continued to encourage a high, but false, sense of confidence. This was in stark contrast to the dire realities that the failing companies were facing, as illustrated by the case studies that follow.

The Case of Kmart

Kmart filed for Chapter 11 on January 22, 2002. On the very same day, three of the firms included in this analysis issued new ratings reaffirming their existing “hold” recommendations on the stock, thereby continuing to discourage investors from selling their shares. Plus, nine “hold” ratings issued earlier were still available on major public sources. It is not known what specifically motivated each firm to actively or passively maintain its “hold” ratings on Kmart. However, the chronology of events leading up to

3. Companies That Filed Chapter 11 in 2002 with Their Ratings from Major Brokerage Firms

Company	Bankruptcy Filing Date	Brokerage Firm Ratings at Time of Filing			Brokerage Firm Ratings 6 mo. before Filing		
		Buy	Hold	Sell	Buy	Hold	Sell
Adelphia Business Solutions (NDQ:ABIZ)	3/27/02	2	3		2	3	
AppliedTheory Corp. (OTC:ATHYQ)	4/18/02	1	1		1	1	
Aremissoft Corp. (OTC:AREME)	3/15/02	1	1		1	1	
Covanta Energy Corp. (NYSE:CVGQE)	4/02/02	1	1		1	1	
Exide Technologies (OTC:EXDTQ)	4/15/02		3			3	
Global Crossing Ltd. (OTC:GX)	1/28/02	5	9		13	1	
Globix Corp. (OTC:GBIXQ)	3/01/02	5	2		5	2	
IT Group, Inc. (OTC:ITX)	1/16/02	1	1		2		
Kaiser Aluminum Corp. (OTC:KLUCQ)	2/12/02	2	2	2	2	3	1
Kmart Corp. (NYSE:KM)	1/22/02	3	9	3	6	7	2
McLeodUSA, Inc. (OTC: MCLD)	1/30/02	4	16	2	14	8	
MedicaLogic/Medscape Inc. (OTC:MDLI)	1/24/02	1		1	2		
Motient Corporation (OTC:MTNTQ)	1/10/02	2	1		2	1	
National Steel Corp. (OTC:NSTLB)	3/06/02		2		1	1	
Simon Trnspt Services Inc. (OTC:SIMNQ)	2/25/02		1			1	
Steakhouse Partners (OTC:SIZLQ)	2/15/02			1			1
Suprema Specialties Inc. (OTC:CHEZQ)	2/24/02	3			3		
USinternetworking Inc. (OTC:USIGE)	1/07/02	2	9	1	3	8	1
Williams Communications (NYSE:WCGRQ)	4/22/02	5	11	1	9	8	

“Buy” = “strong buy,” “buy,” “recommended list,” “accumulate,” and “attractive.”

“Hold” = “hold,” “hold/neutral,” and “market perform.”

“Sell” = “reduce” and “sell.”

the company's failure sheds light on the complex relationships among the firms, the companies and others in the industry:

- July 22, 2001** Six months prior to failure, "hold" ratings are disseminated through major public sources from seven firms, while "buy" ratings exist from six firms. Only two firms, A. G. Edwards and UBS Warburg, are shown to have "sell" ratings on the stock.
- Aug. 23** Kmart announces a net loss of \$95 million for the quarter ended 7/31/01. Prudential Securities issues a downgrade from "buy" to "hold." Bank of America reaffirms its "market performer" rating, while Merrill Lynch reaffirms its "intermediate-term accumulate."
- Sept. 6** The company announces it is restructuring certain aspects of its operations. Major public sources report no changes in the company's stock ratings.
- Nov. 6** Moody's places the company's credit rating on watch for a possible downgrade. Major public sources report no change in the stock ratings.
- Nov. 27** The company announces a net loss of \$224 million for the quarter ended 10/31/01. Standard & Poor's (S&P) lowers its bond rating from BB+ (already a junk bond) to B (a lower-quality junk bond).
- Nov. 28** Lehman Brothers reaffirms its earlier "buy" rating on the stock. Merrill Lynch issues a downgrade from "intermediate-term accumulate" to "intermediate-term neutral."
- Dec. 6** Morgan Stanley Dean Witter reaffirms its "hold" rating for the company.
- Dec. 14** Moody's downgrades its credit rating on the company from Baa3 to Ba2, representing a downgrade from investment grade to junk.
- Jan. 2, 2002** Prudential Securities downgrades the stock from "hold" to "sell." Investors who bought the stock when Prudential first issued its "hold" recommendation and sell it on this date, incur a loss of 53.7%, but they are spared a total loss.
- Jan. 11** UBS Warburg reaffirms its "hold" rating for the company, Merrill Lynch reaffirms its "intermediate-term neutral" rating, and Ladenburg Thalmann reaffirms its "buy" rating. Moody's downgrades its credit rating on the company by three notches from Ba2 to B2.
- Jan. 14** S&P lowers its bond rating from BB to B-. Major public sources report no change in the company's stock ratings.

- Jan. 16** Moody's downgrades the issuer rating two notches from B2 to Caa1. S&P lowers its bond rating from B- to CCC-, implying a high probability of failure. Major public sources report no change in stock ratings.
- Jan. 21** Moody's downgrades the issuer rating two more notches from Caa1 to Caa3, implying imminent failure. Major public sources report no change in stock ratings.
- Jan. 22** Kmart files for Chapter 11. S&P lowers its bond rating from CCC- to D, its lowest rating grade. Bank of America, Bear Stearns and Salomon reaffirm their "hold" ratings on the stock. In addition, "hold" ratings are still disseminated by major public sources from:
- Credit Suisse First Boston
 - Merrill Lynch
 - Midwest Research
 - Morgan Stanley Dean Witter
 - Sanford C. Bernstein
 - UBS Warburg

Also outstanding are "buy" ratings from:

- Buckingham Research
- Ladenburg Thalmann
- Lehman Brothers

The Case of Global Crossing

Global Crossing filed for Chapter 11 just six days after Kmart, on January 28, 2002. Unlike the situation with Kmart, no new stock ratings were issued. However, five "buy" ratings and nine "hold" ratings continued to be displayed at major public sources. Most surprisingly, none of the ratings posted were "sell" or equivalent, leaving the clear impression that Global Crossing was still enthusiastically and unanimously recommended by Wall Street.

Nevertheless, the firms had abundant advance warning of troubles from numerous reputable sources, and ample opportunity to notify major public sources of a rating change, as illustrated by this sequence of events:

Nov. 23, 1998 S&P gives the company a BB- long-term debt rating, three notches below investment grade.

Nov. 12, 1999 Moody's gives the company's preferred stock a rating of B1, four notches below investment grade.

June 18, 2001 First Union downgrades the common shares from "buy" to "market perform."

