Since the end of the stock market boom in 2000, financial markets have been jolted by one corporate scandal after another. The cycle began in December 2001 with the spectacular bankruptcy of Enron Corporation (once valued as the seventh-largest corporation in the United States) and the indictment of Enron's auditor, Arthur Andersen, one of the then-“Big Five” accounting firms. Subsequently, revelations of misleading accounting statements at numerous other corporations, including WorldCom, Tyco Industries, and Fannie Mae, have increased investors’ doubts about the quality of information coming from the corporate sector. Criminal cases have been filed against all of the top investment banks (Morgan Stanley, J. P. Morgan, Merrill Lynch, Lehman Brothers, and Goldman Sachs, among others) that encouraged their stock analysts to hype dubious stocks, which later proved to be disastrous investments.

These scandals have attracted tremendous public attention for several reasons. First, the resulting bankruptcies cost employees of these firms their jobs, their pensions, or both. Second, these activities may have been a factor in the massive stock market decline that occurred from March 2000 to September 2002; during this downturn, the value of the S&P 500 index declined by 50% and NASDAQ's value declined by 75%. Third, the scandals have created doubts about the ethics of those working in the financial service industry.

Conflicts of interest, a type of moral hazard problem that occurs when a person or institution has multiple objectives (interests) and as a result has conflicts between them, may be responsible for the recent scandals. Conflicts of interest may have played an important role in the subprime financial crisis of 2007–2008 by compromising the quality of credit ratings. In each case, people who were supposed to act in the investing public's best interests by providing investors with reliable information had incentives to deceive the public and thereby benefit both themselves and their corporate clients. What are these conflicts of interest, and how serious are they? Where do they occur, and why have they been the source of the recent woes in financial markets? What should, and can, we do about them?

This chapter provides a framework for answering these questions. It first explains what conflicts of interest are, why we should care about them, and why they raise ethical issues. It then surveys the different types of conflicts of interest in the financial industry and discusses policies to remedy them.1

WHAT ARE CONFLICTS OF INTEREST AND WHY ARE THEY IMPORTANT?

In Chapter 8, we saw how financial institutions play a key role in the financial system. Specifically, their expertise in interpreting signals and collecting information from their customers gives them a cost advantage in the production of information. Furthermore, because they collect, produce, and distribute this information, financial institutions can use the information over and over again in as many ways as they would like, thereby realizing economies of scale. By providing multiple financial services to their customers, they can also realize economies of scope—that is, they can lower the costs of information production for each service by applying one information resource to many different services. A bank, for example, can evaluate the creditworthiness of a corporation when making a loan to it, which then helps the bank decide whether it would be easy to sell the bonds of this corporation to the public. Additionally, by providing multiple financial services to their customers, financial institutions can develop broader and longer-term relationships with firms. These relationships further reduce the cost of producing information and, therefore, enhance economies of scope.

Although economies of scope may substantially benefit financial institutions, they also create potential costs in the form of conflicts of interest. Although conflicts of interest arise in almost all aspects of our lives, we need to be precise about the conflicts of interest that concern us here. Given the crucial role of information in financial markets, we focus on those conflicts of interest that arise when financial service firms or their employees serve one interest at the expense of another, that is, their own interest rather than their customers', or the interest of a firm that wants to sell securities rather than the interest of investors who want to purchase the securities. As a result, the firms or their employees might misuse information, provide false information, or conceal information.

Conflicts of interest may occur within financial institutions that provide a specialized service, but they are most problematic when an institution provides multiple financial services to a given client or to many clients. The competing interests of these services may lead employees or a department of a financial institution to conceal information or disseminate misleading information to financial markets. Combinations of services that bring together any group of depository intermediaries, nondepository intermediaries, and brokers, or that allow any of these groups to invest directly in a business, are most likely to lead to conflicts of interest.

Why Do We Care About Conflicts of Interest?

Conflicts of interest can substantially reduce the quality of information in financial markets, thereby increasing asymmetric information problems. In turn, asymmetric information prevents financial markets from channeling funds into the most productive investment opportunities and causes financial markets and the economy to become less efficient.

ETHICS AND CONFLICTS OF INTEREST

Conflicts of interest raise ethical dilemmas for those engaged in the financial service business by generating incentives for financial service firms or their employees to conceal or provide misleading information, thereby hurting the customers for whom they
work. The growing economies of scope in the financial industry that have led financial institutions to offer more services under one roof have increased conflicts of interest and, not surprisingly, led to more unethical behavior. One way to limit unethical behavior is to make those working in the financial industry aware of the ethical issues that arise when they exploit conflicts of interest; with this awareness, employees are less likely to engage in unethical behavior. To address this need to limit unethical behavior, business schools are now bringing the discussion of ethics into the classroom and firms are establishing policies (discussed later in this chapter) that make it harder for individuals to exploit conflicts of interest.

**TYPES OF CONFLICTS OF INTEREST**

Four areas of financial service activities harbor the greatest potential for generating conflicts of interest that ultimately reduce the amount of information available in financial markets:

- Underwriting and research in investment banking
- Auditing and consulting in accounting firms
- Credit assessment and consulting in credit-rating agencies
- Universal banking

**Underwriting and Research in Investment Banking**

Investment banks perform two tasks: They *research* corporations issuing securities, and they *underwrite* these securities by selling them to the public on behalf of the issuing corporation. Investment banks often combine research and underwriting because the information synergies created may lead to economies of scope. In other words, information that is produced for one task is also useful for another task. A conflict of interest arises between research and underwriting because the investment bank attempts to serve the needs of two client groups—the firms for which it is issuing the securities and the investors to whom it sells these securities.

