Testimony of Damon Silvers, Associate General Counsel, AFL-CIO, before the Subcommittee on Consumer Affairs, Foreign Commerce and Tourism of the Senate Committee on Commerce, Science and Transportation

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Good morning, Mr. Chairman, my name is Damon Silvers, and I am an Associate General Counsel of the American Federation of Labor and Congress of Industrial Organizations. The AFL-CIO believes today's hearing on Enron Corporation and the marketing of its stock is a vital contribution to the efforts to both bring to light the causes of Enron’s collapse and protect the public and our economy against future events of this kind.

Directly and indirectly, America’s working families are the ultimate customers in our securities markets. Defined benefit pension funds that provide benefits to the AFL-CIO's 13 million members have approximately $5 trillion in assets. These plans include thousands of pension plans sponsored by AFL-CIO member unions, public employee pension plans, and single employer pension plans subject to collective bargaining. Since the passage of ERISA in the 1970's, these funds have increasingly invested in equities. 401-k and other defined contribution plans, employee stock ownership plans, and union members' personal savings account for further extensive investments in equity markets by America's union members.

Enron’s collapse devastated some workers’ retirement security. You have heard from some of those workers today and their words speak for themselves. But the collapse of Enron also took money out of the retirement savings of practically every worker in America fortunate enough to have retirement savings.

Most pension funds and institutional investors held some Enron stock. Many of the most popular mutual funds held Enron stock. If any person in this room has an S&P 500 index fund in your 401(k) or your mutual fund portfolio, you lost money in Enron-- probably about half a percent of your total assets in that fund. And this is if you invested in index funds-- in a strategy that is designed to cheaply mitigate the risks of investing in any single company.

This was by and large money that was going to fund pension benefits for working families-- for the public employees we are counting on to protect us during this period of national crisis, for the iron workers who are as we speak clearing the rubble at Ground Zero, for the firefighters who today, as on September 11, stand ready to give their lives to save ours. Because of the way that our retirement system has become increasingly interwoven with the capital markets, practically every American fortunate enough to be able to save for retirement in any form was hurt by the collapse of Enron.

Indexed investing is very attractive to both institutions and individual investors. Indexed investing essentially means you buy the whole market, and do not make judgments about whether any given stock is underpriced at any given moment. Indexed investing entails very low fees and guarantees substantial diversification. But it does assume that the market prices for securities are roughly reflective of the real values of those securities in light of the information known at any given time. The indexed investor is very vulnerable to fraud perpetrated on the markets, because the indexed investor is essentially a price taker. Because of the popularity of indexed investing among institutional investors, when a company artificially inflates its stock price by withholding information from the markets or putting out false information, the victims are not only the unsophisticated individual investors, but some of the largest and most sophisticated funds in the country, investing on behalf of hundreds of thousands of individual investors.

Some have suggested that it is too early to know whether anyone is to blame for the collapse of Enron. While no one has as of today been literally indicted, the AFL-CIO believes that a number of responsible parties have emerged. These parties include the senior management of Enron, the board of directors, Arthur Andersen, the outside auditor, the sell-side analyst community, and perhaps some money managers. These people and organizations made up the web of parties with obligations to Enron, its investors, and the public at large. These are the people and institutions that failed to ensure that Enron's assets were used to benefit the company and that the investing public had the information necessary to make fully informed decisions about whether to invest in Enron and if so at what price.

The Subcommittee has asked me to focus today on how consumers purchasing Enron's securities were misled. The AFL-CIO has done considerable analysis of the behavior of Enron's officers and directors. I have attached to this testimony letters we and the Amalgamated Bank, a large manager of worker pension funds, sent to Enron's board in early November laying out the details of some of the transactions that led to Enron's collapse and explaining the undisclosed conflicts of interest that in our view crippled Enron's board.

The AFL-CIO also has been a longtime supporter of efforts undertaken by Arthur Levitt when he was chairman of the Securities and Exchange Commission to rein in conflicts of interest affecting auditor independence. Pension funds affiliated with the building trades unions have for several years submitted shareholder proposals seeking to ensure companies they invest in hire truly independent auditors. Last week we submitted a rulemaking petition to Harvey Pitt, Arthur Levitt's successor at the SEC, asking him to act to end the types of conflicts of interest that appear to have compromised Arthur Andersen's ability to carry out its duties as Enron's public auditor. That petition is also attached.

But in the remainder of this testimony I intend to focus on the analysts' role in the collapse of Enron. Let me begin by summarizing briefly what sell-side analysts do. Sell-side analysts work for full-service investment houses. By full-service I mean that these firms underwrite securities, they make markets in securities, they give investment banking advice to companies, they manage money on behalf of clients, and often they trade on their own accounts in the securities markets. Since the rise of integrated mega-financial service firms after the repeal of Glass-Steagall, these firms also make bank loans to companies.