- July 28** Six months before failure, the latest stock ratings available through major public sources include 13 “buys” and one “hold.”
- Aug. 1** The company announces a net loss of \$630 million for the second quarter of 2001, as compared to a loss of \$365 million in the year-earlier quarter. The company also reduces its forecast for revenues for the year.
- Aug. 2** Despite the widening losses, US Bancorp Piper Jaffray issues a “buy” rating on the company.
- Aug. 3** Credit Lyonnais downgrades the company from “buy” to “hold/neutral.” At the same time, Moody’s reaffirms its credit rating for the preferred stock at B1.
- Aug. 29** The company releases a statement contending that its cash position is solid, adding that its stock is trading based on “highly inaccurate rumors” and “groundless speculation.”
- Aug. 30** Some analysts apparently believe the company. Thomas Weisel, for example, reaffirms its “buy” rating for the stock.
- Oct. 4** Three firms downgrade the company from “buy” or equivalent to “hold” or equivalent: Friedman Billings Ramsey, Deutsche Bank and Prudential Securities.
- Oct. 5** S&P lowers the company’s long-term debt rating from BB+ to BB. Salmon Smith Barney and JP Morgan downgrade the stock from “buy” to “hold” or equivalent. However, Gerard Klauer rates the company as “outperform.”
- Oct. 9** The company announces a management shake-up.
- Oct. 11** Moody’s cuts its rating on the preferred stock by three notches from B1 to Caa1, implying a high probability of missed dividend payments.
- Oct. 23** Lehman Brothers downgrades the stock from “buy” to “hold.” However, this downgrade is not reported by major public sources.
- Nov. 5** The company announces the cancellation of a plan to merge with Asia Global Crossing, reportedly due to market conditions.
- Nov. 6** S&P lowers the company’s long-term debt rating from BB to B+. Merrill Lynch downgrades the stock from “buy” to “neutral.” However, this downgrade is also not reported by major public sources.
- Nov. 14** Kaufman Brothers reaffirms its “buy” rating on the company.

- Nov. 15** S&P again lowers the company's long-term debt rating, from B+ to B-.
- Nov. 16** S&P follows up with a similar downgrade for the company's bond rating, lowering it to B- as well.
- Nov. 19** Merrill Lynch, which has the stock pegged as "intermediate buy," drops coverage. One major public source picks up the information and reports the Merrill position on the stock as "no rating." Moody's downgrades its rating on the preferred stock by four notches from Caa1 to C.
- Dec. 21** The company suspends its dividend on preferred shares.
- Jan. 12, 2002** S&P lowers its long-term debt rating by three notches from B- to CCC-.
- Jan. 28** The company files for Chapter 11. On the date of failure, the major public sources continue to display "buys" from five firms, as follows:
- Gerard Klauer
 - Kaufman Brothers
 - Lehman Brothers
 - Thomas Weisel
 - US Bancorp Piper Jaffray
- The major public sources also display "holds" from nine firms, as follows:
- Credit Lyonnais
 - Credit Suisse First Boston
 - Deutsche Bank
 - First Union
 - Friedman, Billings & Ramsay
 - J.P. Morgan
 - Merrill Lynch
 - Prudential Securities
 - Salomon Smith Barney

The Case of McLeodUSA

McLeodUSA followed Global Crossing into bankruptcy court 48 hours later, with an even larger number of positive ratings than Global Crossing's: four "buys" and 16 "holds." Unlike the situation for Global Crossing, major public sources also displayed two "sell" ratings on the company, indicating at least some dissenting opinion in the public domain. As with the chronology leading to Global Crossing's demise, however, analysts would be hard pressed to defend any assertion that they were caught by surprise:

- Jan. 31, 2001** Morgan Stanley Dean Witter rates the stock “outperform.”
- Apr. 10** William Blair rates the stock a “buy.”
- May 7** Buckingham Research downgrades the stock from “strong buy” to “neutral.”
- June 28** Dain Rauscher Wessels downgrades the stock from “buy” to “neutral.”
- June 29** Friedman Billings rates the stock “market perform.”
- July 3** Moody’s downgrades the company’s issuer rating two notches from B1 to B3.
- July 27** S&P lowers the issuer rating from B+ to B.
- Aug. 1** It is six months before the date of failure. The company announces management reorganization and Board of Director changes. The stock has 14 “buy” ratings and eight “hold” ratings at major public sources.
- Aug. 2** A.G. Edwards downgrades the stock from “buy” to “sell.”
- Aug. 3** UBS Warburg downgrades the stock from “buy” to “hold.”
- Aug. 10** ABN Amro downgrades the stock from “accumulate” to “hold.”
- Sept. 4** Deutsche Bank rates the stock “market perform.”
- Sept. 15** McDonald Investments downgrades the stock from “buy” to “hold.”
- Sept. 27** The company states that its stock has been trading irrationally based on groundless rumors, and that it has no intention of filing for Chapter 11.
- Oct. 3** The company’s Board of Directors approves a new corporate strategy that calls for the sale of assets, reduction of the workforce by 15%, and cuts in capital expenditures. Merrill Lynch downgrades the stock from “neutral” to “sell.” Investors who have followed Merrill’s advice until this date incur as much as a 98% loss.
- Oct. 9** Hibernia Southcoast Capital rates the stock a “buy.”
- Oct. 19** The company suspends its dividend on its preferred stock.
- Nov. 2** Salomon Smith Barney downgrades the stock from “buy” to “neutral.”

- Nov. 15** In a surprise move, Lehman Brothers reasserts its “strong buy” rating for the stock.
- Nov. 16** Thomas Weisel reaffirms its “buy” rating as well.
- Nov. 19** Credit Suisse First Boston downgrades the stock from “strong buy” to “hold.”
- Nov. 30** Robertson Stephens reaffirms its “market performer” rating for the stock.
- Dec. 3** The company announces that it has restructured its financing with Forstmann Little, a creditor.
- Dec. 4** Moody’s downgrades the issuer rating from B3 to Ca. CIBC World Markets reaffirms its “hold” rating for the stock.
- Dec. 5** S&P lowers the company’s issuer rating from B to CC. Robert W. Baird reaffirms its “market perform” rating for the stock.
- Jan. 2, 2002** The company announces that it will not make January interest payments on senior notes and is holding discussions with its bondholders.
- Jan. 30** The company files for Chapter 11. On the date of bankruptcy, major public sources continue to show “buy” or equivalent ratings from four firms:
- Hibernia Southcoast Capital
 - Lehman Brothers
 - Thomas Weisel
 - William Blair
- Plus, major public sources display “hold” or equivalent ratings from 16 firms, as follows:
- ABN Amro
 - Buckingham Research
 - CIBC World Markets
 - Credit Suisse First Boston
 - Deutsche Bank Alex. Brown
 - Friedman, Billings & Ramsey
 - Gerard Klauer Mattison
 - Goldman Sachs
 - McDonald Investments
 - Morgan Stanley Dean Witter
 - RBC Capital Markets
 - RBC Dain Rauscher
 - Robert W. Baird

- Robertson Stephens
- Salomon Smith Barney
- UBS Warburg

Findings From Case Studies

From these and other case studies, the following patterns are evident:

First, despite abundantly available and strikingly clear information that the company was sinking into bankruptcy, the firms rarely warned investors. The data show that the analysts could not have been ignorant of the fact that they were leading thousands of investors directly into severe losses.

