Abstract

Purpose – This paper explores the social-behavioral aspects of financial markets. The purpose of this paper is to examine the role of social relations and networks which contributed to the market crash in the US telecommunications sector in the late 1990s.

Design/methodology/approach – A network theoretic approach is used to examine historical qualitative data. The authors suggest that the network characteristics of financial intermediaries allowed security analysts to control and manipulate information that was disclosed to the investing public.

Findings – The authors find evidence that brokerage locations in the network of actors within the telecommunications market allowed select individuals opportunities to engage in unethical behavior and malfeasance. The authors further highlight the harmful effects of over-embeddedness by illustrating that strong and dense network ties within the financial sector were exploited to distort the flow and reliability of information. The paper concludes with a note on the generalizability of this study and an examination of the current economic-legal structure of the Wall Street.

Originality/value – Recently, some economists and network scholars have begun examining social relations more thoroughly in the financial sector. This paper is one of the first that focuses specifically on the role and network location of research analysts prior to a market collapse.

Keywords Financial markets, Financialization, Social networks, Embeddedness

Paper type Research paper

Introduction

In the 1990s, the market value of domestic telecommunications companies skyrocketed, peaked, and then nosedived. In the years preceding the collapse, market intermediaries and other key players in the finance sector presented falsified information to investors in an attempt to safeguard profits. Assuming them to be well informed about the dealings of domestic telecom companies and evolving market structures, the growing new generation of individual investors made financial decisions based on flawed or fabricated information. Devastating consequences ensued, thwarting economic advancement and growth. In 2002, Fortune Magazine called telecom’s fall “the biggest wreck in corporate history” (Mehta, 2002).

The boom and bust in telecommunications has been studied from several perspectives. Explanations of the crisis range from a historically and causally driven perspective to rational calculations of optimism and rising stock process (Barbarino and Jovanovic, 2007; Fransman, 2004; Hausman and Taylor, 2013). Existing studies have also highlighted the role of security analysts from a behavior causality or agency perspective (see Fransman, 2004).

We contribute to the theories of financial crisis by introducing a network component. Building on the well-established literature of socio-behavioral aspects of financial markets (Abolafia, 1996; Baker, 1984; Fligstein, 2001), we suggest that the network characteristics of financial intermediaries allowed corporate executives, investment bankers, and security analysts to control and manipulate the information disclosed to the investing public. We assert that network brokerage allowed individuals to generate opportunities for unethical behaviors and corporate malfeasance. Additionally, changes in the political-legal
establishment allowed for an increase in the number of legal, yet highly conflicted
relationships to exist. We suggest that the combination of the changing political-legal
culture as well as the prevalence of brokered relationships in the telecommunications
industry contributed to the market collapse. Theories of network brokerage contribute to
our understanding of financial crises and collapses, as this approach has not yet been
documented extensively in financial markets.

Influential security analysts (hereafter analysts) at prestigious investment banks monitored
market activity and provided future valuation and projections of telecommunications
companies to the investing public. Their strategic market position owed to a unique network
structure which evolved within the telecommunications market against the backdrop of
market exuberance. The changing political-legal structure created the potential for multiple
conflicts of interest as a single company was allowed to provide research analyst and lending
services to its clients. This change created incentives to inflate or misrepresent corporate
finances in order to secure larger revenues from financial market services. Reputable analysts
cultivated cozy relationships with telecom executives and suggested that their reports and
opinions were more valuable than their less informed competitors. Investors and fellow stock
brokers across the country looked past these conflicted relationships and relied on the
allegedly independent reports that promised individual profit in the high-risk industry.

Under the "efficient markets" view, competition between investors produces an efficient
market, and prices cannot be manipulated by outside influences. If markets are fully
efficient and all actors are fully informed, then technical analysts eventually will be
eliminated from the market (Fama, 1965). In contrast, our exclusive focus on security
analysts from the network perspective reveals that market intermediaries can and will
influence stock prices by manipulating and controlling the flow of information, by virtue of
their strategic positioning between buyers and sellers.

Research approach
We employ a mix of historical qualitative analysis and a network theoretic framework to
outline the structure of "cozy" relationships that existed on the Wall Street in the late 1990s.
This research is less concerned with hypothesis testing, but rather elaborates the qualitative
aspects of seemingly rational relationships in a market setting and connects empirical facts
into existing theory to generate new empirically sound theory. The rich data that qualitative
and historical analysis generates assist in "developing theories and applying existing
concepts to a new context" (Weischedel et al., 2005). This research follows an inductive
approach which uses empirical observations to "allow the construction of explanations and
theories about what has been observed" (Carson et al., 2001, p. 12).

