FINANCIAL ANALYSTS JOURNAL®
Reflections

Ethics and Investment Management: True Reform

Marianne M. Jennings

These are introspective times for those involved in the financial markets. Some feel a sense of renewal via reform. Others, who have come to the realization that Frank Quattrone, late Silicon Valley guru of Credit Suisse First Boston, will do about one month in prison for each word that he wrote in a hasty e-mail to his employees, feel fear, particularly of New York Attorney General Eliot Spitzer and e-mail.[1] Others wonder if we really "get it." That is, after all that we have witnessed, been involved with, and, sadly, in some cases, sanctioned, are we really renewed and reformed, or have we simply taken our lashes and moved on to find other circuitous ways to do what we were doing before?

The answer to the question of true reform requires exploration of three areas: (1) the crises that led to the current market and regulatory reforms, (2) the reforms themselves, and (3) what will bring about true reform.

In the era of Enron, WorldCom, and the rest, the lapses were great, the conflicts many, and the cost, in terms of investor trust, nearly unspeakable. More than the reforms we have seen is needed: True reform must come from leaders with a strong moral compass.

Crises That Led to Reforms

Taking stock of the types of conduct that led to indictments, reforms, settlements, and fines yields two groups of observations: (1) The practices and conduct of analysts that were sanctioned and reformed were not close calls. (2) We were engaged in repetitive behavior; we've been down this road before.

Not Close Calls. One of the common defenses offered by those accused of ethical or legal lapses is, "It's a gray area," "The law is unclear," "Interpretations vary," or "It depends." These are the phrases of the gray area and a seeming justification or explanation for conduct that is questioned. The notion of whether gray areas exist is a discussion for another time, however, because the crises that led to questions about analysts and reforms in the investment field were not gray areas. Indeed, the various forms of conduct were not even close calls. No one within the field looks at Jack Grubman (late of Salomon Smith Barney), the fee structures, the compensation systems, and the conflicts and frets, "These were very nuanced ethical issues. I never would have seen those coming." Those within the field and its outside stakeholders look at the conduct of analysts and conclude: Where were your minds and what were you thinking when you did that? The ethical (and often accompanying legal) breaches were head-turners in terms of their impact on trust, credibility, and perceptions of analysts in two broad areas—namely, conflicts of interest and giving or allowing false impressions/falsehoods/fraud.

- *Conflicts of interest: Research vs. deals*. The research side of the house is inherently conflicted with the deal-seeking underwriter side of the house. The Chinese Wall compromise was just that, a

Marianne M. Jennings is professor of legal and ethical studies at the W.P. Carey School of Business, Arizona State University, Tempe.

compromise on the inherent conflict that was, itself, bound to be compromised. As the old saying goes, "Three people can keep a secret if two are dead." The assumption that those on the deal side of the house could keep a secret was flawed. Not only did they not keep the secrets on their side of the Chinese Wall in their shops; they also encouraged those on the research side to keep the deal going or make it even sweeter with research findings and releases.

The structure defied human nature and was in no one's best interest, particularly those seeking to maximize returns. Strong evidence indicates that independent analysts provide better investment advice than analysts housed within investment banks. A 2004 study comparing the performance of independent analysts with in-house analysts (in the 1996–2003 time frame) concluded that following the advice of the independent analysts yielded a difference of 8 percentage points (pps) more in returns (Barber, Lehavy, and Trueman 2004). Furthermore, the independent analysts were particularly strong during bear markets. After March 2000, when the NASDAQ peaked, independent analysts were double-digit better (17–22 pps more) than their in-house counterparts because the independents were much quicker to downgrade stocks. During a bull market, the performance tends to be about the same because all stocks are buys. Still, virtually all of the large investment bankers were using these conflicts to gain business and ensure that the businesses' shares retained their value. The investment banks in the study were sanctioned for their conduct during this era, but follow-up work by Barber et al. found the same results for nonsanctioned investment bank analysts. Virtually all of the firms have settled with the U.S. SEC on charges that their analysts issued "buy" recommendations on the basis of their desire to retain investment banking clients. The firms and their fines were as follows:

Citigroup	$400 million
Merrill Lynch & Company	$200 million
Credit Suisse First Boston	$200 million
Morgan Stanley	$125 million
Goldman Sachs	$110 million
Deutsche Bank	$87.5 million
Bear Stearns	$80 million
J.P. Morgan	$80 million
Lehman Brothers	$80 million
UBS Warburg	$80 million
U.S. Bancorp Piper Jaffray	$32.5 million
Thomas Weisel Partners	$12.5 million.[2]

The problems that resulted from the stilted solution offered by the Chinese Wall were predictable and predicted. In 1998, I wrote in an article in the *Journal of Investment Consulting* about the need for a new vision on ethics, conflicts, and the structure of investment management research (Jennings 1998). The article encouraged discussion and change regarding conflicts in investment management research.[3] Despite the warnings and the defiance of human nature on the issue of conflicts, the practices continued until they were brought to a regulatory and prosecutorial head, with resulting mandatory reforms (discussed in the next section). Those in the profession saw the issues, but few in the field were willing to tackle them voluntarily.

■ *Conflicts of interest: Use of position/research for personal gain*. Beyond the systemic conflicts of interest, run-of-the-mill insider trading issues still involved analysts and still affected the stature of the profession. One of the more dramatic probes involved an investigation of Holly Becker, a former star analyst (for retail stocks) at both Salomon and Lehman. The drama-filled accusations involved issues of market-moving information being released that allowed Becker's husband, Michael Zimmerman, a hedge fund trader formerly at Omega Advisors and then SAC Capital Advisors, to trade on inside information. The investigation focused on whether Zimmerman was able to profit by having Becker's research reports in advance.[4]

■ *Conflicts of interest: Soft dollars*. The previous two forms of conflicting interests were both transparent and perhaps not the most significant ones. The public understood that analysts work for, for example, Morgan Stanley and that Morgan Stanley handles underwriting for the very companies given green lights by its analysts. Layers of conflicts existed, however, that were not discoverable by the public or investors.