Second, while credit rating agencies periodically lowered their letter grade ratings on the company and its bonds, research analysts failed to lower their “buy” and/or “hold” ratings on the same company’s stocks. The rating assigned by the credit agencies represented warnings of an increasing probability that the company would fail. Inasmuch as common shareholders are last in line for the available funds and have much more to lose from such failures than bondholders, one would expect the research analysts to be *more* pro-active in announcing downgrades than their counterparts at the credit rating agencies. However, the chronologies show the opposite to be the case. While the credit agencies were pro-active, the research analysts often took no steps, even *retroactively*, to correct past errors of judgment.

Third, the business and financial ties between the firms and the failing companies may have played a significant role in influencing the stock ratings. Some examples follow:

- Morgan Stanley, Merrill Lynch, and Salomon Smith Barney had millions outstanding in loans to Kmart. All three continued to maintain Kmart’s “buy” or “hold” ratings until the date of bankruptcy, based on the ratings available at major public sources.
- Lehman Brothers was the joint lead manager with JP Morgan in a syndicated loan to Kmart, with Lehman’s share at \$160 million. Lehman continued to issue new positive ratings on Kmart until November 2001, three months prior to bankruptcy, and that rating remained in circulation until the date of failure.
- Credit Suisse First Boston acted as the lead manager, contributing \$215 million out of a total of \$430 million loan to Kmart maturing in 2008. Notably, Credit Suisse First Boston’s positive ratings on Kmart remained on major public sources until the date of bankruptcy.
- Salomon Smith Barney led or participated in three syndicated loan offerings, securing \$616 million in loans for Global Crossing between 1990 and 2001.

During that period, the firm's telecom analyst, Jack Grubman, issued 13 "buy" ratings to Global Crossing before finally dropping to a "hold/neutral" rating three months before the company declared bankruptcy.

- Merrill Lynch helped Global Crossing raise \$459 million in loans between 1990 and 2001. The firm continued to issue positive ratings to Global Crossing until two months before the company's failure, when Merrill dropped coverage.
- Lehman Brothers participated in a syndicated loan to Global Crossing, with Lehman's share at \$107 million. Lehman continued to maintain its positive ratings on Global Crossing until the date of failure.

Fourth, there was no special operational difficulty preventing the firms from issuing a warning to investors or preventing them from reporting the warning to major public sources. This is evidenced by the fact that at least some firms did downgrade the stocks to "sell" or equivalent, and those few "sell" ratings were clearly displayed by major public sources.

Business as Usual

In its settlement with New York State's attorney general, Merrill Lynch has promised to make significant changes in its ratings business. Other firms are under increasing pressure from the states and the Securities and Exchange Commission (SEC) to follow suit. Private investor lawsuits are also adding to the momentum. However, for individual investors seeking objective opinions on their shares in failing companies, very little has changed so far. For example,

- **Adelphia Communications** has recently been delisted by the Nasdaq and is widely reported to be on the verge of bankruptcy. Its bonds are trading at 37% of par value. Its shares are down from a high of \$86.59 to a meager 70 cents. Nevertheless, the company continues to boast a "strong buy" rating from CIBC World Markets (just issued on March 28), plus "buy" recommendations from both Bank of America (5/28/02) and Deutsche Bank Securities (4/1/02).
- **Sprint PCS** has \$18 billion in debt, over \$8 billion more than Sprint's market capitalization, implying \$22 per dollar of stockholders' equity, or 20 times more than the average for the stocks in the S&P 500 Index. Nevertheless, as of May 29, 2002, Sprint boasts 35 "buys," four "holds," and no "sell" recommendations.
- **JDS Uniphase** has had five consecutive quarters of declining sales, reducing revenues by nearly three-fourths. Net income is in the red for 12 straight quarters, prompting the recent announcement of 2,000 job cuts. The company's market value has been reduced from a peak of \$127 billion in 2000 to a mere \$4.3 billion today. However, the company continues to receive seven "buys," 24 "holds" and only one "sell."

Although these companies may recover, it is clear that the opinions from major firms are still overwhelmingly weighted to the positive side, despite growing signs of financial difficulties, much as was the case for the companies that have already filed for Chapter 11 in 2002.

Part II. Investor Reaction and the Impact on the Brokerage Industry

The aggregate market value of all the companies listed on the Nasdaq fell from \$7.6 trillion on March 10, 2000, to \$2.4 trillion on April 6, 2001, a decline of \$5.2 trillion. This was the equivalent of almost half the nation's gross domestic product and the largest percentage decline of any major market index since the bear market of 1929-32, all in just 13 months. Today, there has been no recovery and the Nasdaq continues to trade at *less than one third* of its peak value, leaving millions of investors with sweeping losses.

Initially, most investors blamed themselves for their misfortune. More recently, however, in the wake of widely publicized revelations about accounting manipulations and broker conflicts of interest, investors are increasingly turning their ire against the companies, their accountants and their investment bankers on Wall Street. This raises three urgent questions for the industry, regulators, and investors:

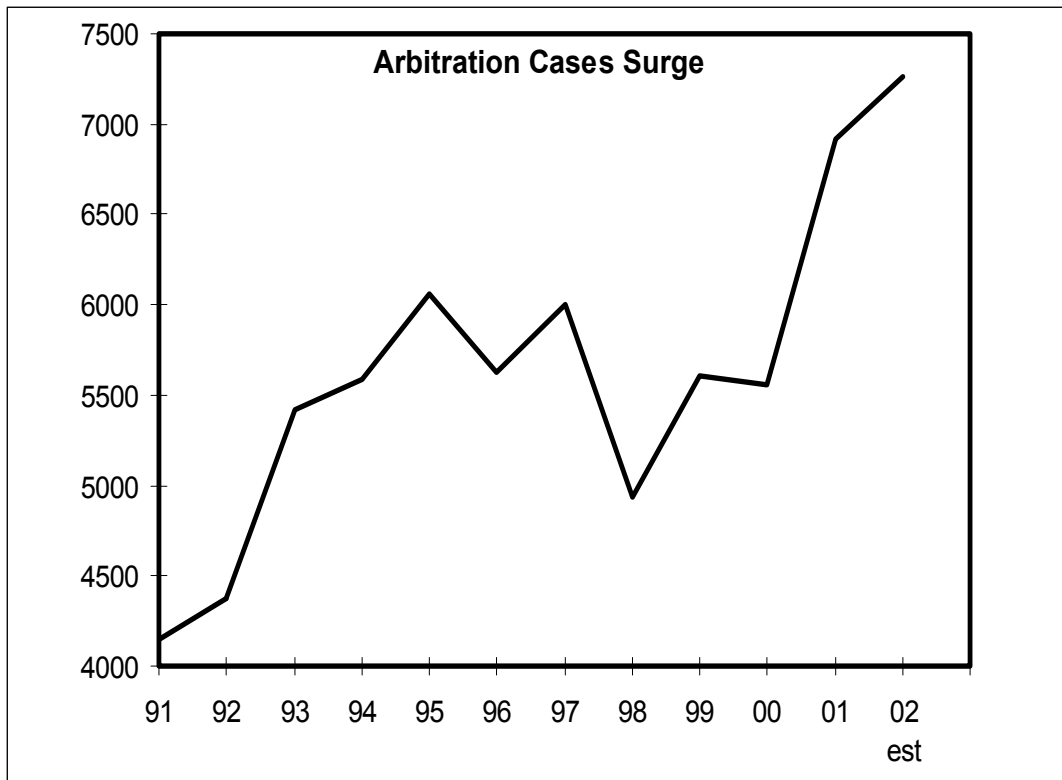
1. Will the recent revelations stir greater investor backlash against the brokerage industry, prompting a sharp rise in the number of arbitrations and other legal actions against the firms?
2. Which firms are likely to be the primary targets of such actions?
3. Which firms are best prepared to finance a vigorous legal defense as well as pay for any awards or fines against them? Which are the least prepared?

1. The Rising Tide of Arbitration Claims Filed against Brokers

Long before the most recent revelations about conflicts of interest on Wall Street by the attorney general of New York and others, the number of arbitration claims filed against brokers and their firms was increasing rapidly, as shown in Table 5 and the chart on the following page, based on National Association of Securities Dealers (NASD) data.

Table 5. Arbitration Filings

<u>Year</u>	<u># of Arbitration Filings</u>
1990	3619
1991	4150
1992	4379
1993	5421
1994	5586
1995	6058
1996	5631
1997	5997
1998	4938
1999	5608
2000	5558
2001	6915
2002 est	7268



Claims surged by 24.4% from 2000 to 2001. In the first three months of 2002, they have again risen by 17%, compared to the equivalent period one year ago. The rise appears to be due to a combination of factors:

- The rapid growth in individual participation in the stock market throughout the past decade, culminating in early 2000.
- A regulatory environment that failed to discourage illegal or unethical broker behavior to the degree that it had in previous cycles.
- A visibly larger role played by Wall Street firms in promoting the purchase of stocks during the 1990s boom.
- The sheer magnitude of the investor losses during the bust, generating a higher-than-average level of investor dissatisfaction.

All of these seem to have played a role in the rising tide of arbitration claims against brokers. However, even the most recent surge recorded for 2002 does not yet reflect the revelations regarding the conflicts of interest among research analysts. These are likely to accelerate the pace of arbitration claims and other legal actions, emerging as a potentially significant threat to the financial stability of many firms.

2. Which firms are subject to the most legal actions?

It is difficult to predict which firms are going to suffer the brunt of the legal actions. However, it is fair to assume that those firms with the worst past record of investor abuses are likely to continue to be among the most frequent targets of future actions.

In order to evaluate the past history of the firms, Weiss Ratings has analyzed 13,232 arbitration cases and regulatory or legal actions recorded by the NASD against 612 brokerage firms.

For the purposes of this paper, the analysis was further narrowed to the 18 most prominent retail-oriented brokerage firms in the United States during the five-year period from 1997 to 2001. Larger firms devoted primarily to institutional clients were excluded. Also excluded were smaller firms with total assets of less than \$5 million and less than 700,000 customer accounts.

Further, to arrive at a relative measure, the number of legal actions against each firm was compared to the number of customer accounts reported in the Securities Industry Association Yearbook 2001- 2002.

Findings

1. Of the actions against firms, 98% arise from arbitration cases and regulatory violations, while the remaining 2% percent are composed of criminal actions, civil judicial actions, and other judgments or liens. Among the 18 largest retail firms, 99.6% of the actions from 1997 to 2001 arose from arbitration cases and regulatory violations.
2. Prudential Securities, Inc., Ameritrade, and U.S. Bancorp Piper Jaffray had the worst record among the 18 most prominent retail brokerage firms of investor abuses from 1997 to 2001.
3. Fidelity Brokerage Services, Credit Suisse First Boston, and Edward D. Jones had the best record among the largest firms.

Table 6 summarizes the results of the study for the 18 largest retail brokerage firms. The data represent only those actions reported on the firm's public record, excluding the many investor complaints that are settled before they are judged. The NASD may expunge from a broker's record court-ordered arbitration settlements, court decisions and other complaints against brokers from its public disclosure database if agreed to in a settlement with a customer. Nevertheless, with most firms registering scores or even hundreds of actions over the five-year period under study, it is reasonable to assume that the NASD database provides a more-than-adequate representative sampling for analysis.

6. Record of Abuses by Top Retail Brokerage Firms 1997-2001

Brokerage Firm	Total Arbitration Cases, Regulatory & Legal Actions	# Per Million Accounts
1. Prudential Securities, Inc.	152	69.50
2. Ameritrade, Inc.	91	67.11
3. U.S. Bancorp Piper Jaffray, Inc.	47	64.46
4. E*Trade Securities, Inc.	118	36.92
5. Raymond James & Associates, Inc.	36	36.07
6. First Union Securities, Inc.	88	35.20
7. UBS Painewebber Incorporated	87	34.80
8. A G Edwards, Inc.	103	31.21
9. Salomon Smith Barney, Inc.	204	30.71
10. Morgan Stanley Dean Witter & Co.	151	27.96
11. Quick & Reilly, Inc.	34	18.89
12. Charles Schwab & Co., Inc.	124	16.53
13. Merrill Lynch Pierce Fenner & Smith	168	16.09
14. TD Waterhouse Investor Services, Inc.	68	15.25
15. American Express Financial Advisors	19	9.50
16. Edward D. Jones & Co. LP	38	8.09
17. Credit Suisse First Boston Corp.	20	4.96
18. Fidelity Brokerage Services LLC	43	3.74

Two brokerage firms have responded with commentary, as follows:

- Prudential Securities** has reportedly stated to press sources that the high number of actions against the firm are a result of problems stemming from its limited partnerships promoted heavily in the early 1990s and that these are now a thing of the past. However, our analysis of cases indicates that the majority of the cases related to limited partnerships were completed by the mid-1990s, and that the high level of cases since 1997 reflects the normal course of business at the firm. Indeed, with rare exceptions, the cases during the five-year period of this study were not related to limited partnerships, but involved instead a litany of other complaints related to stocks, bonds, commodities, options and other investment types.