These client groups have different information needs: Issuers benefit from optimistic research, whereas investors desire unbiased research. Due to economies of scope, however, both groups will receive the same information. When the potential revenues from underwriting greatly exceed brokerage commissions, the investment bank has a strong incentive to alter the information provided to both types of clients so as to favor the issuing firms’ needs. If the information provided is not favorable to the issuing firm, it might take its business to a competitor that is willing to put out more positive information and thereby entice more people to buy the newly issued stock. For example, an internal Morgan Stanley memo excerpted in the *Wall Street Journal* on July 14, 1992, stated: “Our objective … is to adopt a policy, fully understood by the entire firm, including the Research Department, that we do not make negative or controversial comments about our clients as a matter of sound business practice.”

Because of directives like this one, analysts in investment banks might be persuaded to distort their research to please the underwriting department of their bank and the corporations issuing the securities and indeed this seems to have happened during the tech boom of the 1990s. Of course, such actions undermine the reliability of the information that investors use to make their financial decisions and, as a result, diminish the efficiency of securities markets.
Web Chapter 3

Conflicts of Interest in the Financial Industry

FyI Frank Quattrone and Spinning

Frank Quattrone of Credit Suisse First Boston was a highly regarded investment banker specializing in technology companies. But his reputation took a big hit in March 2003, when the National Association of Securities Dealers (NASD) filed a complaint against him for improperly pressuring his analysts to provide favorable coverage in an effort to solicit customers for his firm. Allegedly, Quattrone linked his analysts’ bonuses to their investment banking work and permitted executives of companies whose stock he handled to make changes in his staff’s draft research reports.

NASD also accused Quattrone of spinning because he maintained more than 300 “Friends of Frank” accounts for executives of technology companies that were active or prospective clients of the bank. These “friends” were allocated hot shares at his discretion. Spinning was not isolated to Quattrone’s firm; it was actually quite common on Wall Street. Salomon Smith Barney also allocated hard-to-get IPO shares to a number of executives, including Bernard Ebbers of WorldCom, Philip Anshutz and Joe Nacchio of Qwest, Stephen Garfalo of Metromedia, and Clark McLeod of McLeodUSA. The bank claimed that it issued shares to these executives because they were among the firm’s best individual customers and not because it wanted to persuade these executives to channel their companies’ investment banking business to Salomon Smith Barney. This claim was deemed dubious, at best. Quattrone was convicted in 2004 (the conviction was later overturned) of obstructing the investigation into his activities and was sentenced to eighteen months in prison.

Another practice that exploits conflicts of interest is spinning. Spinning occurs when investment banks allocate hot, but underpriced, initial public offerings (IPOs), shares of newly issued stock, to executives of other companies that may potentially have business with the investment bank (see the FYI box, “Frank Quattrone and Spinning”). Because hot IPOs typically rise immediately in price after they are first purchased by investors, spinning is a form of kickback to other firms’ executives, luring them to use that investment bank. When the executive’s company plans to issue its own securities, he or she will be more likely to use as an underwriter the investment bank that gave the executive the hot IPO shares, which is not necessarily the investment bank that could get the highest price for the firm’s securities. This action may raise the cost of capital for the firm, and therefore hinder the efficiency of the capital market.

Auditing and Consulting in Accounting Firms

Traditionally, an auditor reduces the information asymmetry between a firm’s managers and its shareholders by checking the firm’s books and monitoring the quality of the information the firm produces. Auditors play an important role in financial markets because they can reduce the inevitable information asymmetry between the firm’s managers and its shareholders.

Threats to truthful reporting in an audit arise from several potential conflicts of interest. The conflict of interest that has received the most attention in the media occurs when an accounting firm provides its client with auditing services and nonaudit consulting services—commonly known as management advisory services—such as advice on taxes, accounting or management information systems, and business strategies. Accounting firms that provide multiple services enjoy economies of scale and scope, but have two potential sources of conflicts of interest. First, clients may pressure auditors into skewing
In 1913, Arthur Andersen, a young accountant who had denounced the slipshod and deceptive practices that enabled companies to fool the investing public, founded his own firm. Until the early 1980s, auditing was the most important source of profits for this firm. By the late 1980s, however, the consulting part of the business began to experience high revenue growth with high profit margins, even as the audit profits slumped in a more competitive market. Consulting partners began to assume more power within the firm, and the resulting internal conflicts split the firm in two. Arthur Andersen (the auditing service) and Andersen Consulting were established as separate companies in 2000.

During the period of increasing conflict before the split, Andersen’s audit partners had faced growing pressure to focus on boosting revenue and profits from audit services. Many of Arthur Andersen’s clients that later went bust—Enron, WorldCom, Qwest, and Global Crossing—were also the largest clients in Arthur Andersen’s regional offices. The combination of intense pressure to generate revenue and profits from auditing and the fact that some clients dominated the business of regional offices translated into tremendous incentives for regional office managers to provide favorable audit stances for these large clients. The loss of a client such as Enron or WorldCom would have been devastating for a regional office and its partners, even if that client contributed only a small fraction of the overall revenue and profits for Arthur Andersen as a whole.

The Houston office of Arthur Andersen, for example, ignored many problems in Enron’s reporting. Arthur Andersen was indicted in March 2002 and then convicted in June 2002 for obstruction of justice for impeding the SEC’s investigation of the Enron collapse (the conviction was overturned by the Supreme Court in May 2005). Its conviction—the first ever against a major accounting firm—barred Arthur Andersen from conducting audits of publicly traded firms and so effectively put it out of business.

