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THE FINANCIAL PAGE

THE TALKING CURE

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When you think of Wall Street, candor is probably not the first word that leaps to mind, but in the past few months the Street has been gripped by it. Merrill Lynch now warns, on the first page of each of its research reports, that it may be seeking "investment banking or other business relationships from the companies covered in this report." (That is to say, the analysis may be tainted.) The New York Stock Exchange, meanwhile, has proposed a rule that would bar a stock-market analyst from talking to newspapers that fail to disclose the analyst's conflicts of interest. Even the C.E.O. of Goldman Sachs, one of Wall Street's most discreet firms, has chimed in with a public *nostra culpa* on behalf of the industry, and has exhorted his peers to restore "trust in our system."

This outbreak of straight talk is Wall Street's way of addressing the collapse of its credibility. Everyone agrees that conflicts of interest riddle the securities and accounting industries research analysts touting dubious companies to win their business, auditors signing off on dubious numbers to keep it and that something must be done, so Wall Street has decided to adopt the talking cure. The problem with the conflicts of interest, the argument goes, is that no one knows about them. Fess up, and the problem goes away.

It's a nice thought, but the diagnosis is facile, and the remedy won't work. Start with the central tenet: that during the boom the conflicts of interest were kept secret. The truth is, people knew more than they like to admit. Back in 1998, a Business Week cover story called "Wall Street's Spin Game" put the matter succinctly: "The analyst today is an investment banker in sheep's clothing." When Merrill Lynch hired Henry Blodget as an Internet analyst in 1999, the media explained the decision by saying that Blodget, with his rosy predictions, would help the firm bring in more investment-banking business. Jack Grubman, the former Salomon Smith Barney analyst, bragged of his intimate relationship with the companies he was supposed to be evaluating objectively. And the problems in the accounting industry were even more obvious. Though the firms maintained their game face, it was no secret, by the late nineties, that the game itself was rigged. Most investors accepted this state of affairs with the genial tolerance of pro-wrestling fans.



this week's talk

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Why? One reason, clearly, was the boom itself people didn't care why an analyst recommended a stock, as long as it went up. But there was something else: it turns out that people think conflicts of interest don't much matter. "If you disclose a conflict of interest, people in general don't know how to use that information," George Loewenstein, an economics professor at Carnegie Mellon, says. "And, to the extent that they do anything at all, they actually tend to underestimate the severity of these conflicts."

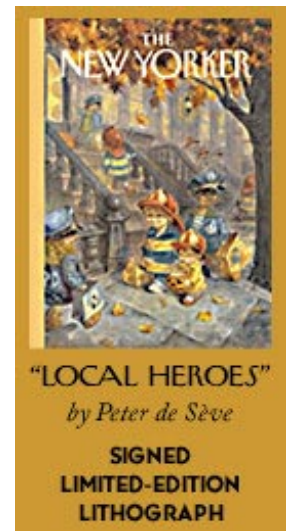
Usually, conflicts of interest lead not to corruption but, rather, to unconscious biases. Most analysts try to do good work, but the quid-pro-quo arrangements that govern their business seep into their analyses and warp their judgments. (Warped judgments subvert the market; although even honest analysts have a hard time picking stocks, everyone benefits from the flow of sound information.) "People have a pretty good handle on overt corruption, but they don't have a handle on just how powerful these unconscious biases are," Loewenstein says.

To test the idea, Loewenstein and his colleagues Don Moore and Daylian Cain devised an experiment. One group of people (estimators) were asked to look at several jars of coins from a distance and estimate the value of the coins in each jar. The more accurate their estimates, the more they were paid. Another group of people (advisers) were allowed to get closer to the jars and give the estimators advice. The advisers, however, were paid according to how high the estimators' guesses were. So the advisers had an incentive to give misleading advice. Not surprisingly, when the estimators listened to the advisers their guesses were higher. The remarkable thing was that even when the estimators were told that the advisers had a conflict of interest they didn't care. They continued to guess higher, as though the advice were honest and unbiased. Full disclosure didn't make them any more skeptical.

In the course of the experiment, Loewenstein discovered something even more startling: that disclosure may actually do harm. Once the conflict of interest was disclosed, the advisers' advice got worse. "It's as if people said, 'You know the score, so now anything goes,'" Loewenstein says. Full disclosure, by itself, may have the perverse effect of making analysts and auditors more biased, not less.

Obviously, we shouldn't keep conflicts of interest secret. But revealing them doesn't fix a thing. To restore honesty to analyses and audits, you need to get rid of the conflicts themselves. That means completely separating research from investment banking, as Citigroup did in October, and barring auditors from serving as consultants and making companies bring in new auditors every few years, as regulators have proposed.

It has become a truism on Wall Street that conflicts of interest are unavoidable. In fact, most of them only seem so, because avoiding them makes it harder to get rich. That's why full disclosure is suddenly so popular: it requires no substantive change. "People are grasping at the straw of disclosure because it allows them to have their cake and eat it, too," Loewenstein says. Transparency is well and good,



but accuracy and objectivity are even better. Wall Street doesn't have to keep confessing its sins. It just has to stop committing them.

James Surowiecki

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