Prudential also states that the number of actions is declining significantly. On the surface, the data shown in Table 7 below seem to support this premise. However, the data for 2000 and 2001 are not complete in that they do not yet reflect cases that were filed in those years but have not yet been completed. These may not appear in the NASD database until as much as one to two years following the close of business of each calendar year. Taking these into consideration, there has

been no significant decline in the number of legal actions against Prudential in the 1997-2001 period.

7. Prudential Securities: Arbitration Cases, Regulatory and Legal Actions By Year

<u>Year</u>	<u>Number of Actions</u>
2001	18
2000	34
1999	36
1998	23
1997	41
1996	55
1995	101
1994	79

- **Ameritrade** has stated that it has a policy of defending arbitration claims more vigorously rather than simply settling the cases in mediation, and, consequently, their number of decided arbitration cases on record is higher relative to other firms. Further, it states that it wins about 60% of the arbitration cases it pursues, thus validating its decisions to contest them. However, it is certain that other firms could make similar claims about their propensity to litigate. Furthermore, an analysis of the results of the Ameritrade arbitrations indicates that it is *not* the prevailing party in more than half of the arbitrations that proceed to decision, and a comparison of the arbitration results published by the *Securities Arbitration Commentator* indicates that Ameritrade's "rate of success" is at or below the industry average.

3. Which firms are the most vulnerable financially?

Many major firms were able to accumulate a substantial amount of capital from large profits earned from their initial public offerings and other investment banking operations during the booming 1990s.

However, there are two disturbing trends which, when combined, imply the growing possibility of failures by some large brokerage firms: First, among the 57 brokerage firms that have failed in the past seven years, the single most common cause of failure was large arbitration awards or other legal actions against the firm. Second, even among the large firms, there are some that have demonstrated signs of weakening finances.³ For example:

- **Morgan Stanley**, comprising institutional divisions of Morgan Stanley Dean Witter, reported 1.93 cents in net capital for every dollar of total assets, as

³ Based on data reflecting strictly the brokerage subsidiaries or operations, as of year-end 2000, the latest available from the SEC.

compared to an average of 8.4% among the 18 largest retail firms. Morgan Stanley also had aggregate indebtedness of more than \$35 billion. Some such debts are deemed acceptable, but excess amounts can make a firm vulnerable to adverse conditions such as a sharp rise in legal actions.

- **JP Morgan Chase's** brokerage and investment banking operations had less than one tenth of a cent in capital per dollar of assets and over \$4 billion in debt.
- **Credit Suisse First Boston** had net capital of 0.74 cents on the dollar, \$3 billion in debt, plus a significant profit decline in 2001.

Table 8 below shows the 20 largest brokerage firms, with their Weiss Safety Ratings.

8. Twenty Largest Brokerage Firms Based on Asset Size

<u>Name</u>	<u>Weiss Safety Rating</u>
ABM Amro Incorporated	C
Banc of America Securities LLC	B-
Barclays Capital Inc and Sub.	C-
Bear Stearns & Co.	C
BNP Paribas Securities Corp.	C+
Charles Schwab & Co. Inc.	B
Credit Suisse First Boston Corp.	C-
Deutsche Bank Alex Brown Inc.	B-
Goldman Sachs & Co. and Sub.	C
Greenwich Capital Markets Inc.	B-
JP Morgan Chase & Co.	C-
Lehman Brothers, Inc.	C-
Merrill Lynch Pierce Fenner & Smith	C-
Merrill Lynch Professional Clearing	B
Morgan Stanley & Co. Inc.	C
Nomura Securities International Inc.	B-
Salomon Smith Barney Inc.	C
SG Cowen Securities Corp.	B+
UBS Painewebber Inc.	C+
UBS Warburg LLC	C-

Weiss Safety Rating A=Excellent, B=Good, C=Fair, D=Weak, E=Very Weak, F=Failed, U=Unrated

The Weiss Safety Ratings of brokerage firms are based upon an analysis of a brokerage firm's capitalization, leverage, earnings, liquidity, and stability. The latter category combines a series of factors including arbitrations, regulatory and legal actions, size, growth, strength of affiliate companies, and risk diversification. The data are obtained from public information, including reports offered by the SEC and NASD.

Although companies with a rated C-, C or C+ are currently stable, many could become vulnerable should their financial performance deteriorate from current levels. Their stability would be of particular concern if they suffer a further increase in the volume of investor legal actions, along with steeper declines in the financial markets.

As of the latest data available, 13 of the 20 largest firms are in the C range, with only seven believed to have the financial wherewithal to withstand a severely adverse business environment. Thus, it is possible that failures in the brokerage industry could emerge as a major future challenge for investors, legislators and regulators.

Part III. Recommendations for Protecting Investors and Restoring Confidence in Financial Markets

Recent recommendations by the industry and regulators include a more efficient separation between investment banking and research, changes in compensation for research analysts, and better procedures for informing the public of dropped coverage, all to be supported by stronger legislation and/or stricter regulation.

To the degree that they are implemented fairly and universally, most of these proposals can contribute to positive reforms. However, recent history demonstrates that it is not possible to achieve a desired level of integrity in our financial system through legislation and regulation alone. For example:

- There have been 4,822 regulatory actions against 612 of the largest brokerage firms by the states, the SEC, and a variety of exchanges, based on our analysis of NASD data. However, despite these regulatory actions, there has been no lasting decline in customer abuses. Quite to the contrary, the number of arbitration filings, a reflection of the level of customer abuses, has continued to rise rapidly.
- Despite concerted actions by the regulators, and repeated warnings from the former Chairman of the SEC, the Chairman of the Federal Reserve, and others, there was no branch or agency of government in the nation with either the will or the power to moderate the Nasdaq boom — let alone prevent the ensuing bust. Had the boom-bust cycle been driven exclusively by the economic cycle, it would have been virtually unavoidable. However, the magnitude of the cycle was amplified by a complex web of accounting distortions, broker hype, and Wall Street's lust for investment banking profits at virtually any cost. Ironically, most of these were well known to industry insiders and regulators, who were either unwilling or unable to take adequate corrective actions.

In light of this history, it is clear that the regulators of the financial markets *need help badly*. They don't have — and probably never *will* have — the funding or the staff to micro-manage thousands of brokerage firms, hundreds of thousands of individual brokers, and trillions of transactions in an ever changing financial system, where new relationships and new financial instruments are created daily.