Credit Assessment and Consulting in Credit-Rating Agencies
Investors use credit ratings (e.g., Aaa or Baa) that reflect the probability of default to determine the creditworthiness of particular debt securities. As a consequence, debt ratings play a major role in the pricing of debt securities and in the regulatory process. Conflicts of interest can arise when multiple users with divergent interests (at least in the short term) depend on the credit ratings. Investors and regulators are seeking a well-researched, impartial assessment of credit quality; the issuer needs a favorable rating. In
the credit-rating industry, the issuers of securities pay a rating firm such as Standard and Poor’s or Moody’s to have their securities rated (see the FYI box). Because the issuers are the parties paying the credit-rating agency, investors and regulators worry that the agency may bias its ratings upward to attract more business from the issuer. The answer is provided by the asymmetric information framework, which was discussed in Chapter 8. By the early 1970s, technological changes, such as the advent of cheap photocopying, made it easier to disseminate information. Market participants were able to readily get information on securities ratings without paying for it. The free-rider problem became more widespread. As a result, the credit-rating agencies were no longer able to earn enough revenues by selling ratings information. The solution was to have the issuers of securities pay for the ratings, and this is the business model that we see currently.

**Universal Banking**

Commercial banks, investment banks, and insurance companies were originally created as distinct financial institutions that offered separate and distinct services. These institutions soon recognized, however, that combining these activities and services would provide economies of scope. In 1933, the Glass-Steagall Act halted the development of universal banking in the United States by banning the consolidation of these services under one organization. When the Glass-Steagall Act was repealed by Congress in 1999, universal banking reappeared. Given that the divisions within universal banks serve multiple clients, many potential conflicts of interest exist. If the potential for revenues in one department increases, employees in that department will have an incentive to distort information (or to pressure employees in another department to distort information) to the advantage of their clients and the profit of their department.

Several types of conflicts of interest can arise in universal banks:

- Securities issuers served by the underwriting department (and the underwriting department itself) will benefit from aggressive sales of the securities issue to customers of the bank, whereas the customers expect unbiased investment advice.
Credit-Rating Agencies and the Subprime Financial Crisis

The credit-rating agencies have come under severe criticism for the role they played during the subprime financial crisis. The rating agencies advised clients on how to structure complex financial instruments that paid out cash flows from subprime mortgages. At the same time, they were rating these identical products, leading to the potential for severe conflicts of interest. Specifically, the large fees they earned from advising clients on how to structure products that they were rating meant they did not have sufficient incentives to make sure their ratings were accurate.

When housing prices began to fall and subprime mortgages began to default, it became crystal clear that the rating agencies had done a terrible job of assessing the risk in the subprime products they had helped to structure. Many AAA-rated products had to be downgraded over and over again until they reached junk status. The resulting massive losses on these assets were one reason why so many financial institutions who were holding them got into trouble, with absolutely disastrous consequences for the economy, as discussed in Chapter 9.

Criticisms of the credit-rating agencies led the SEC to propose comprehensive reforms in 2008. The SEC concluded that the credit-rating agencies’ models for rating subprime products were not fully developed and that conflicts of interest may have played a role in producing inaccurate ratings. To address conflicts of interest, the SEC prohibited credit-rating agencies from structuring the same products they rate, prohibited anyone who participates in determining a credit rating from negotiating the fee that the issuer pays for it, and prohibited gifts from bond-issuers to those who rate them in any amount over $25. In order to make credit-rating agencies more accountable, the SECs new rules also required more disclosure of how the credit-rating agencies determine ratings. For example, the rating agencies were required to disclose historical ratings performance, including the dates of downgrades and upgrades, information on the underlying assets of a product that were used by the credit-rating agencies to rate a product, and the kind of research they used to determine the rating. In addition, the SEC required the rating agencies to differentiate the ratings on structured products from those issued on bonds.

The hope is that these reforms will bring increased transparency to the ratings process and reduce the conflicts of interest that played such a large role in the subprime debacle.

- A bank manager may push the issuing firm’s securities to the disadvantage of the customer or may limit losses from a poor IPO by selling the firm’s securities to the bank’s managed trust accounts.
- A bank with an outstanding loan to a firm whose credit or bankruptcy risk has increased has private knowledge that may encourage the bank to use its underwriting department to sell bonds to the unsuspecting public, thereby paying off the loan and earning a fee.
- A bank may make loans to a firm on overly favorable terms to obtain fees from it for performing activities such as underwriting the firm’s securities.
- To sell its insurance products, a bank may try to influence or coerce a borrowing or investing customer.

All of these conflicts of interest may decrease the amount of accurate information production by the universal bank, thereby hindering its ability to promote efficient credit allocation. Although there have not been any recent banking scandals involving conflicts of interest, they did surface in the aftermath of the stock market crash of 1929 (see the FYI box, “Banksters”).
Conflicts of Interest in the Financial Industry

FYI  Banksters

Just as in the aftermath of the collapse of the tech bubble in 2000, the stock market crash of 1929 prompted many investors to question why they had been encouraged to purchase so many securities that declined in value so quickly. The public blamed the universal banks for hyping securities, and bankers were pejoratively referred to as “banksters” to equate them with gangsters. Public pressure led the Senate Banking and Currency Committee to hold hearings to investigate potential abuses by the universal banks. These hearings, which became known as the Pecora hearings after the chief counsel who led them, were as famous in their day as the Watergate hearings that led to President Nixon’s resignation in 1974 or the hearings of the 9/11 Commission in 2004.

The Pecora hearings turned up several cases of apparently severe abuses of conflicts of interest in the banking industry. An affiliate of National City Bank (the precursor to Citibank) was accused of selling “unsound and speculative securities” to the bank’s customers, particularly bonds from the Republic of Peru that went into default. Chase National Bank and National City Bank were accused of converting bad loans to companies such as General Theaters and Equipment and the General Sugar Company into securities that were sold to the public and investment trusts managed by these banks. The president of National City Bank, Charles E. Mitchell, and the head of Chase National Bank, Albert H. Wiggin, were accused of setting up pool operations, in which resources from the banks were used to prop up the bank’s stock price for the benefit of these executives and their associates.