Recent literature in economics and finance recognizes the importance of the architecture,
or network structure, of financial networks and its influences on market stability and
systematic risk (e.g. Acemoglu et al., 2015). However, the sole application of a structural,
or quantitative, approach is incomplete as it omits important interpersonal aspects of the case
study and qualities of the network tie. To augment the network theoretic approach in financial
markets, we incorporate qualitative and relational information about the ties analysts created
and nurtured on Wall Street. The combination of structural network theory and qualitative
information offers a unique method of understanding the structure and the empirical qualities
of the given network (see Emirbayer and Goodwin, 1994; Kalish and Robins, 2006; Mehra et al.,
2001; Aalbers et al., 2013; Ibarra, 1995). Additionally, the synthesis of qualitative data and
historical accounts further elaborates and generates comprehensive information that highlights
perceptions and attributes of individuals involved (Echchabi and Olaniyi, 2012).

In order to generate an in-depth case study, we use data from multiple sources. We use
historical monographs, personal narratives, media coverage, periodicals, records from
Securities and Exchange Commission’s legal proceedings, and other government documents.
We focus primarily on accounts that include information on the relationships between brokers and other prominent actors and corporations. Thus, as this paper highlights the network approach, we give attention to who was connected to whom. Since financial collapse has not been outlined with a network approach, our account offers a fresh perspective to understanding financial collapse. Finally, the deeper understanding of the telecommunications collapse elaborated through qualitative historical analysis provides means for theory construction and theory building using empirical information.

Network brokerage

A central aspect to network theory is brokerage. Brokerage is commonly conceptualized as an actor that connects two otherwise disconnected groups, cliques, or individuals (Burt, 2005; Borgatti et al., 2013). Brokers are important in larger networks as they serve as gatekeepers, they assist in access to unfamiliar markets, and they facilitate the transmission or flow of information and other assets from one group to another. In doing so, the broker gains access to novel information and increased opportunity to control said information between the groups being brokered. Brokers’ loyalties are often fleeting as brokerage frequently spurs conflict, exploitation, the pursuit of personal profit, accumulation of power, corruption, and can exacerbate inequalities (Stovel and Shaw, 2012). In this sense, the broker acts as the gatekeeper and has increased control over who receives what information, or if information is transferred at all.

A widely accepted application of brokerage is Ron Burt’s (1992) concept of structural holes. The concept draws on several lines of research and theory grounded in the sociological literature, including the strength of weak ties (Granovetter, 1973), the structural concepts of betweenness centrality (Freeman, 1977), the exclusivity of exchange partners (Cook and Emerson, 1978), and the structural autonomy created by network complexity (Burt, 1980).

In financial markets, there are a variety of occupations that naturally broker information between groups of individuals. For example, an analyst occupies a brokering position between investors and corporations, as shown in Figure 1. This structural location typically requires the analysts to be closer to the individuals within the corporations they follow than

![Figure 1. A hypothetical brokerage network of a security analyst](image)
the individuals that may hear their research projections (Brown et al., 2015); thus the analyst creates a biased and mixed cohesive network (Gould and Fernandez, 1989).

The broker, acting as the tertius gaudens or “third who enjoys,” is privy to valuable information and acts with a “vision advantage” (Burt, 2010). Assuming that the broker acts in a neutral manner, the unideal network structure may be of little concern. However, as Wolff (1950, p. 154) suggests, brokers may take the interaction as a “means for his own purpose” or for purely egoistic interests. The negative results of the tertius gaudens may be as simple as a severed relationship or friendship or may contribute to a much larger catastrophe such as market crises.

Financial markets, financial analysts, and asymmetric information
Since the 1980s, the nature of financial markets has changed substantially. The importance of financial markets to the functioning of modern day capitalism is unquestioned (Abolafia, 1996). However, there is some tension within the literature as to the characteristics that define financial markets. Abolafia (2006) concisely suggests that financial markets are made up of buyers and sellers. While this crude definition suffices as the fundamental idea, it understates the role of numerous actors involved in securities trading. To illustrate, a recent recruitment booklet lists fourteen different sectors in which one may choose to work within financial markets, ranging from wealth management to quantitative analytics (published by www.efinancialcareers.com) and the range of occupations within each sector is vast. Buyers and sellers are, however, essential to financial markets as they occupy two distinct structural locations within the overall network and analysts play a brokering role between the two parties.

The efficient market hypothesis assumes that perfect information exists in the market, and that all actors are well-informed. Under this assumption, the actual price of a security reflects all available information in the market and becomes a reasonable estimate of its intrinsic value (Fama, 1965). If true, the role of analysts would be frivolous and “completely without value” (p. 55).