The best defenders of investors are investors themselves; the best regulator of markets is the marketplace; and the most efficient dispenser of financial justice, the crowd of customers.

Investors need not hire lobbyists or pound on the desk of faceless bureaucrats. They don't even have to wait for the next election to make their voices heard. In the case of dishonest companies or deceptive ratings, all they have to do is pick up the phone or click a mouse, putting through a simple instruction: SELL. Their actions, multiplied manifold, immediately punish any CEO, investment banker, or broker who may be perceived to be

acting amorally, unethically or illegally. At the same time, buy orders reward those who demonstrate integrity.

Investors can also vote with their dollars by closing accounts with firms that have a track record of skewed advice and investor abuse, while opening accounts with those boasting a solid record.

Unfortunately, investors will not be able to exercise this function without specific, objective information presented in an easy-to-understand, standard, comparable format. When the information is not comparable, the policing power of the market is stifled. When the flow of information is slowed, filtered, or blocked, that power is snuffed out. Worst of all, when the information is skewed and misleading, as it has been in recent years, the marketplace can emerge as a powerful force that diverts society's precious capital to ill-conceived, poorly managed ventures, while leaving worthy enterprises struggling to raise funds.

Instead of capital and business flowing to those companies that are most skilled at efficient production, it winds up instead in the hands of those most adept at destructive deception. Later, instead of disclosures building confidence, they are the cause of anger, frustration and even panic. Indeed, a key reason confidence in the financial markets has floundered in recent months is precisely because information has been withheld from the public for so long, and is now coming forth so quickly, in a torrent of shocking revelations.

Ironically, many Wall Street executives still believe that the investor's loss of confidence is justification for even more attempts to talk up the market or erect darker shrouds of secrecy to protect the public from what they believe the public need not know. These proponents of corporate secrecy seem to forget that the public has a great capacity to absorb bad news in small doses. It's the backlog of bad news, hidden in dark closets for years and suddenly bursting into the sunlight, that is so damaging.

What is most unfortunate is that the shroud of secrecy is perpetuated not only by the corporations, financial vendors, and intermediaries with the most to hide, but, frequently, also by the regulators with the most to gain from uncovering their secrets. The NASD refuses to disclose its data on the overwhelming majority of investor complaints, and the data it does provide is largely unusable by individual investors. The SEC provides financial data on brokers, but severely limits the number of requests from the public, while failing to disclose certain key financial aspects from the Focus Reports submitted by broker-dealers. Broker-dealer data held by states is difficult to acquire and even more difficult to compare. Even professional researchers are often stumped.

This is especially unfortunate given the regulators' dire need for investor assistance in monitoring vendors and intermediaries, and given the fact that investors can only exercise that function when they have the needed information that some regulators are now holding closely to their vests.

The Urgent Need for True Disclosure

Investors lack the single most important element they need to help cut through much of the distortions and dislocations discussed in this paper: clear, full, and specific disclosure of accurate, unbiased, comparable information.

The term “disclosure,” however, is often misused. Many in the industry believe that partial and selective disclosure is adequate. For example, to address allegations of conflicts of interest, industry players would be glad to consent to a disclaimer footnoted in research reports along the lines of “analyst compensation may sometimes be related to the sale of recommended securities.” A noncommittal and vague footnote such as this would become standard, investors would learn to dismiss them, and the firms would be free to go about business as usual.

Sometimes, industry leaders consent to broader disclosures, but only because they know they can overwhelm investors with reams of relatively useless information. As an illustration, investors can log onto the NASD website, enter the name of a firm, and receive a report with a partial list of legal actions. However, even for sophisticated investors, the data is next to worthless. Due to wide variations in a firm’s size and volume of business, it is impossible for the investor to judge what is normal and what is excessive; there is no facility available for comparing firms; and the data is provided in a text format that creates still another roadblock to analysis.

Some regulators go as far as to view disclosure as dangerous in certain circumstances. They seem to believe that their primary mission is to protect Wall Street firms from the potentially angry backlash of the mass of investors, rather than protect the public from demonstrably egregious acts of the firms. Thus, details of settlements with brokers may often be sealed, investors are left in the dark, and problems endemic to the industry continue to fester.

The New York State attorney general’s complaint against Merrill Lynch was one of the first to thrust analyst conflicts of interest squarely into the public domain. Indeed, the events that ensued demonstrate that public outrage can often play a more effective role in driving positive change than legal sanctions. Full-service firms like Merrill Lynch may have legal departments that are well equipped to negotiate with regulators, but their advertising gurus may not be so well prepared to combat the likes of Charles Schwab, which is deploying a massive ad campaign overtly designed to capitalize on Merrill’s bout of bad publicity. In response, Merrill is taking steps to restore its reputation. Indeed, as the first major firm targeted by the attorney general, Merrill may have the opportunity to be one of the first to regain public confidence. In the final analysis, the more public exposure, the better it is for both investors and the firms themselves.

Three Types of Disclosure Needed From Brokers and Brokerage Firms

When consumers take out a loan, they are required to sign disclosure statements mandated by Truth in Lending legislation. However, when doing business with a broker-dealer, there is no equivalent “Truth in Brokerage” disclosure. Moreover, the primary risk of a loan is shouldered by the lending institution, whereas the primary risk of investing through a broker is shouldered by the investor. Therefore, in addition to the terms of the transaction, Truth in Brokerage disclosures must reveal critical information about the individual broker and the firm, covering the following three areas:

1. *The nature of stock ratings and the track record of research analysts.* Currently, when reports and ratings from brokerage firm analysts are distributed, there is:

- no accompanying distribution of information with respect to the analyst’s methods or outside influences;
- no disclosure of loans made by or through affiliates;
- no disclosure of other investment banking relationships;
- no consistency with respect to how and when the ratings themselves are disseminated via major public sources;
- no information regarding the percentage of ratings assigned to each rating category; and
- no single publicly available source providing a complete list of (a) the stock ratings issued by a particular research analyst, (b) the ratings issued by a firm, or (c) the ratings issued on a particular company.

This is not only dangerous to the investor; it can also damage the reputation of the analyst and his or her firm. Even if an analyst issues a “sell” rating of the stock in a timely manner, if the information is not disseminated in the same venues as an earlier “buy” recommendation, investors may blame the analyst for losses that he or she sought to prevent.

2. *The legal history of the individual broker and the firm.* In the current environment, when customers open an account, they are given little or no information on:

- the individual broker’s personal background or history of legal actions;
- the firm’s overall history of legal actions;
- a relative measure of legal actions, such as the quantity of actions per account;
- a comparison of these indicators with industry averages; or
- where the above information might be available and how to acquire such information independently.

3. *Financial stability of the firm.* It is often next to impossible for a consumer to obtain relevant information on the financial stability of a brokerage firm because:

- Privately held broker-dealers are under no obligation to disclose their financial statements directly to the public.