Percolating beneath the conflicts within the firms and the individual use of market-moving research was the industry practice of soft dollars. Although widely used, rationalized, justified, and touted, the practice of compensating advisors through soft dollars is a conflict of interest.[5] Rather than being paid for advice, the advisor is paid a portion of the trading commissions from the broker designated as the trader for the client. The more trades, the more the advisor earns. For example, on a pension fund, the significant trades made on the advice of the investment advisor could produce millions in compensation. Regardless of avowed integrity on everyone's part, a conflict exists and abuses have occurred. In many cases, the self-interests of those receiving commissions trumped the interests of the client. For example, the pension fund for city employees of Chattanooga, Tennessee, is involved in litigation with its former advisor, William Keith Phillips, and his firms, UBS Wealth Management USA (Paine Webber) and Morgan Stanley, over soft dollar payments (Morgenson and Walsh 2004). Other cities are following suit, as it were, with San Diego also involved in a dispute with its pension fund advisor and cities in Florida, Virginia, and Pennsylvania pursuing various complaints against their advisors. Given the $5 trillion in pension funds in the United States, the issue is neither remote nor over in terms of its fallout.

Nor is the issue new or surprising. In 1998, the SEC released a report on its one-year sweep investigation of 75 broker/dealers and 280 investment advisors (SEC 1998). Fully three years before the market drop caused intense scrutiny, the SEC issued a wake-up call, a warning, and a proposed solution.[6] The executive summary of the SEC investigation presented the investigators' conclusions that soft dollars were being used for inappropriate expenses and that disclosures to clients were inadequate:

> While most of the products acquired with soft dollars are research, we found that a significant number of broker-dealers (3%) and advisers (28%) provided and received non-research products and services in soft dollar arrangements. Although receipt of non-research (or non-brokerage) products for soft dollars can be lawful if adequate disclosure has been made, our sweep inspections revealed that virtually all of the advisers that obtained non-research products and services had failed to provide meaningful disclosure of such practices to their clients. Examples of products acquired included: advisers using soft dollars to pay for office rent and equipment, cellular phone services and personal expenses; advisers using soft dollars to pay an employee's salary; an adviser using soft dollars to pay for advisory client referrals and marketing expenses; an adviser using soft dollars to pay legal expenses, hotel and rental car costs and to install a phone system; and an unregistered hedge fund adviser using soft dollars to pay for personal travel, entertainment, limousine, interior design and construction expenses.
>
> We also found that, even with respect to research and brokerage products and services within the safe harbor, many advisers' disclosure of their soft dollar practices was inadequate, in that it did not appear to provide sufficient information to enable a client or potential client to understand the adviser's soft dollar policies and practices, as required under the law.[7] Nearly all of the advisers that we examined made some form of disclosure to clients regarding their brokerage and soft dollar practices. Most advisers, however, used boilerplate language to disclose that their receipt of research products and services was a factor that they considered when selecting brokers. In our assessment, only half of the advisers that we examined described in sufficient detail the products, research and services that they received for soft dollars such that clients or potential clients could understand the advisers' practices. (SEC)

The vigorous defenses by firms and advisors in the arbitration proceedings brought by clients over soft dollar use is that the pension plans are sophisticated parties who understand the fee arrangements and the trade-offs for independent advice and research versus commission-compensated advice and that the client benefits from a net savings. The SEC's findings from nearly seven years ago explain the disparate views: There is a disconnect in the resolution of the conflict in that the disclosure by advisors may not be as forthcoming as they believe it to be.[8] As the 30th anniversary of the safe harbor provision and the resulting soft dollar fees approaches, the SEC has created a task force to study the issue once again and make recommendations on the issues, problems, and abuses.

■ *Giving or allowing false impressions, falsehoods, and frauds: The cheerleader vs. the analyst*. The discussion of conflicts in the industry also revealed the parallel nature of the issues of false impressions, falsehoods, and fraud. That is, false impressions, falsehoods, and fraud arise if there has not been full and complete disclosure about the nature of advisor fees. The façade of analyst independence is, in itself, a false impression, but egregious examples of far more damaging falsehoods occurred that bordered on or constituted market frauds.

For example, Citigroup's Salomon Smith Barney and Grubman, its star telecommunications analyst of the dot-com era, continued a marketwide false impression about WorldCom that lasted for years beyond the time when WorldCom had already begun accounting fraud to maintain a false rise to the heights of the market. In the month WorldCom collapsed with admissions of the need for $3 billion in earnings restatements (that amount would later balloon to $9 billion), Grubman's quote about WorldCom still appeared on the company's website, to wit: "If one were to find comparables to WorldCom . . . The list would be very short and would include the likes of Merck, Home Depot, Wal-Mart, Coke, Microsoft, Gillette and Disney" (Weinberg 2002). Grubman crossed the line from analyst to cheerleader early on in the WorldCom relationship: "The sycophantism of Grubman is difficult to describe because it seems almost parody" (Jennings, forthcoming 2005). Grubman attended WorldCom board meetings and offered advice, and he introduced Bernie Ebbers, WorldCom's CEO, at analyst meetings as "the smartest guy in the industry" (Smith and Solomon 2002, p. C1). Grubman and his firm were completely intertwined with WorldCom, Ebbers, and the success of both (Smith and Solomon; Backover and O'Donnell 2002). Grubman's evaluation included the following conclusion: "We do not think any other telco will be as fully integrated and growth-oriented as this combination [WorldCom plus Sprint]" (Smith and Solomon, p. C3).

Conflicts of interest were fueling this logic-defying support. Salomon stood to earn $21 million in fees if the WorldCom–Sprint merger was approved in 1999. WorldCom did indeed give the bulk of its investment banking business to Salomon Smith Barney, but the hook was far more personal because Grubman and others gave Ebbers (and other officers of client companies) the opportunity to be first purchasers of hot IPO stocks. The figures in Congressional records indicate that Ebbers made $11 million in profits from investments in 21 IPOs recommended to him by Grubman (Morgenson 2002a, 2002b, 2002c).

Salomon and others later faced charges of profiteering on the IPO allocations (Valdmanis and Backover 2002). All denied any *quid pro quo* arrangement, but the impression left on the market and investor trust was indelible.