One of the services these full-service firms provide to their clients who trade securities through their brokers is access to research reports written by their research analysts. These analysts are called "sell-side analysts" because their firms do a substantial business selling securities to their clients, and fundamentally the research is paid for by the brokerage fees generated by the firm's sales and trading activity. The research itself is not sold. This business model means that sell-side analysts are eager to share their work with investors generally, through their reports, and through appearances on television, radio and the Internet. As a result, sell-side analysts shape investor opinions out of proportion to their numbers.

Sell-side analysis is widely available to market participants, both directly through the brokerage houses and through services like First Call and Investext. While firms try and keep the most up to date reports available only to clients, relatively recent sell-side analyst reports are widely available at a relatively reasonable price.

Few union members or other individual investors are in a position to master the raw data that informs the financial markets, and even fewer have routine access to insiders in the companies they invest in. Most union members, and the trustees of their pension funds, for that matter, rely on a variety of professionals for their information about the equity markets. Sell-side analyst reports are likely to be the most detailed, critically analytical information the typical small investor has to consult in making investment decisions. For that reason, America's working families have an enormous stake in the honesty of the investment information they receive from the analyst community.

Analysts are investment advisors subject to the Investment Advisors Act of 1940. Under the Act, analysts have a fiduciary duty to their clients. They are not mere marketers, serving the needs of their firms' underwriting business. They owe a duty of loyalty and of care to the investors they advise.

Unfortunately, in recent years the structure of the securities industry has shifted in ways that appear to have compromised sell-side analysts. There is substantial statistical evidence that analysts' decisions whether or not to recommend that investors buy a stock are influenced by whether their firm is an underwriter for the issuer. That is the conclusion of a 1999 study by Roni Michaely of Cornell University as well as a 1997 study by Hsiou-wei Lin of National Taiwan University and Maureen McNichols of Stanford Business School.1 CFO Magazine reported last year that analysts who work for full-service investment banks have 6% higher earnings forecasts and close to 25% more buy recommendations than analysts at firms without such ties.2

In some ways what we find more persuasive than the statistics are the comments of analysts in the financial press. In the last few months, analysts have been quoted by name saying such things as "a hold doesn't mean it's ok to hold the stock" and "the day you put a sell on a stock is the day you become a pariah."3

It should not be surprising that this is true given that issuers pick underwriting firms based on their ability to bring effective positive analyst coverage to their businesses. This is the conclusion of a soon to be published paper on why firms switch analysts by Laurie Krigman of the University of Arizona, Wayne Shaw of Southern Methodist University and Kent Womack of the Tuck School Business at Dartmouth College.4

In addition, the data cited by CFO Magazine suggests several quite disturbing things. First is that it is not just existing relationships that are affecting analyst recommendations, but also the prospect of future business. The result is a systematic positive bias affecting recommendations across the board. Second, the response from the securities industry that analyst involvement in underwriting helps ensure that the firms only do quality deals at the right price is simply inadequate to explain the distortion in the data affecting all recommendations.

But these conflicts are exacerbated by the ways in which analysts are used and compensated. It has become a common practice for analysts to accompany teams from the corporate finance department on underwriting road shows, and most importantly, analyst compensation has become tied at many firms to analysts' effectiveness at drawing underwriting business.

In addition, the consolidation of the financial services industry, and in particular the repeal of Glass-Steagall, has created a wide array of further potential conflicts. Issuers are in a position to withhold business from the firms of critical analysts across a wide array of markets, including commercial loans and commercial banking services, pension fund and treasury money management, and insurance contracts. This leverage is particularly powerful when the issuer is itself a financial services company. For example, CFO Magazine reported last year that the troubled financial services giant First Union cut off all bond trading business with Bear Stearns in response to negative comments by their analyst, and Bear Stearns ordered the analyst to be more positive.

At the same time, issuer executive compensation has been linked to issuer stock price, often in ways that give incentives to executives to manipulate short term movements in stock prices. The result is that issuer executives have tremendous personal incentives to use the resources of their companies to pressure analysts into issuing conflicted reports.

The rise in the importance of proprietary trading at major firms also creates further possible conflicts of interest for analysts. A version of this problem has always existed when firms' trading operations and market making operations lead to a buildup of inventory in particular issuers' securities. However, the addition of firms investing significant capital in proprietary trading creates a risk of senior executives aware of the positions taken in proprietary trading encouraging research departments to prop up demand for certain securities.

Finally, among the most lucrative business areas for full-service firms is providing investment banking advice to companies going through large mergers and acquisitions. Such deals are typically dependent on shareholder approval or effectively dependent on the price of the stocks of the companies involved remaining within a certain range. These circumstances can give a full-service firm that is advising a participant in a deal a substantial interest in trying to encourage investors to behave in ways that support the transaction closing.