The resulting scandals led to passage of the Glass-Steagall Act in 1933, which eliminated the possibility of these conflicts of interest by mandating complete separation of commercial banking from investment banking activities. It was not until 1999 that this act was repealed by Congress to enable banks to be more competitive.

CAN THE MARKET LIMIT EXPLOITATION OF CONFLICTS OF INTEREST?

Conflicts of interest become a problem for the financial system when they lead to a decrease in the flow of reliable information, either because information is concealed or because misleading information is disseminated. The decline in the flow of reliable information makes it harder for the financial system to solve adverse selection and moral hazard problems, which can slow the flow of credit to parties with productive investment opportunities.

Even though conflicts of interest exist, they do not necessarily reduce the flow of reliable information because the incentives to exploit the conflict of interest may not be very high. When an exploitation of a conflict of interest is visible to the market, it can punish a financial services firm by denying it business. Given the importance of maintaining and enhancing a financial firm’s reputation, exploiting any conflicts of interest would decrease the firm’s future profitability because it would have greater difficulty selling its services. In this way, the firm has incentives not to exploit a conflict of interest. These incentives limit conflicts of interest in the long run, but they may not be effective in the short run depending on structural factors within the firm, such as a lack of transparency and inappropriate monetary incentives.

One enlightening example of how the market can limit exploitation of conflicts of interest occurs in credit-rating agencies. At first glance, the fact that rating agencies are
paid by the firms issuing securities to produce ratings for these securities looks like a serious conflict of interest. Rating agencies would seem to have powerful incentives to gain business by providing security-issuing firms with higher credit ratings than they deserve, making it easier for the firms to sell their securities at higher prices. In reality, little evidence suggests that rating agencies take advantage of this conflict of interest, despite prominent examples such as Enron. Much research has shown that a reasonably close correlation exists between ratings and default probabilities. Ratings agencies do not exploit the conflict of interest because giving higher credit ratings to firms that pay for the ratings would lower the credibility of the ratings, making them less valuable to the market. The market is able to assess the quality of biased ratings because it can observe poorer performance by individual securities. Furthermore, credit-rating agencies themselves provide evidence on the relationship between their ratings and subsequent default history. If a rating agency continually gave high ratings to firms that eventually defaulted, investors in the market would no longer trust its ratings, its reputation would become tarnished, and good, nondefaulting firms would go elsewhere for their ratings. For this reason, the rating agency has an incentive not to exploit this conflict of interest and overrate the bonds of its customers.

Commercial banks that underwrote securities prior to the enactment of the Glass-Steagall Act do not appear to have exploited this conflict of interest. When a commercial bank underwrites securities, the bank may have an incentive to market the securities of financially troubled firms to the public because the firms will then be able to pay back the loans they owe to the bank, while at the same time the bank earns fees from the underwriting services. The evidence suggests that in the 1920s, markets found securities underwritten by bond departments within a commercial bank to be less attractive than securities underwritten in separate affiliates where the conflict of interest was more transparent. To maintain the bank’s reputation, commercial banks shifted their underwriting to separate affiliates over time, with the result that securities underwritten by banks became valued as highly as those underwritten by independent investment banks. When affiliates were unable to certify the absence of conflicts, they focused on underwriting securities from well-known firms, for which less of an information asymmetry existed and conflicts of interest were less pronounced. Again, the market provided incentives to control potential conflicts of interest. However, it is important to note that the market solution was not immediate, but took some time to develop.

The responsiveness of the market is also evident in the apparent conflict of interest present in investment banks when underwriters who have incentives to favor issuers over investors pressure research analysts to provide more favorable assessments of

---


issuers’ securities. Analysts at an investment bank that is underwriting particular IPOs tends to make more “buy” recommendations for these IPOs than do analysts at other investment banks, and the market takes account of this tendency in pricing these securities. Over a two-year period, the performance of other analysts’ recommended securities was 50% better than the performance of securities recommended by analysts at the investment banks that underwrote these IPOs. The market appears to recognize the difference in the quality of information when the potential for a conflict of interest exists.4

Fewer empirical studies have examined how the market addresses conflicts of interest that arise in accounting firms, but the limited evidence available does suggest that the market adjusts securities’ prices to account for potential conflicts of interest. The evidence suggests that clients, who are concerned about the conflicts of interest that arise from the joint provision of auditing and management advisory services, ascribe less value to audit opinions and limit their nonaudit purchases from the accounting firms that have these conflicts of interest.5

Although the market can sometimes ameliorate the effects of conflicts of interest in financial services firms, it cannot always constrain the incentives to exploit conflicts of interest. For the market to prevent this type of exploitation, it needs to have enough information to assess whether an exploitation of conflicts of interest is actually occurring. In some cases, parties who want to take advantage of conflicts of interest will try to hide this information from the market. In other cases, alerting the market to potential conflicts of interest would reveal proprietary information that would help a financial firm’s competitors, thus reducing the firm’s incentives to reveal its true position.

The recent scandals described in this chapter demonstrate that the exploitation of a conflict of interest often leads to large gains for some members of the financial firm even while it reduces the value of the firm as a whole. Inappropriately designed compensation plans (the result of poor management), for example, may produce conflicts of interest that not only reduce the flow of reliable information to credit markets but also end up destroying the firm. Indeed, the collapse of Arthur Andersen illustrates how the compensation arrangements for one line of business, such as auditing, can create serious conflicts of interest. In the Arthur Andersen case, the partners in regional offices had incentives to please their largest clients even if their actions were detrimental to the firm as a whole. The conflict of interest problem can become even more hazardous when several lines of business are combined and the returns from one of the activities—such as underwriting or consulting—are very high for only a brief amount of time. Also, a compensation scheme that works reasonably well in the short term might become poorly aligned over time.