Far more was at stake for Citicorp than simply the investment banking business from WorldCom. In fact, the loans were tied to the value of WorldCom stock (Pulliam, Solomon, and Mollenkamp 2002). WorldCom's biggest lender was Citicorp, and it served as personal lender for Ebbers. One expert noted:

> Looking back, it looks more and more like a pyramid scheme. The deals explain why people were not more diligent in making decisions about funding these small companies. If the money was spread all over the place and everyone who participated early was almost guaranteed a return because of the hype, they had no incentive to try and differentiate the technology. And in the end, all the technology turned out to be identical and commodity-like. (Backover 2002)

Only after WorldCom stock had lost 90 percent of its value, just six weeks before its collapse, did Grubman issue his first negative recommendation on WorldCom, despite having issued negative recommendations on other telecom companies. Grubman, however, had doubts about WorldCom that he expressed privately even as he continued to issue nothing but positive reports on WorldCom. In e-mails uncovered by an investigation of analysts conducted by Spitzer, Grubman complained privately that he was forced to continue his buy ratings on stocks that he considered "dogs" (Gasparino 2002).

But the e-mails revealed more than candor about Grubman's recommendations. Grubman, the father of twins, wanted to see them admitted to one of Manhattan's most prestigious preschools—92nd Street Y—as the following memo to Sanford Weill, the chairman of Citigroup, reveals:

> On another matter, as I alluded to you the other day, we are going through the ridiculous but necessary process of pre-school applications in Manhattan. For someone who grew up in a household with a father making $8,000 a year and for someone who attended public schools, I do find this process a bit strange, but there are no bounds for what you do for your children.
>
> Anything, anything you could do Sandy would be greatly appreciated. As I mentioned, I will keep you posted on the progress with AT&T which I think is going well.
>
> Thank you.

Citigroup pledged $1 million to the school at about the same time Grubman's children were admitted, and Weill asked Grubman to "take a fresh look" at AT&T, a major corporate client of Citigroup on whose board Weill served (even as AT&T's CEO, C. Michael Armstrong, served on Citigroup's board). Weill was counting on Armstrong's support to oust John Reed as co-CEO of Citigroup. Grubman then sent the following in an e-mail to Carol Cutler, another New York analyst, which brings the preschool admissions full circle with market analysis and battles for board control:

> I used Sandy to get my kids in the 92nd Street Y pre-school (which is harder than Harvard) and Sandy needed Armstrong's vote on our board to nuke Reed in showdown. Once the coast was clear for both of us (i.e., Sandy clear victor and my kids confirmed) I went back to my normal self on AT&T.

Grubman had upgraded AT&T from a "hold" to a "strong buy." After Reed was ousted, Grubman downgraded AT&T again. Grubman said that he sent Cutler the e-mail "in an effort to inflate my professional importance."

These actions are not close calls. Reviewing these missteps of one of the financial market's premier analysts, we are numb. There is no room for disagreement and no space for comfort in the reassurance that these are gray areas. The ethical lapses were clear; the conduct was indefensible. False impressions, falsehoods, and fraud were the results of the deep conflicts that consumed both financial and ethical judgments.

A Well-Trodden Road. The significant legislative and regulatory reforms, many still ongoing, that followed the bursting of the dot-com bubble and the Enron, WorldCom, Tyco International, and Adelphia Communications debacles represent the third great regulatory reform involving financial markets since the 1980s.

In the late 1970s and early 1980s, in the first of the three events that led to great regulatory reforms, 525 savings and loan institutions went into bankruptcy. Not only did auditors give their imprimatur to questionable accounting used by the S&Ls, they often gave clean audit opinions to insolvent S&Ls. In California, of the 36 S&Ls that went bankrupt, 28 had received clean audit opinions.[9] The reaction of Judge Stanley Sporkin to this debacle remains the classic question in all corporate financial collapses: "Where were these professionals . . . when these clearly improper transactions were being consummated? Why didn't any of them speak up or disassociate themselves from the transactions?"[10] Judge Sporkin was indicting both the lawyers and the accountants for their complicity in the collapses of most S&Ls in the United States.

Then came the era of investment banking firms and analysts giving their seal of approval to the junk bond deals, mergers, and hostile takeovers. The collapses following the wild ride of the 1980s market meant losses for bondholders that left these conservative investors with nothing but bankruptcies, even of government entities. Running simultaneously with this speculative market was a spat of insider trading that yielded many prosecutions, including those of the infamous Ivan Boesky and Michael Milken.[11]

In the third wave of scandals, analysts of the 1990s lent their credibility to teetering dot-coms and telecoms. In the aftermath, the cover of *Fortune* for 14 May 2001, just after the bubble burst, featured analyst Mary Meeker and the caption "Can We Ever Trust Again?" One year later (10 June 2002), the cover of *Fortune* featured Sallie Krawcheck and the caption "In Search of the Last Honest Analyst."[12]

The pattern in the three periods of excess followed by severe reforms is the same.[13] We lose our minds, anchors, and rational thought in the exuberance of the boom. Lines are crossed—by auditors, analysts, investors, and companies. Each in its own way pushes the envelope in terms of legal and ethical behavior, and the result is oppressive regulations that affect all who are involved in the markets. Although we cannot blame analysts for all the problems in all three eras, we can see the patterns in the behavior of all professionals associated with the markets.

In this last era of excess, analysts played a more prominent role than in the two previous collapses. One research director explained the role of analysts in the latest round of market excesses as follows:

> Prior to the bubble, I never saw an instance of an analyst being so spineless that he supported a transaction he didn't believe in. It was reputational suicide. But during the bubble, that changed. (Nocera 2004, p. 112)

Analysts became an integral part of the investment banking divisions of their companies and took a share in the deals that were brought about, often because of their recommendations (Nocera). At Credit Suisse First Boston, a group of analysts actually reported to investment banker Quattrone, subsequently convicted of obstruction of justice.

We fear nonconformity and shun the basics of finance and economics. So long as the market is rising, no one is harmed by these attitudes; there is no bad analysis because rising tides lift all boats and the dogs in them. In fact, those who dare question the emperor's clothing are often mocked or, worse, fired.