- Publicly traded financial service corporations which include broker-dealer divisions do not report critical data on broker-dealer operations separately.
- Financial data on private and publicly held broker-dealers are available strictly from the Washington, D.C., office of the SEC, and limited to 10 firms per request.
- The data provided by the SEC are incomplete with respect to key financial information on the broker-dealers, such as earnings details, affiliations with other firms and net capital requirements.
- The data may often be outdated, reflecting the status of the firm as much as six months prior to the date the reports are first made publicly available by the SEC.
- The SEC provides virtually no assistance in interpreting the reports and hardly any educational materials to the public regarding the financial security of broker-dealers.
- There is little or no disclosure to consumers regarding the risks of broker-dealer failure. Moreover, consumers are often led to believe that SIPC and private insurance covers all risks up to the specified limits, when, in reality, they do not cover (a) fraud, (b) failure to pay arbitration claims due to bankruptcy, or (c) market losses incurred if accounts are frozen during the process of rehabilitation or sale of a firm's assets.

Thus, even the most sophisticated analysts are often unable to gain a clear and complete picture of a broker-dealer's financial stability, while for consumers, the task of evaluating a firm's security and the consequences of a possible bankruptcy is practically impossible.

Standards and Procedures Needed For Full Disclosure

As indicated above, in order to fill these gaps and help investors select an appropriate broker, disclosures should include complete information regarding the nature and history of stock ratings, the legal history of brokers and their firms, plus the financial security of each firm. Further, the information provided must be:

(1) Presented in context, and in comparison to other brokers and brokerage firms.

Industry defenders often claim that disclosures would be unfair because consumers would take the information out of context. However, it is the industry's own resistance to full disclosure that has led to partial release of bits and pieces, making it extremely difficult for investors to put those pieces into a proper context. For example, if an investor retrieves a report on an individual broker from the NASD website, it is likely that almost any information in the report, no matter how benign, will hurt business. In contrast, more complete disclosure will give the investor the ability to compare the broker to industry averages and view it in the context of that broker's overall volume of business.

Comparative measures could include (a) the number of legal actions per customer account, (b) the total dollar value of awards and fines against the firm as compared to the total value of securities held for customers, and (c) the number of complaints settled compared to the total number of complaints filed.

(2) Clear and easy to understand. Disclosure opponents will also react with the common refrain that most financial concepts are too complex for the average person to

comprehend. But this attitude is perceived as an insult by most investors. They will readily admit that they may not be as sophisticated as industry insiders, but they rightfully insist that they are no less intelligent. Indeed, the overwhelming majority of investors have both the ability and desire to grasp virtually any concept that impacts their personal finances, provided it is explained in language that is straightforward and clear.

(3) Presented at the point and time of sale. Many so-called disclosures are theoretically available on request but, in reality, difficult to acquire. Most customers have no inkling of what information exists or where to get it, and most brokers are also in the dark. The disclosures need to be made to the customer whether requested or not, *before* a customer opens an account.

(4) Accompanied with consumer education programs that disclose and explain all significant points of risk and drawbacks. Investors are generally aware that stocks can go down in value. What they often fail to realize is that the stocks of well-established, household-name companies can decline very significantly and swiftly, often wiping out billions in market capitalization in just hours of trading, as shocking revelations are made. These events demonstrate the need for a broader education on real risks, which, until this day, typically remain unknown or misunderstood: the risk of earnings manipulations, the risk of ratings exaggerations, the risk of fraud, and the risk of failure.

(5) Based on standard questionnaires used industry-wide. Some sample questions are offered in Appendix B as a basis for disclosure legislation or regulations. It is anticipated that the industry will put up stiff resistance. In that event, more specific measures, including a full separation of the research and investment banking businesses, would be mandated.

Separately, these and other similar documents are offered gratis to investors to be used as instruments to facilitate their own requests for disclosure. Investors can print them from the Weiss Ratings website (www.WeissRatings.com), present them to existing or prospective financial intermediaries or vendors, and use them as tools to help get specific answers. The website also provides benchmark data for comparison purposes. Investors will be encouraged to demand adequate responsiveness before opening accounts or doing additional business, and it is hoped that other investor protection organizations will offer similar consumer-friendly tools.

(6) Distributed to the public in a standard format with standard procedures. In its settlement with the State of New York, Merrill Lynch has agreed to develop procedures for notifying investors when coverage is dropped on a stock. This is a good beginning. However, where does it leave investors who bought the shares based on earlier “buy” recommendations and who now need to know what to do next? The firms should:

- Maintain coverage on stocks until such time as recommendations are given to investors regarding their final disposition, especially following an earlier recommendations to “buy.” Dropping coverage should not be used as a substitute for issuing an outright “sell” rating.

- Conform to a standard procedure and format for reporting all ratings and ratings changes to major public sources.
- Make sure the same procedure and format used in the distribution of *positive* ratings is carried forward with respect to the distribution of *negative* ratings on those same companies.
- In sum, conform to the basic intent of fiduciary responsibility rules even though investor funds may not be managed directly.

(7) Complete, including all information currently available to regulators and self-regulatory institutions regarding the past conduct of firms or individuals, made readily accessible in a user-friendly format. The regulators do disclose a significant amount of information, but there remains a wealth of information that is either not publicly available or is very difficult to acquire. Prime examples include data on arbitration complaints filed and not settled, or claims settled before a decision is made, plus other data held by the NASD, SEC, New York Stock Exchange, and regulatory bodies of the 50 states.

(8) Strictly enforced and backed up by severe penalties. Currently, to open broker accounts, investors must sign away many of their legal rights by consenting to arbitration. However, the ugly secret of the arbitration system is that it is designed primarily to protect the firms, with few advantages for investors. Rules of evidence favor the firms, and even when a customer prevails, less than one fourth of the money awarded is paid, according to the U.S. General Accounting Office. Thus, new federal and state legislation is needed to grant investors better access to data and to improve enforcement of arbitration awards with measures such as pre-award attachment procedures and fidelity bonding of brokers. In addition, investors with large or complex claims should be restored the right to sue in court.

The Role of Government and Self-Regulatory Bodies

Rather than getting bogged down in the micro-management of daily transactions, business models, or strategic plans of Wall Street firms, the primary role of the authorities should be to standardize, facilitate, and strictly enforce the complete disclosure of critical information to consumers. State regulators, the NASD, and the exchanges can play a particularly constructive role by placing complaints against firms into the public domain and alerting investors to any present abuses or dangers. Using questionnaires such as those presented in Appendix B, it is proposed that:

1. Copies of the latest, completed questionnaires be presented to each new customer prior to opening an account and to each existing customer on a yearly basis.
2. The answers be tabulated and made available in public databases for comparison. This will help ensure an equal playing field for all, while also giving brokers the opportunity to place their own performance within the context of industry norms.
3. The databases be made available to investors, independent research organizations, and the brokers themselves to encourage further comparative and trend analysis.

