Look inside the history of the securities game and see how today's analysts, traders, executives and bankers sometimes form a troubling quid pro quo alliance that leaves independent investors out in the cold, and in Enron's case, their employees with nothing.

Trading on Trust

A great irony of Enron's collapse is that one of its main strategies for success—manipulating its own stock value as if with puppet strings—resulted in the ultimate downfall of that very stock, as the fantasy bubble burst and public trust evaporated.

Public trust has been recognized as critical to a healthy market economy ever since 1929, when the U.S. stock markets crashed and the ensuing Depression prompted President Roosevelt to sign the Securities Act of 1933 and create the Securities Exchange Commission in 1934 to regulate the stock market and prevent corporate abuses related to securities.

There is no question that stock markets are vital to the American economic machine. Investing in stocks gives companies the means to raise capital and expand, promoting a healthy distribution of consumer resources which circulate back into industry ideally producing dividends for the investor. The markets level the field by making company ownership as shareholders possible for all citizens, rich and poor, who can take their dividends, reinvest and inch or race up the ladder with profit.

Historically, stocks have helped to keep corporate management accountable to shareholders, while acting as an economic barometer, predicting recession, depression or upward trends.

Forecasting Finance

Fundamental to this system are the research analysts—the economic forecasters who watch that barometer closely. Analysts issue reports on the value of a stock to brokers at investment banks, and the reports help the brokers decide which stocks, bonds or mutual funds to buy, sell or hold.

In 1975, deregulation of brokerage commissions opened up a Pandora's box of competition for securities analysts. Suddenly discount brokerages abounded and took business from investment banks. As trade commissions declined, brokerage firms had diminished resources to fund analyst services. As a result, stock analysts relied less on brokerage fees for income and more on investment banking fees. They began to be judged more for their investment banking skills than their insights or analysis, and this is how what many regard as a systemic conflict of interest was born.

The Art of Prediction

While stock analysts have different roles, they all share a principal task of researching securities, companies and industries before issuing a report that puts a price on the security (securities may include stocks, bonds or mutual funds). Their research might involve reading public company records or having conversations with management, though today's fair disclosure laws require management to publish the kind of information that used to be gained by those often confidential conversations.

There are two main approaches analysts use to research securities: fundamental analysis and technical analysis. Fundamental analysts evaluate the intrinsic value of a stock based on the current economic and industrial conditions along with data from financial statements and information about the management and overall health of the company. In contrast, technical analysis is a gut-based, intuitive approach, drawing conclusions about future stock performance based on past market trends, future hunches and observed patterns of investor and consumer behavior.

The collapse of Enron confounded some analysts who did not take into account the company's cryptic "mark to market" accounting, which allowed Enron to count as current earnings the profits they expected from future contracts. This system, rarely used in the power industry though perfectly legal, had the positive effect of pushing Enron's

earnings numbers up, creating the illusion of profit in the absence of proof. In reality, many of the contracts evaporated, and yet analyst predictions stayed buoyant well after the company's earnings began to plummet.

Within the "fundamental" and "technical" analysis schools, analysts generally serve either "sell-side" or "buy-side" needs. Analysts who report to sellers generally work for investment banks and the public. The analysts serving buyers work for investment advisors or large institutional investors trading in mutual or hedge funds.

Caveat Emptor: The Circle Game

For buy-side analysts there is no particular conflict because they serve a known entity with a single, clear set of needs. But particularly since deregulation, the sell-side analysts are subject to two simultaneous goals of investment banks: underwriting securities and selling the securities that they underwrite.

Reputation is everything for the analyst, whose predictions, if respected, cause investors to buy, sell or hold, in turn affecting the performance of the stock, thus validating the analyst's prediction and reinforcing his reputation. Here, the analyst shifts from watching the barometer to controlling the weather it measures.

Within this circular logic, conflict of interest intensifies when stock predictions are founded on cozy relationships with company executives who have the means to make an investment company (and its star analysts) rich with profits, and the power to retaliate against analysts who don't promote their stocks by communicating their disappointment to the investment banks who employ them.

Reforms

Beginning in 2002, following the corruption scandals of Enron, Tyco, Worldcom and others, partitions were set in place in an effort to reduce conflicts of interest between investment and public needs. As a result, research analysts are now often identified within their firms as either serving the brokerage (investment) needs or the independent (public) needs, so that it's obvious to investors who has incentive to report overly favorable views on companies and who is basing their analysis on unfettered facts.

In addition, the Sarbanes-Oxley Act of 2002 created oversight, inspection and regulation controls over accounting firms and corporations in an effort to restore the public trust in accounting and reporting practices.

The Sarbanes-Oxley Act also made it illegal for public companies to make loans to directors or executive officers and it stipulates that the blackout periods for selling stock—which caused financial ruin for employees of Enron and Portland Gas and Electric—also applies to company stock owned by directors and executive officers, and must be preceded by 30 days' notice for employees.

In the case of Enron, the employee blackout period (when selling stock is prohibited) occurred because the company happened to be changing 401(k) administrators, which is a common reason to prohibit investment changes. But the blackout had catastrophic consequences as it occurred just when stock prices were plummeting. By the time the period ended, employee accounts were wiped out, and the devastation wrought by executive hubris and corporate greed was complete.