Throughout the times of the market's and analysts' enthusiasm for the likes of the WorldComs and Enrons, however, some analysts, using basic tools, questioned whether the enthusiasm for the companies that would eventually collapse was misplaced. For example, Scott Cleland, founder of Precursor Group, a Washington, DC–based investment research firm, predicted that the WorldCom–Sprint merger would fail and that if the merger failed, WorldCom would be a "dead model walking." WorldCom CEO Ebbers promptly called Cleland an "idiot." Interestingly, Cleland has been a bit of a stickler on conflicts of interest and disclosure. He owns no individual stocks, and in his interview for *Fortune* magazine on his prescient call on WorldCom, he said, "I should tell you I'm a Republican" (Gasparino, p. C1).

Enron's climb and stellar status did not charm analyst John Olson. Olson gleaned his information on Enron from talking with former employees who described the company as doing everything "on the edge" ("Why John Olson . . ." 2002). When Olson issued cautions to clients about Enron, Kenneth Lay, at that time Enron's chairman, wrote a letter to Olson's employer complaining, "John Olson has been wrong about Enron for over 10 years and is still wrong. But he is consistant [*sic*]" (Schwartz 2002). When Olson's boss showed him the note from Lay, Olson responded, "You know that I'm old and worthless, but at least I can spell consistent." Olson was quoted (Schwartz, Note 204) after Enron's collapse as believing that too many Wall Street analysts were being "schnuckels," a Yiddish word for dupes. He believed that too few "kicked the tires" of the company.

Indeed, the obvious principles of finance and economics were being left by the wayside in analyses of these companies. For example, using basic financial analysis, Bethany McLean, a liberal arts undergraduate and *Fortune* reporter, ran a story that picked up on the obvious problems with Enron, such as phenomenal earnings and no cash, but her story ran and lay dormant until Enron's collapse.[14] Peter Eavis of TheStreet.com also raised questions about Enron, including the suggestion that Enron's profit may have been a result of constant asset transfers. He also wrote about Chief Financial Officer Andrew Fastow's dual roles as CFO of Enron and principal in the companies taking title to Enron assets. No mainstream media outlets or analysts picked up on his observations or questions. Ironically, McLean has since noted that she relied on a short seller as a source of information and expertise for doing her story. So, the quality of scrutiny by those whose interests lie in the truth about a company contains a message.

In these manias that develop, there is a cycle. It begins with a lack of scrutiny that is fueled not simply by conflicted analysts but also by a media enamored of companies and stories that defy all odds. The quotations and media accolades in **Exhibit 1** are comical when examined in hindsight because they reflect an evaluation that is opposite to the failing reality of the companies involved. As we look at what we know about the companies now, we think, "Why didn't we realize the hype? Why were we so duped by the hyperbole?"

There is no substitute for solid, objective analysis that finds the Achilles heel, no matter how much resistance and no matter what the media reports and denials of the officers may say.

Reforms the Crises Hath Wrought

We are on the upside of a dramatic regulatory swing. The reforms in the area of investment analysis and management are detailed and demanding. The micro level of regulation is staggering:

- independent research on the part of the 10 largest brokerage firms (negotiated as part of a $1.4 billion settlement) at a cost estimated to be $7.5 million to $75 million over the next five years;
- independent boards of directors required at mutual funds;
- disclosure of holdings;
- codes of ethics required of investment advisors;
- training in ethics required of investment advisors;
- compliance officers required of funds and investment advisors;
- compensation disclosure requirements;
- required proxy vote disclosure;
- required costs disclosure, including costs related to investment advisement;
- rules on timing of trades to eliminate post-4:00 p.m. trading;
- restrictions on analysts attending pitch meetings for underwriting business;
- blocked phone and e-mail access between analysts and investment bankers;
- certification on analysts' reports that "all the views in this research report accurately reflect our personal views."

Exhibit 1. The Cycle Begins

Quote/Award Question	Answer
What company's CEO was named one of *Business Week*'s top managers for 2000 and 2001?	Dennis Kozlowski (Tyco)
What CFOs were named CFO of the Year for 1999, 2000, and 2001?	Andrew Fastow (Enron), Scott Sullivan (WorldCom), and Mark Swartz (Tyco)
What company was ranked #44, #24, and #22 by *Fortune* as one of the 100 best companies to work for in the 1990s?	Enron
What company was described in 2001 as having a delivery and marketing model that would change its industry?	HealthSouth
What CEO said in 2001, "We have no perks, not even parking spaces"?	Dennis Kozlowski (Tyco)
What CEO said, "We are the good guys. We are on the side of angels"?	Jeffrey Skilling (Enron)
What company had a 64-page, award-winning code of ethics?	Enron
Who said, "People have an obligation to dissent in this company. . . . I mean, I sit up there on the 50th floor, in the library. I have no idea what's going on down there, so if you've got a problem with it, speak up. And if you don't speak up, that's not good"?	Jeffrey Skilling (Enron)
What corporate founder said, "It's more than just money. You've got to give back to the community that supported you"?	John Rigas (Adelphia)
Who said, "You'll see people who in the early days . . . took their life savings and trusted this company with their money. And I have an awesome responsibility to those people to make sure that they're done right"?	Bernie Ebbers (WorldCom)
What CEO said, "Boards should be absolutely certain that the company is run properly from a fiduciary standpoint in every degree. I am a great believer in the audit committee having full access to the auditors in every way, shape, or form"?	"Chainsaw Al" Dunlap (Sunbeam's nemesis)

Note: The last three quotes are from *Fortune* (18 November 2002), p. 54. The other material and quotes were collected by the author from various sources, including interviews, company materials, and speeches.

In addition are the Sarbanes–Oxley reforms that apply to all publicly held companies, including those involved in investment banking and brokerage:

- independent boards;
- independent audit committees;
- codes of ethics and ethics training;
- officer certification of financial statements;
- increased penalties for false financial statements;
- increased penalties for securities fraud;
- increased penalties for obstruction of justice, conspiracy, and other crimes chargeable for activities such as shredding documents;
- complete regulation of the accounting and audit professions.

The reforms are not complete; pending rules are in all stages of development—from promulgation to comment to research.