The extraordinary surge in the stock market created huge temporary rewards, making it possible for well-positioned analysts, underwriters, and audit firm partners to exploit the conflicts before incentives could be realigned. Often, these conflicts of interest were not readily visible to the market, and they may have been invisible even to the top management of a firm. In the most severe cases, opportunistic individuals were able to capture the firm’s reputational rents, profits that the firm earns because it is trusted by the marketplace. The exploitation of conflicts of interest clearly damaged the reputation of such investment banks as Merrill Lynch, Salomon Smith Barney of Citigroup, and

---

and Credit Suisse First Boston—and perhaps the credibility of analysts in general. Audit firms have lost much of their nonaudit business, while Arthur Andersen was destroyed.

**WHAT HAS BEEN DONE TO REMEDY CONFLICTS OF INTEREST?**

Two major policy measures have been implemented to deal with conflicts of interest in financial markets: the Sarbanes-Oxley Act and the Global Legal Settlement.

**Sarbanes-Oxley Act of 2002**

In 2002, the public outcry over the corporate and accounting scandals led to the passage of the Public Accounting Reform and Investor Protection Act, more commonly referred to as the Sarbanes-Oxley Act after its two principal authors in Congress. This act had four major components.

1. The act increased supervisory oversight to monitor and prevent conflicts of interest:
   - It established a Public Company Accounting Oversight Board (PCAOB), overseen by the SEC, to supervise accounting firms and ensure that audits are independent and controlled for quality.
   - It increased the SEC's budget to supervise securities markets.

2. Sarbanes-Oxley also directly reduced conflicts of interest:
   - The act made it unlawful for a registered public accounting firm to provide any nonaudit service to a client contemporaneously with an impermissable audit (as determined by the PCAOB).

3. Sarbanes-Oxley provided incentives for investment banks not to exploit conflicts of interests:
   - It beefed up criminal charges for white-collar crime and obstruction of official investigations.

4. Sarbanes-Oxley also had measures to improve the quality of information in the financial markets:
   - It required a corporation’s chief executive officer (CEO) and chief financial officer (CFO), as well as its auditors, to certify that periodic financial statements and disclosures of the firm (especially regarding off-balance-sheet transactions) are accurate (Section 404).
   - It required members of the audit committee (the subcommittee of the board of directors that oversees the company’s audit) to be “independent”—that is, they cannot be managers in the company or receive any consulting or advisory fee from the company.

**Global Legal Settlement of 2002**

The second policy arose out of a lawsuit brought by New York Attorney General Eliott Spitzer against the ten largest investment banks (Bear Stearns, Credit Suisse First Boston, Deutsche Bank, Goldman Sachs, J. P. Morgan, Lehman Brothers, Merrill Lynch, Morgan Stanley, Salomon Smith Barney, and UBS Warburg). Spitzer alleged that these firms allowed their investment banking departments to have inappropriate influence
over their research analysts, thereby creating a conflict of interest. On December 20, 2002, the SEC, the New York Attorney General, NASD, NASAA, NYSE, and state regulators reached a global agreement with these investment banks. The agreement included three key elements:

1. Like Sarbanes-Oxley, the Global Legal Settlement directly reduced conflicts of interest:
   - It required investment banks to sever the links between research and securities underwriting.
   - It banned spinning.
2. The Global Legal Settlement provided incentives for investment banks not to exploit conflicts of interest:
   - It imposed $1.4 billion of fines on the accused investment banks.
3. The Global Legal Settlement had measures to improve the quality of information in financial markets:
   - It required investment banks to make public their analysts’ recommendations.
   - It required investment banks for a five-year period to contract with no fewer than three independent research firms that would provide research to their brokerage customers.

A FRAMEWORK FOR EVALUATING POLICIES TO REMEDY CONFLICTS OF INTEREST

The information view of conflicts of interest developed in this chapter provides a framework for evaluating whether conflicts of interest require public policy actions to eliminate or reduce them. Some combination of financial services activities may result in incentives for agents to conceal information, but they may also result in synergies that make it easier to produce information. Thus preventing the combination of activities to eliminate the conflicts of interest may actually make financial markets less efficient. This reasoning suggests that two propositions are critical to evaluating what should be done about conflicts of interest:

1. **The existence of a conflict of interest does not mean that it will have serious adverse consequences.** Even though a conflict of interest exists, the incentives to exploit the conflict of interest may not be very high. An exploitation of a conflict of interest that is visible to the market will typically tarnish the reputation of the financial firm where it takes place. Given the importance of maintaining and enhancing its reputation, exploiting the conflict of interest would decrease the firm’s future profitability because the firm would have greater difficulty selling its services. As a consequence, firms try to structure their salary and reward systems so as to include incentives to avoid the exploitation of the conflict of interest. Hence, the marketplace may be able to control conflicts of interest because a high value is placed on financial firms’ reputations. When evaluating the need for remedies, this proposition raises the issue of whether the market has adequate information and incentives to control conflicts of interest.

2. **Even if incentives to exploit conflicts of interest remain strong, eliminating the economies of scope that create the conflicts of interest may be harmful because it will reduce the flow of reliable information.** Thus, in evaluating possible remedies, we need to examine
whether imposing the remedy will do more harm than good by curtailing the flow of reliable information in financial markets.

**Approaches to Remediying Conflicts of Interest**

In thinking about remedies for specific problematic situations, it is worthwhile to discuss five generic approaches to reconciling conflicts of interest. These approaches are discussed in the order of their intrusiveness, from least intrusive to most intrusive.