But information is far from perfect, is not available to all, and is not symmetrical between buyers and sellers. More importantly, it is not simply that some players have better information than others. From a network perspective, some have better access to information than others by virtue of their positioning within the social structure. Information is embedded within social networks, available only to those who occupy strategic positions that bridge the chasm between buyers and sellers.

Within financial markets, opportunism coupled with boundedly rational behavior increases the financial risk for buyers and creates an exploitative environment for sellers. As the number of market intermediaries increases, so does the probability that investors will encounter opportunists that capitalize on their bounded rationality. As such, while there are several actors that can manipulate the flow of information, the financial analyst is the primary candidate that occupies the brokering location between buyers and sellers to facilitate such behavior.

Historically, the role of a market analyst was to recommend which stocks investors should purchase. Traditional research has assumed that financial analysts are experts in making forecasts and recommendations on trading behavior (Kahn and Rudd, 1999). This view suggests that analysts incorporate new information immediately into their projections and recommendations in an unbiased manner. Their role as a financial intermediary, or broker, between investors and corporations offers an informal representation of the financial soundness of the firm. Shareholder and potential shareholder behavior is thus influenced by analyst reports. A positive stock market performance accompanied by praise from financial analysts will influence investor financial behavior more than solely the stock market performance, without the analyst’s opinion (Hayward et al., 2004). Additionally,
analyst reports, or mediating market actors, dictate the extent to which a firm is regarded as a legitimate market actor (Zuckerman, 1999).

In recent years, however, research in behavioral finance literature has questioned the accuracy and conflicting interests of analysts’ reports (Chen, 2010; Jones and Johnstone, 2012; So, 2013; Zaleskiewicz, 2011). Primarily, analysts have been critiqued for being overly optimistic in their projections in turn increasing the expectation of greater financial gain for the investor (Jones and Johnstone, 2012; Lee, et al., 2008). Chen (2010) suggests that although the media has primarily focused on corporate executives in financial scandal, other individuals including analysts, can significantly affect the level of misrepresentation and should bear some blame in market crises.

Indeed, to the extent that an analyst’s recommendation reflects his/her opinion, valuation is not an exact science but one that leaves ample room for interpretations, human judgment, and social influence. Objectivity may be distorted further through embedded and biased ties between analysts and the firms they follow, which potentially generate conflicts of interests. The pursuit of objectivity may be further impeded if the analysts’ recommendations are tied to their compensation. For example, since investment banks receive a hefty commission from underwriting, and the same banks also employ security analysts, it may be in their interest to produce an optimistic valuation to ensure that the financial transaction is carried out successfully.

Markets are environments of asymmetric information (Baker, 1984). While ideally, investors are made aware of a company’s financial details prior to investing, there have been numerous cases in the recent past in which companies withheld important financial information from the public. Investors are nonetheless dependent on analysts and other social intermediaries for quality information about the companies they invest in. Analysts, who are privy to insider information, use their brokering location to make decisions on which information to share, how to share it, and whom they share it with. Furthermore, any information in finance capitalism that potentially increases stock value is presented optimistically because ultimately, it is viewed as a benefit to the market economy.

To illustrate, a trader was quoted in the PBS documentary The Bottom Line regarding the importance of increased stock price; “If firing people gets the stock up, it’s good. If hiring people gets the stock up, it’s good. They don’t care” (from Krier, 2005). PBS’ NewsHour offered another example of market optimism during their report on Citigroup’s announcement of a mass layoff of over 11,000 employees. In her report, PBS Senior Correspondent Gwen Ifill (2012) stated that, “stocks soared on the news of these layoffs”. Such market optimism obscures and may not accurately reflect the intrinsic value of the firm.

The increasing prevalence of this type of “money game” behavior can be viewed in the greater context of the transition in corporate governance toward shareholder capitalism. The financialization movement brought about a transformation where firms were no longer viewed as discrete organizational entities with unique product lines, but as “bundles of assets” subject to speculative behavior (Fliigstein, 2001; Krippner, 2011). The rise of finance capitalism made it increasingly clear that the primary purpose of the corporation is to maximize shareholder value (Van der Zwan, 2014).

As seen in Figure 1, financial analysts have a bridging function within financial markets; their brokerage role spans the chasm between corporations or banks and the investing public. The vertical line in Figure 1 represents the separation between the types of parties an analyst may broker, namely sell side and buy side. Analysts, especially in times of financial exuberance, focus primarily on the market value. They process information selectively, and devalue any negative reports that may criticize analysts’ behavior or deflate, if even slightly, market excitement (Gasparino, 2005). While analysts ideally play an unbiased or objective role, they often maintain cozy relationships with executive management that may breach ethical guidelines. The insider information accessed through their embedded relationships may then be used to exploit or disadvantage the investing public through inherently biased

Relationships of collapse

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research reports. Subsequently, important financial decisions are made based on information selected by analysts. Analysts are also motivated by personal financial gain, which creates an incentive to promote and endorse any investment.

