

Restoring Trust in Markets.

The securities industry recently agreed to the largest settlement in its history. Ten firms will pay \$1.4 billion to settle charges that they issued overoptimistic stock reports about firms to secure their investment banking business. They were also accused of “spinning” initial public offerings (IPOs) – a practice of allocating shares of coveted IPOs to top corporate executives, who quickly “spin” (sell) them for a sizeable personal profit. Particularly egregious is the extent of influence peddling that is made public in the documents detailing the charges. The CEO of Citigroup (parent of Salomon), Sanford Weill, personally called the Salomon analyst covering AT&T and asked him to take a “fresh look” at AT&T stock just before AT&T chose Salomon for an underwriting assignment that paid \$ 63 million in fees. Bernie Ebbers, CEO of the bankrupt World Com, received \$ 11.5 million in personal profits on hot IPOs allocated to his account by Salomon. Perhaps not coincidentally, Salomon received \$ 76 million in investment banking fees from World Com.

To some, these transactions reflect the essence of capitalism: a system based on greed, which inevitably fosters greed in people, a system where only the rich get richer, a system which needs to be regulated out of existence. To others, what we have here are the proverbial bad apples, a few miscreants who have abused the system. They argue that this is inevitable in any system and that left alone, the system is capable of regulating itself.

Neither view is correct. While the market economy is based on self-interest, the essence of a free market is equal access and competition. To achieve this, we have rules that ensure the market is a level playing field where no one fears to enter. These rules prevent the market from degenerating into an arena where the law of the jungle prevails and only the powerful can participate. There is probably no more democratic institution, and no institution less respectful of the rich, than a well-functioning market.

It is equally wrong to think of the abuse of these rules as a minor aberration. It is a recurrent lesson from history that powerful industry insiders will misuse their market power – in this case, the power to write favorable research reports – to shut out competition. Moreover, self-regulation does not always take care of these problems. IPO spinning was highlighted as a problem in the 1920s (then as now, lists of those who benefited looked like pages from the Who’s Who). It made the headlines again a few years ago when Speaker Tom Foley seemed to be unusually favored in IPO allocations. Even though there are easy ways to deal with it, the industry has repeatedly refused to part with this handy method of legal bribery, for obvious reasons.

What are the consequences of these abuses? Interestingly, the indirect effects may be much larger than the direct economic effects. Every academic study of conflicts of interest in financial institutions that we have seen (or done) suggests that market prices typically account for these conflicts. Put another way, large institutional investors know through the grapevine when an analyst is compensated for bringing in investment banking business, and accordingly discount his reports. Since large investors often determine market prices, small investors are protected even if they rely on these biased reports, because the prices they buy and sell at are honest. While it

may be convenient to blame conflicted analysts for the stock market crash, other factors were probably more important.

Similarly, initial public offerings are often priced below their eventual market price for good reasons listed in any elementary finance textbook. Given that these offerings are almost a sure bet to rise in value when they are issued, it is tempting for the securities houses to use them as rewards or, worse, bribes to favored clients.

These are therefore abuses without direct victims. But we are all indirect victims. If a firm pays excessive fees to its investment bank when faced with the threat that analyst coverage would otherwise be withdrawn (or be unfavorable), we all pay higher prices for the goods those firms produce. CEOs of firms should not really be concerned about reports put out by conflicted analysts, but which CEO is so courageous? Similarly, if investors distrust analyst coverage, stock prices are not as accurate as they would be if those analyst reports could be trusted. And if initial public offerings are allocated in ways that reek of crony capitalism, small investors become wary of bidding for them and the market loses an important source of liquidity.

However, since the direct economic effects are small and the indirect effects are large but spread across all of us, there is little within the market itself to stop the abuse. And continuing abuse has a very serious political consequence: it diminishes belief in the fairness of the system. The message that episodes like this and the recent fiasco at American Airlines convey to the wider public is that the system of free enterprise offers two paths, one for the well connected, and one for the rest of us. The reason free market capitalism has had such wide support in this country despite such large inequalities in wealth (relative to say Europe) is partly because people believe that they roll the same dice as the richest billionaire. To undermine such a belief will be to undermine the free market system.

The true supporters of free markets should distance themselves both from those who advocate laissez faire and those who want to strangle markets with regulation. The best remedy for dealing with corrupt markets in a democratic society is the one forcefully advocated at the beginning of the century by the legal giant, Justice Brandeis: "Sunlight is the best of disinfectants, electric-light is the most efficient policeman." In practice, this means more transparency. For example, forcing investment banks to disclose the list of those allotted a significant number of shares in IPOs would curb abusive spinning more effectively and less intrusively than any direct regulation. The settlement should not suggest a return to business as usual, but the beginning of a process of heightened scrutiny of market practices. In that lies the hope that trust in the markets will be restored.

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