**Leave It to the Market**  This approach has a powerful appeal to many economists and may be a sufficient response in many cases. Market forces can work through two mechanisms. First, they can penalize the financial services firm if it exploits a conflict of interest. For example, a penalty may be imposed by the market in the form of higher funding costs or lower demand for the firm’s services, in varying degrees, even to the point of forcing the demise of the firm. Second, market forces can promote new institutional means to contain conflicts of interest. For example, they can generate a demand for information from nonconflicted organizations. This is exactly what happened in the United States in the 1920s, when security affiliates took preeminence over in-house bond departments in universal banks.

One advantage of market-driven solutions is that they can hit where it hurts the most, through pecuniary penalties. Moreover, they may help avoid the risk of overreaction. It can be hard to resist the temptation to adopt nonmarket solutions to appease a public outcry that may reduce information production in financial markets. Conversely, market-based solutions may not always work if the market cannot obtain sufficient information to appropriately punish financial firms that are exploiting conflicts of interest. Memories may be short in financial markets, as is suggested by the new field of behavioral finance discussed in Chapter 7. Once a triggering event has faded from memory, conflicts may creep back in unless reforms have been “hard-wired” into the system.

**Regulate for Transparency**  A competitive market structure does not always adequately reduce information asymmetries. The gathering of information is costly, and any individual economic agent will gather information only if the private benefit outweighs the cost. When the information collected becomes available to the market immediately, the free-rider problem may reach serious levels. Information has the attribute of a public good, which will be undersupplied in the absence of some public intervention. To some extent, mandatory information disclosure can alleviate information asymmetries and is a key element of regulation of the financial system.

When mandatory disclosure of information reveals whether a conflict of interest exists, the market is able to discipline the financial firm that fails to ameliorate conflicts of interest. In addition, if a financial institution is required to provide information about potential conflicts of interest, the user of the institution’s information services may be able to judge how much weight to place on the information this institution supplies.

At the same time, mandatory disclosure could create problems if it reveals so much proprietary information that the financial institution is unable to profitably engage in the information production business. The result could then be less information production, rather than more. Also, mandatory disclosure may not work if financial firms can successfully avoid the regulation and continue to hide relevant information about potential conflicts of interest. The free-rider problem might likewise result in insufficient monitoring of conflicts of interest because the benefits of monitoring and constraining
these conflicts accrue only partially to the monitors. Finally, complying with regulations requiring information disclosure may be costly for financial firms—possibly exceeding the costs due to conflicts of interest.

**Supervisory Oversight** If mandatory disclosure does not work because firms continue to hide relevant information, because the free-rider problem is severe, or because mandatory disclosure would reveal proprietary information, supervisory oversight can come to the rescue and contain conflicts of interest. Supervisors can observe proprietary information about conflicts of interest without revealing it to a financial firm’s competitors so that the firm can continue to profitably engage in information production activities. Armed with this information, the supervisor can take actions to prevent financial firms from exploiting conflicts of interest. As part of this supervisory oversight, standards of practice can be developed, either by the supervisor or by the firms engaged in a specific information production activity. Enforcement of these standards would then be placed in the hands of the supervisor.

As we saw in Chapter 11, supervisory oversight of this type is very common in the banking industry. In recent years, bank supervisors have sharpened their focus on risk management. They now examine banks’ risk management procedures to ensure that the appropriate internal controls on risk taking have been established at the bank. In a similar fashion, supervisors can examine banks’ internal procedures and controls to restrict conflicts of interest. When they find weak internal controls, they can require the financial institution to modify them so that incentives to exploit conflicts of interest are eliminated.

Although supervisory oversight has proved successful in improving internal controls in financial firms in recent years, if the incentives to exploit conflicts of interest are sufficiently strong, financial institutions may still be able to hide conflicts of interest from the supervisors. Furthermore, supervisors have not always done their job well, as we saw in Chapter 11.

**Separation of Functions** Where the market cannot obtain sufficient information to constrain conflicts of interest—because there is no satisfactory way of inducing information disclosure by market discipline or supervisory oversight—the incentives to exploit conflicts of interest may be reduced or eliminated by regulations enforcing separation of functions. Several degrees of separation are possible. First, activities may be separated into different in-house departments with firewalls between them. Second, the firm may restrict different activities to separately capitalized affiliates. Third, regulations may prohibit the combination of activities in any organizational form.

The goal of separation of functions is to ensure that agents are not placed in the position of responding to multiple principals. Moving from relaxed to more stringent separation of functions, conflicts of interest are reduced to an increasing degree. Of course, more stringent separation of functions also reduces synergies of information collection, thereby preventing financial firms from taking advantage of economies of scope in information production. The resulting increased cost of producing information could, in turn, lead to a decreased flow of reliable information because it becomes more expensive to produce it. Deciding on the appropriate amount of separation therefore involves a trade-off between the benefits of reducing conflicts of interest and the cost of reducing economies of scope in producing information.

**Socialization of Information Production** The most radical response to conflicts generated by the existence of asymmetric information is the socialization of the
provision or the funding source of the relevant information. For example, much macroeconomic information is provided by publicly funded agencies, because this particular public good is likely to be undersupplied if left to private provision. It is conceivable that other information-providing functions—for example, credit ratings and auditing—could also be publicly supplied. Alternatively, if the information-generating services are left to the private sector, they could be funded by public sources or by a publicly mandated levy to help ensure that information production is not tainted by obligations to fee-paying entities with special interests.

Of course, the problem with this approach is that a government agency or publicly funded entity may not have the same strong incentives as private financial institutions to produce high-quality information. Forcing information production to be conducted by a government or quasi-government entity—although it may diminish conflicts of interest—may reduce the flow of reliable information to financial markets. Furthermore, government agencies may have difficulty paying the market wages required to attract the best people. This problem may become even more serious if economies of scope are affected. For example, analysts in an investment banking firm are likely to receive additional compensation when their research has multiple uses. By contrast, a government agency that is interested in only one use of research may not provide a level of compensation sufficient to produce high-quality information. In addition, the government might not provide sufficient funds for information collection. Indeed, government provision of important series of macroeconomic data has already been discontinued because of a lack of funding.