Interestingly, however, even though the investment industry is under a microscope and regulations are heaped upon regulations, the spark of true reform is not present. As with the two previous cycles of regulatory reform, we have details as a proxy for change, dramatic sweeps as a substitute for true reform, and fear as an assumed impetus for ethical conversion. Also, as with the two previous reform cycles, there is the inevitable tendency for those in the regulated industry to assume that the rules are intended for "the other guys," the unethical ones in the business.

This year, both the National Association of Securities Dealers and the SEC have announced investigations of rebates and where those rebates are going:

> It's something that's talked about in the business. Some hedge funds don't put that rebate back into their funds, but rather keep it for themselves. If a rebate is going to the fund manager, and not the fund, that is a big deal. It's not the fund manager's money. (Pulliam and Zuckerman 2005)

At the heart of this practice is a lack of disclosure, dishonesty, and the basic ethical breach of taking something that does not belong to you, yet the issues have gone unaddressed despite an industry besieged not only by regulatory questions but by reputational questions and issues of trust. The firms may be in compliance with the new regulations and outfitted with compliance officers, but they have not grasped the picture of true reform. The spirit of ethics is missing even as the regulations descend and consume.

The missing spirit of ethics emerges in matters as simple as attitudes about Sarbanes–Oxley, regulators, and Spitzer. Critics of Spitzer "couple theories of his desire for a political future with theological discussions of his origins from somewhere in the bowels of hell" (Jennings 2005). There is little rationality left in the discussions about Spitzer and less recollection by many of the industry practices that led to the fury and settlements of Spitzer.

Recent studies indicate that 74 percent of us believe our ethics are higher than those of our peers and 83 percent of us say that at least one-half of the people we know would list us as one of the most ethical people they know. An amazing 92 percent of us are satisfied with our ethics and character. Now juxtapose these data with the most recent revelations about our young people and their perceptions of business and ethics. More than half of male high school students and 32 percent of the female students agree with the following statement: "In the real world, successful people do what they have to do to win, even if others consider it cheating."[15] A joint Deloitte/Junior Achievement study reveals that 82 percent of U.S. high school students believe business leaders are unethical or are not sure whether they are ethical. Among U.S. college students, cheating increased from 11 percent in 1963 to 75 percent in 2003.

Moreover, the list of companies experiencing ethical collapse doesn't end. We may have moved on from WorldCom and Enron, but the past year has brought us Parmalat, round two of restatements from Nortel, reserves overstatements from Royal Dutch/Shell, price fixing at Marsh & McLennan Companies, and the near collapse of Fannie Mae (Federal National Mortgage Association). These scandals are as large as the initial ones that began the market slide and all the reforms.

We suffer from a dependency on laws and regulations and from myopia when it comes to ethics. Until the law tells us a practice is wrong, we continue what we're doing, taking comfort in dotting the *i*'s and crossing the *t*'s to comply with detailed reforms. In focusing on the details of the reforms, we miss the big picture of industry practices that clearly cross ethical lines but continue because current regulations have not yet found them to be legally problematic.

Chairman William Donaldson of the SEC has noted that "rulemaking alone cannot reform an industry. An industry must be motivated and committed to reforming itself."[16] Paul F. Roye, former director of the SEC Division of Investment Management, recently noted:

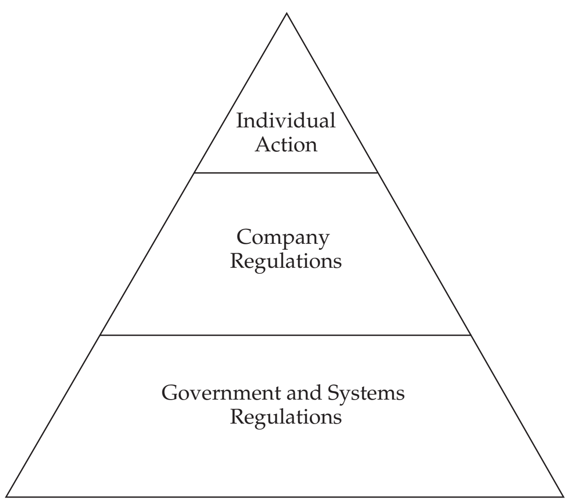
> I hope that the recent effort to review compliance policies and procedures has been therapeutic and an opportunity to rethink practices and ways of doing business, and that you have addressed or eliminated conflicts of interest and practices that can compromise investor interests. The fund business was built on trust and integrity, and trust and integrity must again become funds' hallmarks, if they are to continue to serve as the primary investment vehicle of American investors. That is why I challenge you to work seriously to implement not just the letter, but the spirit of the Commission's new mutual fund reforms. (Roye 2004b)

Embracing the spirit of the law applies to individual action and industry leadership. In all three of the regulatory cycles, true reform did not come about; that is, there was always another scandal, another loophole, another area in which abuses occurred (obvious abuses, as noted). New statutes and regulations simply made the conduct illegal; it was always unethical. The reforms in structure and practice are designed to keep the uncovered abuses from happening again. But reforms are chasing tigers, trying to catch them by the tail. They are always one step behind and incapable of keeping the tigers under control, unless the tigers agree to self-imposed control.

For example, in 1999, the SEC required mutual funds to track the stock and bond trades of their fund managers because the commission was concerned that these managers were abusing their positions by trading ahead of their purchases and sales for the funds (the market-moving blocks). Mutual fund share trades were exempt because no one anticipated, with a 4:00 p.m. eastern time close and what is in the funds at the end of the day, that their situation allowed any room for abuse. The funds proved them wrong, and now the 4:00 p.m. deadline is under additional regulation. No matter which turn the regulation takes, the market finds a means around it.[17]

The layers of responsibility for ethics are depicted in **Figure 1**. True market reform requires self-imposed control in the top layer—individual action—where the issue is whether conduct is ethical, not whether it is legal. When all the *systems* are installed at each level, we are ultimately dependent on individuals to exercise ethical courage and leadership in their companies and in the industry. Big-name lawyers as compliance chiefs and management consulting firms creating ethics programs are not substitutes for individuals with ethical spines. In the words of Stephen Cutler, the SEC's director of enforcement, all regulations and all enforcement actions are undertaken with one purpose: "Ultimately, what we're really interested in changing is behavior" (Davis 2004, p. C4).