There has been some good news though in the effort to protect analyst independence. Much of the literature in the 1990's on securities analysts' behavior noted the ability of issuers to reward and punish analysts by providing and withholding information. This power meant that analysts who were doing their best to be loyal to their customers could not provide customers with the timely information that is the minimum requirement of the job without tilting their recommendations so as to ensure they weren't on the losing end of the business of selective disclosure.

Earlier this year the SEC promulgated Regulation FD barring selective disclosure. In doing so the Commission recognized selective disclosure not only harmed those not privy to the selective disclosure, it gave issuers power that resulted in warping the behavior of those who *were* the recipients of the selectively disclosed information. The adoption of Regulation FD marked an important step toward restoring analysts' independence. However, Harvey Pitt has at various times suggested he is not an enthusiastic supporter of this rule. Regulation FD is an important step toward restoring analyst independence and deserves Congress' continuing support.

The story of the collapse of Enron illustrates the consequences of these conflicts of interest on the larger market environment. Enron was throughout the late '90's a high-flying stock, trading at up to 70 times earnings. Even though its earnings growth as shown in pre-restatement numbers was around 5% per year from 1998 to 2000, Enron's stock price quadrupled over the same period.

During the spring and summer of 2001, Enron's stock price was falling, apparently due to the normal reasons stock prices fall-- deteriorating conditions in certain of Enron's markets, and trouble with certain large projects. However, in addition, some journalists were raising concerns that Enron was both opaque and overvalued.[5]

What is noteworthy about this is that during this period Enron executives were engaged in extensive selling of Enron shares. At the same time Enron's CFO was telling the press "We don't want anyone to know what's on those books. We don't want to tell anyone where we're making money." During this period, according to First Call, which surveys sell-side analyst reports, there was clearly insufficient transparency to Enron's financial disclosures to allow an analyst to be able to give an opinion as to whether the company's stock was a good investment.[6] Nonetheless, as one might expect from the general data we have surveyed, out of 11 sell-side firms tracked by Briefing.Com there were no downgrades of Enron from May 11, 1999 until August 15, 2001.[7]

Compare this record to the independent investment newsletters surveyed by Forbes Magazine.8 Of the eight Forbes looked at, six were advising their subscribers to sell Enron, four before May 1st, and two in October. One of the eight advised subscribers to sell until the price hit $9, then went to a buy, and only one of the eight maintained a consistent buy during the period of Enron's collapse.

On August 15, following the sudden resignation of Enron's CEO Jeffrey Skilling, Merrill Lynch's analyst, downgraded Enron from Near Term Buy/Long Term Buy to NT Neutral/Long Term Accumulate. This may sound like a modest downgrade. But compare it to the firms that were underwriters for Enron. The earliest downgrade among this group appears to be J.P. Morgan-Chase, which went from Buy to Long-Term Buy on October 24, 2001. Strangely enough though, J.P. Morgan-Chase appears never to have downgraded Enron below a Long-Term Buy in the weeks that followed. In fact of the twenty seven firms we could find that covered Enron, the only sell-side firm that actually downgraded Enron to a Sell was Prudential, which downgraded Enron twice in the week that followed the announcement of the $1.2 billion charge to earnings on October. These results of our research parallels a Forbes Magazine study that looked at 13 sell-side firms and found as of the end of October, two weeks after the initial announcements of the charge to equity and the SEC investigation, only one firm recommended Sell, one firm recommended Hold, and the remaining eleven still had various forms of buy recommendations.

In late October and November, as Enron attempted to sell itself to Dynegy, key firms with an interest in the transaction maintained what appeared to be positive ratings. JP Morgan Chase and Citigroup were Enron's advisors and stood to earn large fees. These fee arrangements have not been disclosed but are likely to have been in excess of $50 million per firm. Citigroup lent Enron more than $500 million, monies in part that came from federally insured commercial bank deposits. Citigroup's analyst at Salomon-Smith Barney maintained a Neutral-Speculative rating. JP Morgan Chase lent Enron $400 million, while its analyst rated the stock a Long-Term Buy all the way through November. Lehman Brothers, the advisor to Dynegy on the Enron purchase, also stood to earn a similarly large fee if the deal closed. Lehman kept a Strong Buy rating on Enron throughout the fall.9

What can be concluded from this record. First, though Enron's financials included somewhat cryptic references to the partnership structures Enron's management used to hide liabilities and pass interests in company assets to executives, no analyst appears to have paid any attention to these items until they became widely known in October. Second, with one notable exception in Merrill Lynch, no analyst took action based on Skilling's resignation. Finally, with the exception of Prudential, no analyst thought it worthwhile to actually recommend their clients sell the stock. Interestingly, neither Prudential nor Merrill Lynch were underwriters for Enron or had any part in advising or lending money to either Enron or Dynegy.