**APPLICATION ✦ Evaluating Sarbanes-Oxley and the Global Legal Settlement**

Using the analytic framework discussed earlier, we now can turn to evaluating the Sarbanes-Oxley Act and the Global Legal Settlement.

We have seen that policies that regulate conflicts of interest can help to increase the amount of information in financial markets. Sarbanes-Oxley did exactly this when it required that the CEO and the CFO certify the periodic financial statements and disclosures of the firm. It increased the likelihood that these statements will provide reliable information. In addition, Sarbanes-Oxley required disclosure of off-balance-sheet transactions and other relationships with special-purpose entities. Again, this step helped increase information in the marketplace because these off-balance-sheet transactions were often used, as in the Enron case, to hide what was going on inside the firm. However, the costs of complying with the new regulations imposed by Sarbanes-Oxley were not cheap. Small firms were hit particularly hard: The estimated costs of complying with Sarbanes-Oxley exceeded $800,000 for smaller firms with revenues of less than $100 million, which amounted to nearly 1.5% of their sales. Sarbanes-Oxley might have severely hurt such companies’ profitability and made it harder for them to make productive investments.

We have also seen that the market is often able to constrain conflicts of interest when it has sufficient information to do so. The Global Legal Settlement included a provision that required investment banking firms to make their analysts’ recommendations public. This policy helped the market to assess whether the analysts were acting in good faith. The SEC also required increased disclosure by investment analysts, credit-rating agencies, and auditors, forcing them to reveal any interests they have in the firms they analyze. Provision of this information made it more likely that financial institutions will
develop internal rules to ensure that conflicts of interest are minimized, so that their reputations remain high and they remain profitable.

Of course, disclosure may not be enough to get markets to control conflicts of interest, because firms still have incentives to hide information so that they can profitably exploit conflicts of interest. Disclosure may also reveal so much proprietary information that the financial institution is unable to profitably engage in the information production business. In addition, some of the most damaging conflicts of interest have resulted from poorly designed internal compensation mechanisms, which are difficult for markets to observe. Supervisory oversight can focus on exactly these issues.

Increased supervisory oversight was a key feature of the Sarbanes-Oxley Act. First, the act established the PCAOB to supervise accounting firms. The PCAOB monitors compensation mechanisms to verify that they are in accord with the best practices to control conflicts of interest. Second, Sarbanes-Oxley provided substantially more resources for the SEC. A supervisory agency cannot do its job properly without adequate resources. Indeed, one reason why the SEC may have failed to provide adequate supervisory oversight during the boom of the 1990s is because it was starved for resources. A similar problem occurred for the supervisors of the savings and loan industry, and it helped lead to scandals and a bailout that cost taxpayers more than $100 billion.

By keeping the audit committee independent of management, Sarbanes-Oxley eliminated the conflict of interest that occurs when the management of a firm hires its auditor. The PCAOB will be instrumental in writing the regulations to ensure that auditors will report to, be hired by, and be compensated by an independent audit committee that is supposed to represent shareholders other than management.

The Global Legal Settlement also directly eliminated one Wall Street practice that led to obvious conflicts of interest—spinning, in which executives received hot IPO shares in return for their companies’ future business with the investment bank underwriting the new issue. The Global Legal Settlement punished investment banks that exploited conflicts of interest by imposing a fine of more than $1.4 billion. This tough punishment, along with the harsher criminal penalties established by Sarbanes-Oxley, provided incentives for investment banking firms to avoid taking advantage of conflicts of interest in the future.

The more radical parts of Sarbanes-Oxley and the Global Legal Settlement involved separation of functions and socialization of information. Sarbanes-Oxley made it illegal for accounting firms to provide nonaudit consulting services to their audit customers. This law will potentially reduce the economies of scope available to auditing firms that also offer consulting services. It is unlikely that the proscription of nonauditing services in this situation, as envisioned by Sarbanes-Oxley, would have prevented the recent audit failures. However, greater transparency about the nature and role of nonaudit services would be a valuable aid to control a firm’s temptation to exploit this conflict of interest. Similarly, the Global Legal Settlement required investment banking firms to sever the link between research and investment banking. This divestiture also has the potential to eliminate economies of scope in information production. After all, analysts may be able to obtain much more information on firms they cover when the investment banking arm of the firm can share information with them.

The Global Legal Settlement required that for a five-year period, brokerage firms contract with independent research firms to provide information to their customers. In addition, part of the $1.4 billion fine paid by the investment banks will be used to fund independent research and investor education. While it remains to be seen how the terms of this agreement will be implemented, there are both potentially positive and
potentially negative features. Independent research may produce unbiased information. However, by socializing research, firms can no longer compete for customers on the basis of the quality of their research. Because they are being taxed to fund independent research, firms may decrease their investment in their own research analysis. Indeed, this is exactly what has already happened, with research budgets at the seven largest securities firms being cut almost in half since 2000. If the investment banks do not control the information that they are being forced to acquire, the analysis produced may be of a lower quality.

SUMMARY

1. Conflicts of interest arise when financial services firms or their employees are serving multiple interests and develop incentives to misuse or conceal information needed for the effective functioning of financial markets. If taking advantage of conflicts of interest substantially reduces the amount of reliable information in financial markets, asymmetric information increases and prevents financial markets from channeling funds to those firms with the most productive investment opportunities.