Figure 1. Layers of Responsibility for Ethics



Cutler also expressed frustration with current investment industry attitudes and an interest in the application of ethical principles to industry conduct, not more regulations:

> Shed the blinder of "industry practice" that may have made it possible for you not to see the conflicts that surround you daily. Just because the industry has always done something "that way," don't assume it's acceptable. It won't be acceptable to your customers when they come to understand the conflicts involved. (Davis, p. C4)[18]

Achieving True Reforms

Now that this groundwork is in place—understanding that the missteps were not close calls and that true reform cannot come through regulation—the question is: How does the industry achieve true reform? The path is not quite a 12-step program, but critical elements do need attention, study, and work before reform can be realized. The following three steps were developed with the idea of changing people's mind-sets from regulatory fear and compliance to ethical leadership.

A Meaningful Ethical Compass. Moral relativism, the philosophical focus of liberal arts education from the 1960s forward, made its way into personal, business, and professional lives. The field of financial analysis was not exempt. The mantra of "there are no moral absolutes" has been used as a rationalization for inflated financial reports, commission rates for advisor fees, and favoritism for larger clients over others.

A look at the history of Merrill Lynch provides a glimpse of what was once a climate of absolutes. When Charles E. Merrill created his firm with Edmund Lynch, they had a motto: "Investigate, then invest." He formed his own firm because he was disgusted as a bond salesman for George H. Burr & Company when he realized he was pushing the bonds of companies that were near bankruptcy. As 1929 approached, Merrill told everyone that stocks were overpriced and to cash out. Perceived as a "nut," he sold his interest and left to run Safeway. Merrill was right; the rest lost their shirts. He reentered the business in 1940 with a new creation—an investment firm intended for the average person. He separated banking from research and paid analysts salaries, not commissions (Vickers 2004). His idea led to a small percentage of Americans with investments (16 percent) becoming today's figure of more than 50 percent. He did it running a business, at least through his passing in 1956, with moral absolutes. The questions we have now about analysts and investment firms are like those we had when Arthur Andersen collapsed: How do companies with such roots of absolute integrity drift so far from those founding principles? The answer lies in the word "absolute": They drift from their moral absolutes.

A moral absolute for analysts stems from the imperative to put clients first and is easily defined: Engage in no conduct that compromises reputation, integrity, or investors' perception of either.

Put more simply: If you were the client, how would you react to this conduct? Or, perhaps more relevantly for investment managers, how would you react to this conduct by your analyst if you were the client when it was finally revealed to you?

There are two ways to manage a conflict of interest under this simple standard: (1) Do not do it (and the law has taken care of much of that approach through the reforms) or (2) disclose the conflict to those affected. And the disclosure requires that those affected truly understand the conflict and the degree of that conflict. In some situations, a conflict is so pervasive and controlling that the second resolution is not a workable option. Again, the post-Enron reforms have taken care of a number of such conflicts. But the second approach should apply for future relationships.

The lawsuits by various city pension funds indicate at least a misunderstanding by the pensions, if not a misrepresentation by the investment managers, about the commission arrangements and the costs associated with that compensation arrangement versus the costs of payment in hard dollars. Whether the investment professionals believe they did disclose the information properly is not the issue. If the client feels otherwise, perception and trust are at risk.

Perception and trust are not simply controlling factors in market research credibility; they are critical for the market's viability. It is stunning to read a quote such as the following from a Morgan Stanley spokesperson in response to the Chattanooga pension suit over fee disclosures:

> The Chattanooga Pension Board was a sophisticated and knowledgeable investor that was advised by its own counsel about all aspects of its relationship with us. (Morgenson and Walsh 2004, p. 13)

This statement illustrates how industry blinders have dimmed the bright ethical lines and how legal standards have become a substitute for ethical ones. Morgan Stanley had a fiduciary relationship with the pension board. The pension fund should not need its own separate counsel to explain its relationship and fee arrangements with its investment advisor, in whom trust is necessary and has been placed.

As the data on ethical opinions indicate, nearly all of us would swear that we adhere to ethical standards—such as making sure clients understand our disclosures. Yet the ethical lapses outlined here demonstrate that many have been operating without a moral compass. What happened?

The answer is that they were not engaged in ongoing introspection that forced examination of company and industry practices outside the comfort of groupthink. Analysts did not wake up one day and say, "Wait a minute! Conflicts of interest! Unfair IPO allocations! Lying about companies that are dogs! These are the ways to make real money!" Instead, there was a gradual degradation of reputation and integrity, a slow release of discomfort at crossing ethical lines until the bright lines so obviously crossed in the lapses discussed earlier were gone. "Everybody does it." "That's the way it has always been done." "This is done at the best firms." And "Who is really harmed by it anyway?" These attitudes became the basis for ethical analysis, and the discomfort of parting ways with an ethical compass was slowly whittled away by compensation and the commonality of an industry adrift. There was little introspection because everyone was wearing the industry blinders of rationalization. The city pension lawsuits are indicative of a loss of perspective; the advisors and their companies now battle their own clients for being sophisticated investors who should have known.

Retention of moral absolutes requires constant introspection, discussion of practices, and exploration of those practices from the perspective of clients and the market, not from industry practice. Presently, the SEC is examining new issues related to conflicts of interest. One is relationships between consultants and money managers and what fuels the recommendations consultants make to their clients about their fund managers. Another is industrywide practices involving fees, conferences, and soft dollars in the form of software or other perks (Solomon 2004). Many see the relationships, the conferences, and the fee arrangements as gray areas, but there are no gray areas, only rationalizations applied to conduct that, when viewed through absolute standards, is wrong. The conduct simply becomes more palatable when cushioned with the justification of industry practice or pressures of the moment.

