<u>Take on the Street: What Wall Street and Corporate America Don't Want You to Know/What You can Do to Fight Back</u> (2002), Arthur Levitt, Former Chairman of the Securities and Exchange Commission

The insights and stories of, retired SEC Chairman, Levitt speak plainly of the culture that surrounds Wall Street. In one word: GREED. By championing Regulation Fair Disclosure (FD), speaking out against Wall Street analysts' conflicts of interest, and setting forward legislation to require corporate options packages to be recorded as an expense to the company, Levitt sought to help the individual investor. His introduction well summarizes the issues at hand.

"The web of dysfunctional relationships among analysts, brokers, and corporations would grow increasingly worse. For instance, many CEOs were paying more attention to managing their share price than to managing their business. Companies technically were following accounting rules, while in reality revealing as little as possible about their actual performance. The supposedly independent accounting firms were working hand in glove with corporate clients to try to water down accounting standards. When that wasn't enough, they were willing accomplices – helping companies disguise the true story behind the numbers. With 51 percent of accounting firm revenues coming from management consulting in 1999 it was hard not to conclude that auditors had become partners with corporate management rather than the independent watchdogs they were meant to be.

CEOs and their finance chiefs were trading important information about earnings and product development with selected analysts, who in return were writing glowing reports. Such selective disclosures got passed on to powerful institutional investors – mutual funds and pension funds – and to brokers who could be counted on to place a substantial number of shares in the accounts of individual clients. Analysts were often paid more to help their firms win investment banking deals than for the quality of their research. This unholy alliance was producing revenue for the analyst's firm but hardly any benefits for most of their clients.

Mutual funds and pension funds were getting far better information, and a lot earlier, than retail investors. Individual investors were unaware of this side of Wall Street. And yet they were the victims of these long-standing conflicts." [Pages 6-8]

In speaking about the many difficulties he encountered in trying to get legislation passed that would benefit individual investors, Levitt writes of the symbiotic nature of Washington and CEOs.

"For the CEOs, the ability to have access to and rub shoulders with well-known people who represented America's political elite had an addictive allure. The politicians, in turn, used these meetings as an opportunity to raise funds. Once I started pursuing my agenda to require companies to count their options as an expense on the income statement, I saw a dynamic I hadn't fully witnessed before. The rule would have crimped earnings and hurt the share price of many companies, but it also would have revealed the true cost of stock options to unsuspecting investors. Dozens of CEOs and Washington's most skilled lobbyists came to my office to urge me not to allow this proposal to move forward. At the same time, they flooded Capitol Hill and the support of lawmakers. When we proposed new rules to make sure that auditors were truly independent of corporate clients, some fifty members of Congress promptly wrote stinging letters in rebuke. In the final days of negotiation over new independence rules, I was constantly on the phone with lawmakers who were trying to push the talks toward a certain conclusion, or threatening me if they didn't like the outcome." [Pages 10-12]

"Reg FD (full disclosure) would require companies to release important information to all investors at the same time, and not just to a favored few. Such 'selective disclosure' had gotten out of hand in the 1990s, and put small investors at a disadvantage to the analysts, brokers, and institutional investors who were routinely getting advance information on corporate earnings ahead of the rest of the market. That was wrong, plain and simple.

Never before had so many lined up against me. For the past year [prior to 2000], much of Wall Street and the corporate establishment fought to kill Ref FD. The agency was inundated with comments – more than six thousand in all, the highest in SEC history. It made a deep impression on me when I saw that the industry comments were almost uniformly negative while the public comments were almost uniformly positive." [Pages 87, 93] Reg FD was passed in 2000.

Lastly, Levitt's comments about mutual fund companies appears just as pertinent today as the time he served as the SEC Chairman.

"A mutual fund's past performance, which is the first feature that investors consider when choosing a fund, doesn't predict future performance. Funds buy expensive ads in newspapers and magazines to tout their performance over the past one, three, five, and ten years. The mutual fund industry irresponsibly promotes this 'culture of performance,' even though it knows perfectly well that is misleads investors. When it comes to mutual funds, the past is not prologue." [Page 56]

Levitt's comments are similar to those Jim Chanos' made in our research paper, *Rider on the Storm*, where Chanos stated, "Wall Street is a giant positive reinforcement machine."

While I agree with much of Levitt's assessment of the incestuous relationships that exist throughout much of Wall Street, his suggestion that the solution is to buy an index fund seems to miss the mark. If the system has many problems and a good number of companies are using the system to benefit themselves to the exclusion of retail investors, investors would be better advised to look for money managers, and companies, with high ethical standards. Levitt also notes, "Investors should give greater weight to the recommendations of independent research analysts." [84] As such, rather than chasing the fad of indexing [64], investors would do better to invest with a manager who is tenacious enough to do his own independent research, and, "who considers his client's interest before his own," rather than one who, for the sake of his own livelihood, ends up, "taking an action which may not be appropriate or timely to take." [25]