2. Four types of financial services activities have the greatest potential for conflicts of interest that reduce reliable information in financial markets: (1) underwriting and research in investment banking, (2) auditing and consulting in accounting firms, (3) credit assessment and consulting in credit-rating agencies, and (4) universal banking.

3. Even though conflicts of interest may exist, they do not necessarily have to reduce the flow of reliable information, because the market provides strong incentives for financial services firms to avoid damaging their reputations. The evidence suggests that the market often succeeds in constraining the incentives to exploit conflicts of interest. However, conflicts of interest still pose a threat to the efficiency of financial markets.

4. Two major policy measures deal with conflicts of interest: the Sarbanes-Oxley Act of 2002 and the Global Legal Settlement arising from the lawsuit by the New York Attorney General against the ten largest investment banks.

5. Two basic propositions are critical to evaluating what should be done about conflicts of interest: (1) The fact that a conflict of interest exists does not mean that the conflict will necessarily have serious adverse consequences. (2) Even if incentives to exploit conflicts of interest remain strong, eliminating the conflict of interest may be harmful if it destroys economies of scope, thereby reducing the flow of reliable information. Five approaches to remedying conflicts of interest, going from least intrusive to most intrusive, have been suggested: (1) leave it to the market, (2) regulate for transparency, (3) provide supervisory oversight, (4) mandate separation of functions, and (5) require socialization of information.

6. Sarbanes-Oxley and the Global Legal Settlement helped increase the flow of reliable information in financial markets by requiring the CEO and CFO to certify financial statements, corporations to disclose off-balance-sheet transactions and entities, investment banks to make public their analysts’ recommendations, and by requiring increased disclosure of potential conflicts of interest. Sarbanes-Oxley increased supervisory oversight by establishing the Public Company Accounting Oversight Board (PCAOB) and by increasing the resources available to the SEC. The act also reduced conflicts of interest in auditing by making the audit committee independent of management. The Global Legal Settlement eliminated the conflict of interest inherent in spinning. The $1.4 billion fine and harsher criminal penalties imposed by Sarbanes-Oxley provided incentives for investment banks not to exploit conflicts of interest in the future. The more radical parts of Sarbanes-Oxley and the Global Legal Settlement, which involved separation of functions (research from underwriting, and auditing from nonaudit consulting) and socialization of research information, may ultimately reduce the information available in financial markets.
KEY TERMS

conflicts of interest, p. 1
initial public offerings (IPOs), p. 4
reputational rents, p. 10
economies of scope, p. 2
management advisory services, p. 4
spinning, p. 4

QUESTIONS AND PROBLEMS

All questions and problems are available in myeconlab at www.myconlab.com/mishkin.

1. Why can provision of several types of financial services by one firm lead to a lower cost of information production?

2. How does the provision of several types of financial services by one firm lead to conflicts of interest?

3. How can conflicts of interest make financial markets less efficient?

4. How can conflicts of interest lead to unethical behavior?

5. Describe two conflicts of interest that occur when underwriting and research are provided by a single investment banking firm.

6. How does spinning lead to a less efficient financial market?

7. Describe two conflicts of interest that occur in accounting firms.

8. Some commentators have attributed the demise of Arthur Andersen to the combination of auditing and consulting activities in the firm. Is this assessment correct?

9. Describe two conflicts of interest that occur in credit rating agencies.

10. Describe two conflicts of interest that occur in universal banks.

11. “Conflicts of interest always reduce the flow of reliable information.” Is this statement true, false, or uncertain? Explain your answer.

12. Give two examples of conflicts of interest that do not seem to have been exploited and thus did not lead to a reduction of reliable information in the financial markets.

13. When is it more likely that conflicts of interest will be exploited?

14. How can compensation schemes in financial service firms lead to conflicts of interest?

15. What are the advantages and disadvantages of mandatory disclosure in dealing with conflicts of interest?

16. How can supervisory oversight help reduce conflicts of interest?

17. What are the disadvantages of separating financial activities into different firms in an effort to avoid conflicts of interest?

18. What are the advantages and disadvantages of government provision of information as a solution to the problems created by conflicts of interest?

19. Which provisions of the Sarbanes-Oxley Act do you think are beneficial, and which are not?

20. Which provisions of the Global Legal Settlement do you think are beneficial, and which are not?

WEB EXERCISES

   a. Summarize in two or three sentences the primary reason for passage of the Sarbanes-Oxley Act.
   b. Summarize one of the articles discussed under the news/current events section. Address how this article relates to conflicts of interest in the financial markets.

2. Go to www.sec.gov/ and click on “Press Releases.”
   a. Summarize the major types of issues that the SEC addresses in these press releases.
   b. Review the last three months of releases, and count how many appear to be enforcement actions aimed at firms or individuals who have violated SEC regulations. From this review, does the SEC appear to be active in its effort to prevent fraud and misrepresentation in the securities industry?
WEB REFERENCES

http://stockcharts.com/charts/historical/
To review the timing of the stock market declines, this website graphs a variety of stock market indexes for easy viewing.

www.moodys.com
Moody's is a major rating agency for company debt. To view the Moody's website and learn more about how it evaluates company credit, you must register to view Moody's Web materials.

www.sarbanes-oxley.com/
A website devoted to discussion and dissemination of information about the Sarbanes-Oxley Act.

www.sec.gov/
The SEC is primarily responsible for preventing fraud in the securities markets. Click on “What We Do” to learn what role the SEC envisions for itself in the securities industry.

MyEconLab CAN HELP YOU GET A BETTER GRADE

If your exam were tomorrow, would you be ready? For each chapter, MyEconLab Practice Test and Study Plans pinpoint which sections you have mastered and which ones you need to study. That way, you are more efficient with your study time, and you are better prepared for your exams.

To see how it works, turn to page 20 and then go to: www.myeconlab.com/mishkin