Proper Ethical Analysis: Seeing the Issues and Avoiding Chicken-and-Egg Ethics.[19] In groups, industries, and companies where the ethical compass is askew, ethical analysis is also askew. Few things are more aggravating for a business ethicist than to watch debates on ethical issues in which the participants have missed the ethical issue altogether. The following excerpt from the audit field offers an example that induces such aggravation. It is taken from a Statement on Standards for Accounting and Review Services (SSARS) interpretation from the American Institute of Certified Public Accountants:

- Question (SSARS No. 1): When, during the performance of a compilation or a review engagement, the accountant suspects that a fraud or an illegal act may have occurred, what steps should be taken in performing the required communication?
- Interpretation: When an accountant suspects that a fraud or an illegal act may have occurred 1) the accountant communicates the matter, *unless clearly inconsequential*, to an appropriate level of management. If the suspected fraud or illegal act involves senior management, the matter should be communicated to an individual or group at the highest level within the entity, such as the manager (owner) or the board of directors. When the suspected fraud or illegal act involves an owner of the business, the accountant should consider resigning from the engagement. 2) Additionally, the accountant should consider consulting with his or her legal counsel and insurance provider whenever fraud or an illegal act is suspected. [Emphasis added.]

Focus on the term "unless clearly inconsequential" and recall that the question is whether the auditor must take steps to disclose illegal acts or fraud. When is illegality or fraud by an audit client inconsequential? The amount involved may be immaterial, but if the auditor has uncovered fraud or illegality by officers of a company, the future looks a bit foreboding.

Nonetheless, an analysis by a CPA of the problem offered the following:

> "We are asking management if they have knowledge of any fraud or suspected fraud involving management or others, *where fraud could have a material effect on the financial statements*," Cohen, an NYSSCPA [New York State Society of Certified Public Accountants] board member, said of the standard. "We are required to ask that question in the inquiries and then put it in the representation letter so management signs off on it. That's what the difference is, that was not there in the past." (Dismukes 2004) [Emphasis added.]

Again, focus on that phrase in italics and consider: When does fraud *not* have a material effect on the financial statements? When does the public *not* deserve to know that the officers of a company have engaged in just a teeny, tiny fraud? Lawyers once developed a similar standard excusing them from reporting the fraud of a client if it could prove embarrassing. To paraphrase the American Bar Association's rule on lawyer disclosure of such client misdeeds, fraud is almost always embarrassing, so an ethical analysis based on this standard would conclude that fraud need not be reported.

These issues and their resolutions are classically referred to as "sandbox" dilemmas and resolutions. The issues are resolved within the context of the industry, profession, or company's sandbox rules—the industry's way-we've-always-done-it rules—without reference to the ethics of virtue or moral absolutes. The resolution is inherently flawed because the blinders of the rules of play lead those affected to resolve the wrong dilemma. For example, one accounting profession ethical dilemma is as follows: What does the auditor do when he or she discovers through one client that purchases services from another client that the second client is about to lose that contract? The question is posed as "Does the auditor say anything to the other client?" This question shows that those in the auditing profession miss the ethical issue. The real issue is why the auditor took two companies with such conflicting interests as audit clients. The initial decision to handle both clients, with each possessing sensitive information about the other, was flawed, and the dilemma was bound to result.

Perhaps in the field of financial analysis, some of the initial decisions on industry practices, compensation, and structure were similarly flawed and the result was the misguided resolution of ethical dilemmas. The issue is not whether the Chinese Wall was breached. The issue is: Whatever made us think a Chinese Wall would work in the first place?

These types of dilemmas remind us of the great moral dilemmas and decline in the novel *A Simple Plan* by Scott Smith. Three friends come across millions in a crashed plane that has been buried in the snow. The plane was that of a drug runner, and the three friends remove the money, hide it, and plan to split it and then move to warmer climes once spring comes and the investigation of the plane and accident are completed. They will live elsewhere and spend their treasure trove without anyone noticing. From that moment on, the friends must lie, steal, and even backstab each other to keep their secret. They are even forced to resort to murder for the sake of preserving their money. The dilemmas they face in their concealment are what they debate and resolve, each time sinking farther into moral bankruptcy. They do not realize until it is too late that it was their initial decision to take the money that did not belong to them that was flawed. Every subsequent decision simply led them down a path of further corruption. Spotting and resolving ethical issues as they arise, not ignoring them until another crisis arises, is a key to the industry restoring its reputation and trust.

Heartfelt Reform and Individual Ethical Courage. A glance through the coverage of the industry in the financial press paints a picture of an industry besieged—but also resistant. Each speech by an SEC commissioner or regulator carries an overarching theme: Change yourselves or we will have to do it for you. Consider this example from Roye:

> I'd like to conclude my remarks by stating what should be obvious to all of us: Investors are asking whether they can trust the investment management industry. Winning back the trust of these investors will require effort and commitment—commitment to compliance, commitment to ethics, commitment to reform. As I have said before, the status quo is no longer acceptable to America's investors. Nor will they accept empty promises of reform. They are looking for action; they are looking for meaning behind the words; they expect a reinvigorated, investor-oriented investment management industry. (Roye 2004a)

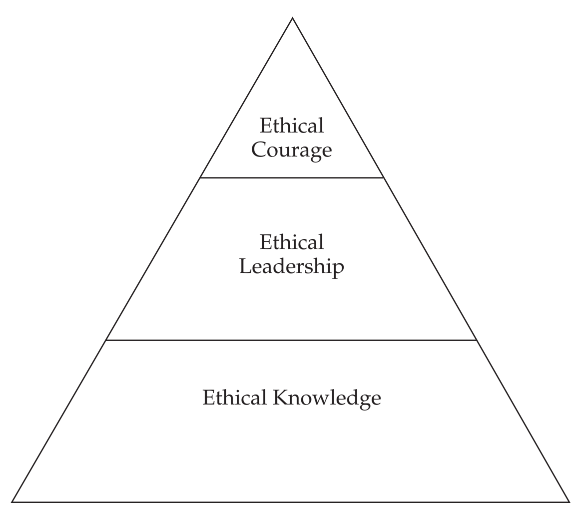
Or consider a similar plea from another of his speeches:

