

Enforcement Settlement with Wall Street Investment Firms

Article

By [Shadow Financial Regulatory Committee](#)

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On April 28, 2003 the SEC, the New York Attorney General and others announced a settlement totaling almost \$1.4 billion in payments from ten major investment banking firms to resolve enforcement actions relating to misleading analysts' reports and recommendations. These actions are important because, unlike large institutional investors who tend to do their own stock analysis and are capable of evaluating the analysis of others, many small retail investors have relied, directly or indirectly, on the advice about individual stocks provided by research analysts employed by investment banks.

The settlement obligates the ten firms, in the aggregate, to pay \$487.5 million in penalties, \$387.5 million in disgorgement (of commissions and other monies), \$432.5 million to fund "independent" research, and \$80 million intended for investor education. Out of the total penalties and disgorgement (of \$875 million), \$387.5 million is to be placed in a fund to

benefit customers of the firms. Another \$415 million will go to state securities regulators.

Attempting to deter illegal activity by imposing monetary penalties is a central tenet of our legal system. In principle, the total \$1.4 billion under the settlement, supplemented over time by the costs and damages from a multitude of class action suits that have been or will be filed, furthers this objective.

A second objective of the legal system is to compensate injured parties for their harms. But, in this case, it is difficult to establish exactly who may have been injured and in what amount by a specific analyst report that can be shown to be intentionally misleading. In addition, the relationship between the fund for the benefit of customers and damages arising from the lawsuits is not yet determined (nor is the way in which the fund itself will be administered).

Apart from compensation, approximately one-third of the entire fund will be devoted to financing independent research and investor education. In addition, the settlement agreement separates the research analysis and investment banking functions in an effort to remove conflicts of interest, while providing a separate outside source of investment advice. For the next five years, the investment banking firms will have to pay over \$400 million for recommendations from independent research firms that are to accompany their own recommendations.

These provisions rest on the false premise that the small retail investor can and should be able to outperform the market by picking individual stocks. The provisions aimed at ensuring more "objective" internal analysts' recommendations are thought to further this goal. The parties to the settlement apparently are less than fully confident that this step is sufficient, however, so they also added a large sum to fund five years of "independent" outside research and recommendations.

In all likelihood, these measures will entail a significant waste of resources in pursuit of an unobtainable goal. A large body of academic research on investment decision-making has yielded little or nothing to support the idea that any significant number of individual investors, even with the assistance of recommendations from sell-side or independent sources, can consistently outperform the market and obtain superior returns from stock-picking. The studies point in the opposite direction: individual investors will obtain better results by diversifying across the market or in many sectors, not attempt to choose particular stocks.

Another \$80 million is to be used by state and federal authorities for investor education. If the SEC and state securities regulators were to use these funds to educate investors about the difficulties of attempting to outperform the market, that effort could be really valuable. But this result would run counter to all past agency behavior in the area of securities regulation, and for this reason, spending monies in this fashion is also likely to be wasteful.