If this level of disclosure had existed in the 1990s, along with equally good disclosure from the nation's public corporations and accountants, it would have been extremely difficult, if not impossible, for trillions in investor funds to have been diverted to shaky corporations.

Some speculative funds may have flowed into high-risk ventures, where failures and even accounting shenanigans would have still been possible. But the overwhelming bulk of investment money would have naturally been directed to well-managed, stable companies with accounting integrity. The great anomaly of our era — chicanery at some of the nation's most respected, large institutions — would have been next to impossible.

Looking ahead, the very fact that big names have been embroiled in the melee provides a powerful catalyst for change and a unique opportunity for reform. However, without a broad, sweeping reform — to unlock the floodgates of information and truly empower investors to defend their personal interests — we are doomed to perpetuate the current crisis of confidence and, sooner or later, repeat the blunders of the 1990s.

Some small steps are already underway, but they have barely scratched the surface. Moreover, backsliding is already a present danger. In early June, the CEO of Goldman Sachs, in a speech at the National Press Club, boldly placed the blame for Wall Street's crisis of confidence on corporate CEOs and their accountants, including some of his firm's top customers. But in the process, he minimized the responsibility of his own firm and the industry. Similarly, on the CNBC program, "Louis Rukeyser's Wall Street," the chief executive of Merrill Lynch, fresh out of a settlement with New York State, brushed off the entire conflict-of-interest matter by asserting the offenders were just a "few bad apples." These approaches are nonproductive, calculating, and disingenuous. Until the industry leaders fully recognize their own offenses, real solutions will continue to elude them.

Appendix A. Definitions and Scope of Research on Broker Stock Ratings

<i>Buy</i>	includes “strong buy,” “buy,” “recommended list,” and “market outperform.”
<i>Hold</i>	includes “hold,” “neutral,” and “market perform.”
<i>Sell</i>	includes “sell” and “reduce.”
<i>Positive ratings</i>	Ratings that recommend or imply investors buy or hold shares in a company.
<i>Negative ratings</i>	Ratings that recommend or imply investors sell shares in a company.
<i>Firms</i>	Brokerage or investment banking firms included in the analysis.
<i>Companies</i>	Failed companies included in this analysis.
<i>Major public sources</i>	Services that track research reports from the firms and are most widely used by brokers or investors. For the purposes of this analysis, these are Bloomberg, Yahoo.com, Zacks, and First Call.

Scope of the Analysis

1. The analysis was completed on May 30, 2002.
2. The analysis included all ratings available on that date from major public sources. Ratings available from other sources that are largely inaccessible to, or not normally used by, the public were excluded.
3. The analysis initially focused on the 87 public companies that filed for Chapter 11 between January 1 and April 30, 2002. Companies that filed for Chapter 11 before or after that four-month period were excluded.
4. Among the 87 companies that failed in the first four months of 2002, only 19 of the companies had brokerage firm ratings that were tracked by major public sources within six months of their failure. These 19 firms were included in the analysis. The 68 failed companies not covered by research analysts during that period were excluded.
5. There were 121 ratings available from major public sources six months before the date of failure. There were another 121 ratings available on the date of failure. Ratings only available prior to the six months before failure were excluded. Ratings issued prior to January 1, 2001 and not reaffirmed after that date were also excluded.
6. These ratings were issued by 50 different brokerage and investment banking firms. The firms that did not issue ratings on the 19 companies or whose ratings were not reported to, or picked up, by major public sources were excluded.
7. Based on their peak market prices of recent years, the 19 companies included in this analysis had an aggregate market value of \$150 billion, representing 81% of the investor peak wealth that was ultimately lost by investors in the companies filing for Chapter 11.
8. Based on the latest available data, the 50 firms included in this analysis had aggregate total assets of approximately \$1.7 trillion, representing at least 90% of the assets of the securities brokerage industry.

Appendix B. Proposed Disclosure Questionnaires for Brokers and Analysts

Disclosure questionnaires for research analysts can include questions such as:

1. What is your past record in rating this company? Provide a history of rating changes from the date you began coverage.
2. Among the stocks that you have rated a “buy” at any time in the past 12 months, how many are currently selling at a higher price? How many are currently selling at a lower price?
3. Have your superiors at your current firm ever requested that you withhold a negative rating or report on a particular company or sector?
4. If the answer to the above is “yes,” what is the most recent such occurrence?
5. Have your superiors at your current firm ever requested that you issue a positive rating or report on a particular company or sector, despite misgivings you might have had about them?
6. If the answer to the above is “yes,” what is the most recent such occurrence?
7. What was the basis of your total compensation package last year at this firm?
 - Exclusively salary
 - Included bonus tied to accuracy of forecasts
 - Included bonus tied to success of investment banking sales in general
 - Included bonus tied to success of investment banking sales to companies you cover.
8. Do you currently hold any positions in the securities in any of the companies you are currently covering?
9. If the answer is yes, what is your position and when was it acquired?
10. Do you or your firm have any business relationship with the companies that are the subject of your research?

Disclosure questionnaires for brokers and firms can include questions such as:

To be answered by individual brokers:

1. Is there any record about past or ongoing legal, regulatory, disciplinary actions, investor actions, or arbitrations filed against you available from the following sources?

	Yes	No
NASD database	_____	_____
NYSE database	_____	_____
State database(s)	_____	_____

Note to brokers: If you are not certain, it is your responsibility to determine what information does exist. For a list of state agencies that may pertain to you, see http://www.nasaa.org/nasaa/abtnasaa/find_regulator.asp.

2. If the answer to any of the above is “yes,” please provide a list of case numbers, along with the name of the regulatory agency.
3. Are there any such actions pending that may not be in the above databases? Please provide a description.
4. In the past five years, have there been any legal or formal disciplinary actions taken against you for which records are not available to the public? How many?

To be answered by a compliance officer, or equivalent, of the firm:

5. Indicate the number of records of past or ongoing legal actions, regulatory actions or investor actions against your firm in the following areas:

	<u>2002</u>	<u>1997-2001</u>
NASD database	_____	_____
NYSE database	_____	_____
State database(s)	_____	_____

6. Indicate the number of retail customer accounts your firm has currently.
7. Calculate the number of total legal actions or arbitrations filed against your firm in the past five years, per million customer accounts.
8. Indicate the number of pending legal actions or arbitrations filed against your firm.
9. Indicate the percentage of your firm’s gross revenues in the most recent full fiscal year from the following sources:

	%
Commissions	_____
Investment banking	_____
<u>Other</u>	_____
Total:	100%



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