> I further encourage you to commit the energy and resources that are necessary to fully implement the reforms so that they will foster an ethical atmosphere at fund firms and a focus on the needs and interests of fund investors. As the scandals revealed, many fund firms were not focused on their core responsibilities of serving their investors. Instead they were cutting unlawful quid pro quo deals to grow assets under management and maximize fund fees. Greed overtook integrity and a focus on profitability triumphed over firms' focus on fiduciary obligation and responsibility.
>
> All of us involved in managing, distributing and overseeing mutual funds must guard against these types of unhealthy attitudes from again infiltrating the fund business. When I asked one industry executive about the reason for the late trading and market timing abuses, he attributed the problem to the rapid growth of, and new entrants to, the fund business. But our enforcement docket is replete with names of old-line mutual fund organizations. (Roye 2004b)

The plea from the regulators—and, indeed, the plea I am making in this piece—is for individual ethical courage and organizational and individual ethical leadership. Dean Ned Hill of the Marriott School of Business at Brigham Young University has asked whether we have evolved from the point of simply having ethical knowledge to the point of acting on that knowledge through ethical courage and ethical leadership. His question can be formed into another pyramid that depicts what constitute the evolutionary keys necessary for true reform. The pyramid in **Figure 2** shows this ethical evolution. The pyramid in Figure 1 and the pyramid in Figure 2 meet, as they should, on the point of individual action born of individual courage and individual leadership within structural and systemic reforms.

As reforms are debated, opportunities arise that both analysts and investment firms can seize to position themselves as market leaders in the restoration of trust.[20] Far more is at stake than individual and company reputations. Markets do not function without trust. Capitalism depends on investor

Figure 2. Ethical Evolution



Source: Developed from thoughts by Dean Ned Hill, Marriott School of Management, Brigham Young University.

trust, and investor trust comes from the consistent, vigilant exercise of ethics by market participants, not from mere compliance. These past three years have been turbulent and trying times for investment firms. Embracing true reform, however—reform that consists of moral absolutes and vigilance in retaining the bright line between right and wrong—can restore the reputations that have been tarnished by years of ethical drift. Statutes, codes, and structural reforms cannot change an industry. Individual actions and ethical courage can.

Notes

1. Quattrone forwarded a 22-word e-mail from his colleague, a lawyer, Richard Char, to his staff on 5 December 2000 that included a suggestion to his employees that they "clean-up those e-mails," a reference to the company's document retention and destruction policy, and the additional caveat, "I strongly advise you to follow these procedures." (See Sorkin 2004; portions of the quote were also found in Valdmanis 2004b.)
2. The settlement total was $1.4 billion from a series of cases brought by Spitzer, who detected the pattern of conflicts by sorting through e-mails from analysts that contained statements that were inconsistent with their recommendations and public statements about the stock (Valdmanis 2004a).
3. Interestingly, the review process for the 1998 article carried with it some tension when those reviewing the article objected to stating that there were conflicts of interest in the way analysts were employed and the structuring of their compensation. The article appeared only after language of appeasement was added to the piece.
4. Smith (2004). Becker resigned from Lehman while the investigations were pending.
5. The SEC (1998) described the conflict as follows: "Under traditional fiduciary principles, a fiduciary cannot use assets entrusted by clients to benefit itself. As the Commission has recognized, when an adviser uses client commissions to buy research from a broker-dealer, it receives a benefit because it is relieved from the need to produce or pay for the research itself. In addition, when transactions involving soft dollars involve the adviser 'paying up' or receiving executions at inferior prices, advisers using soft dollars face a conflict of interest between their need to obtain research and their clients' interest in paying the lowest commission rate available and obtaining the best possible execution."
6. The soft dollar phenomenon came into effect in May 1975 when the practice of fixed commissions was abandoned.
7. Section 28(e), known as the "safe harbor provision," was added to the Securities Exchange Act in 1975; among other things, it allows money managers to use the commission dollars of their advised accounts to obtain research and brokerage services. Also, it allows market forces to have more effect on commissions and analysis. CFA Institute standards on soft dollars may be found at www.cfainstitute.org/standards/ethics/soft_dollar/.
8. One survey found that 75 percent of respondents could not accurately define a fund expense ratio and 64 percent did not understand the impact of expenses on fund returns ("Investors Need to Bone Up on Bonds and Costs . . ." 2002).
9. For descriptions of the role of Charles Keating in the S&L scandal, see Stevenson (1991). For information on Keating's prison sentence, see Schine (1990).
10. Lincoln Savings & Loan Ass'n v. Wall, 743 F. Supp. 901, at 920 (D.D.C. 1990).
11. For background on Milken, Boesky, and junk bonds, see Smith (1997). See also Stewart (1991).
12. And beneath the caption was the stinging phrase, "Her analysts are paid for research, not deals."
13. The S&L collapse reforms are largely found in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), 12 U.S.C. § 191 *et seq.*, which required new minimum capital requirements for loans. The Boesky–Milken excesses brought us the Insider Trading Sanctions Act, 15 U.S.C. § 78u-l (2002), which made it possible for the government to recover as a penalty three times the amount of profit made or loss avoided from the inside deal. Also, the Insider Trading and Securities Fraud Enforcement Act, 15 U.S.C. § 78ff (2002), upped the penalties for insider trading to 10 years and $1 million (now increased again as a result of the Sarbanes–Oxley Act).
14. Barringer (2002). In this story, *Fortune*'s managing editor, Rik Kirkland, said McLean's March 2001 story on Enron was "prescient, but it kind of went out and sank."
15. From the 2004 Josephson studies on character among youth: available at josephsoninstitute.org/Survey2004/.
16. Available at www.sec.gov/news/speech/spch120604pfr.htm.
17. In the accounting profession, the saying goes, "It takes the FASB four years to come up with a rule and the finance guys about four hours to find a way around it."
18. The areas of focus for the SEC's exploration of conflicts are expected to be hedge funds and client favoritism.
19. Chicken-and-egg ethics bogs down in the question of which comes first—personal or organizational ethics. According to Hamilton (2002), "Regardless of which comes first, personal or organizational ethics, both must move towards a higher ground."
20. A series of ads by TD Waterhouse contains the following language in large print: "'Objective, independent, third-party research.' Can your broker say that?" The copy in the ad emphasizes that the research does not come from "in-house research analysts."

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