One can observe in the analysts' treatment of Enron many of the problems critics of analyst conflicts pointed to before the Enron debacle. These include the linkage between analyst behavior and the investment banking, and now commercial banking, interests of their firms; the use of codes by analysts, where Long-Term Buy may mean Sell, and Hold certainly means Sell; the reliance on company projections and the failure to either look deeply into company financials or to consult outside sources. Taken together, these conflicts seem to have converted the analysts from providers of analysis with a fiduciary duty to their investor clients to simple salesmen for their firms' investment banking clients. And when the investment banking client is defrauding the investor client, too often the analyst, like the auditor, becomes a part of the fraud.

The AFL-CIO believes strongly that Congress, the regulatory agencies, and the self-regulatory agencies need to act in a coordinated fashion to protect the independence of analysts. In particular, we believe that what used to be called the Chinese Wall between research and investment banking in full service houses needs to be rebuilt. The AFL-CIO has submitted shareholder proposals to several full-service financial services companies seeking to have those firms make such changes on their own. However, we believe that short-term competitive pressures are likely to lead to the continued violation of analysts' fiduciary duties unless regulatory action is taken.

Currently, as a result of pervasive conflicts of interest, our capital markets are treacherous places for the unwary. Enron is only the most recent and most dramatic example of this unfortunate fact. This is in part why the labor movement strongly believes that America's working families need retirement security that rests on three legs-- Social Security, a defined benefit pension plan and personal savings, only one of which should be directly at risk in the capital markets.

In conclusion, the AFL-CIO believes that systematic problems with the ways in which information flows to and in the capital markets contributed to both Enron's collapse and the severity of the impact of its collapse. While analyst conflicts were not the cause of the collapse of Enron, they contributed to a climate in which Enron's shares were artificially inflated and in which the conduct of management at Enron remained hidden long after it could have been brought to light. Finally, it appears that these conflicts contributed to a false optimism about the success of the Dynegy deal, an optimism that allowed Enron executives to continue to withhold vital information from the markets about Enron's liabilities and demands on its cash until the final collapse of the Dynegy deal.

We commend this Subcommittee for opening the Senate's formal inquiry into these matters. We urge both this Subcommittee and all involved: in Congress, the SEC, the Department of Labor, and the Justice Department to continue to investigate both the actions of particular individuals and firms and the larger structural arrangements that led to the collapse of Enron and the loss of so many peoples' savings. On behalf of the AFL-CIO, we look forward to continuing to work with the Subcommittee on this vital matter. Thank you.

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Damon A. Silvers is an Associate General Counsel for the AFL-CIO. His responsibilities include issues involving corporate, securities and bankruptcy law, benefit fund investment policy, and mergers and acquisitions. Mr. Silvers has represented the AFL-CIO and the Trade Union Advisory Committee to the Organization for Economic Cooperation and Development at the OECD=s Corporate Governance Taskforce. Mr. Silvers has testified before the House and Senate Judiciary Committees on bankruptcy law, the House Subcommittee on Capital Markets on securities analysts' independence, and before the House Pensions Subcommittee on ERISA reform. He is a member of the Advisory Committee on Analyst Independence to the House Capital Markets Subcommittee. He has also addressed the National Association of Corporate Directors and the University of Delaware's Corporate Governance Center on corporate governance issues.

Prior to working for the AFL-CIO, Mr. Silvers was a law clerk at the Delaware Court of Chancery for Chancellor William T. Allen and Vice-Chancellor Bernard Balick. Mr. Silvers has previously worked in the Mergers and Acquisitions Department at Credit Suisse First Boston, for the law firm of Cravath, Swaine & Moore, the Enforcement Division of the United States Securities and Exchange Commission, Monitor Company, a management consulting firm, and in the General Counsel=s office at the International Brotherhood of Teamsters.   Mr. Silvers has also been the Assistant Director of the Office of Corporate and Financial Affairs for the Amalgamated Clothing and Textile Workers Union, and the Research Director for the Harvard Union of Clerical and Technical Workers, AFSCME.

Mr. Silvers received his J.D. with honors from Harvard Law School. He received his M.B.A. with high honors from Harvard Business School and is a Baker Scholar. Mr. Silvers is a graduate of Harvard College, summa cum laude, and has studied history at Kings College, Cambridge University.

Mr. Silvers is the primary author of "Challenging Wall Street's Conventional Wisdom: Defining a Worker-Owner View of Value," published in *Working Capital: The Power of Labor's Pensions*, Fung, et al. eds, Cornell University Press (2001).