Case study: the telecommunications market
The telecommunications industry gained significant recognition and visibility due to its exponential growth and increased market capitalization in the 1990s. Wireless technology emerged, ownership of home computers flourished, and the internet became common and widely used. The Telecommunications Act of 1996 allowed for widespread competition in a sector that had been legitimately monopolized by AT&T since the 1920s. AT&T was highly regulated as a protected monopoly until 1975 when telecommunications was partially deregulated for long-distance competition. Talk of widespread deregulation began in 1985 when multiple domestic companies lost significant amounts of capital due to accounting irregularities in international calling. The Telecommunications Act of 1996 deregulated telecommunications and widespread competition was permitted. The stated purpose of the Act was to “create a regulatory platform that would permit broad competition among different kinds of telecommunication service providers, encourage innovation, and recognize rapid technological change” while preserving the strength and vitality of an already established industrial sector (Aufderheide, 1999, p. 8). Later, the Federal Communications Commission (2011) stated that an additional goal of the law was “to let anyone enter communications business – to let any communications business compete in any market against any other”.

Industry growth increased following the implementation of the Telecommunications Act of 1996. Startup companies rapidly emerged and market activity accelerated. The record of a seemingly guaranteed return on investment encouraged large telecommunications companies to take on enormous amounts of debt with the expectation of limitless growth in the sector. Companies raced to build communication networks, but by the year 2000 executives realized that public demand for additional communication capabilities was insufficient to cover costs. Several companies became quickly aware of the great telecom myth – an imagined endless demand for bandwidth (Malik, 2003).

By the end of the collapse, 23 companies had declared bankruptcy including WorldCom, which was the single largest bankruptcy in American history at the time. While the Dow Jones Index has nearly doubled since 1998, the technology-heavy NASDAQ composite index, which peaked at just over 5,000 points in 1999, has yet to return to such heights (Figure 2).

![Performance of major indices – 1998-2013](source: Google Finance)
Financial deregulation in the telecom sector was expected to yield substantial improvements in social welfare via competition. The competitive environment originated as a potential benefit to both consumers and businesses. However, the financialization of deregulation, occurring because investors sought to profit from the supra-normal profits by liberally providing capital to telecom firms, gave rise to financial speculation and exuberance which resulted in unethical and illegal behaviors by market actors. Ultimately, the deregulated sector ran off course due to the financial exuberance and market euphoria that ensued.

The telecommunications market collapse affected countless individuals and families who were not invested in the market. Employees of the large telecommunications companies were particularly affected because executives encouraged them to invest retirement funds into the company stock. In the crash, many employees lost both retirement funds and employment. Additionally, *Money Magazine* reported that Fidelity’s domestic equity funds had invested $25 billion in telecommunications markets, and investors in Standard & Poor’s index funds indirectly owned Qwest, Global Crossing, WorldCom, and ten other large telecommunications companies (Feldman and Caplin, 2002). The NASDAQ stock market peaked at above 5,000 only to drop more than 4,000 points over the next three years. The scandal and bankruptcy that occurred in large corporations, like WorldCom, Qwest, Global Crossing, Winstar, and others, devastated the investing public’s confidence in the Wall Street and large investment banks.

There were many key players within the business and political-economic spheres that contributed to the telecommunications growth and collapse. However, there were three Analysts who were particularly vocal and influential in the years leading up to the crash: Mary Meeker, Henry Blodget, and Jack Grubman. These analysts persuaded investors to purchase high-risk stock options in companies that had taken on massive amounts of capital debt, and fostered a market frenzy in which the actual share price was considerably higher than its intrinsic value. Grubman was the most vocal promoter of the new economy strategy and the never-ending market growth, unlimited demand for wireless products, and ever-expanding opportunities for profit in the financial markets.

**The social nature of investment banking**

While an entire market collapse cannot be reduced to the behavior of a few individuals, in some circumstances individual contributions cannot be ignored. Indeed, financial markets are embedded in their social environments, and are susceptible to norms and values as well as human error, greed, and self-preserving impulses. The neoclassical model of perfect competition suggests that individuals are too few and insignificant to affect market price. However, we argue that status and prestige coupled with individual motivations and strategic network positions gives certain individuals increased power and influence within financial markets and networks in general. Specifically, we focus on the content of ties, the role of the larger market context, and the functions of underlying socio-political mechanisms (Erikson, 2013; Gross, 2009).

In the mid-1990s, high-profile analysts created and cultivated close relationships with the firms they followed which came to illustrate the “dangers of over-embeddeness” (Pozner et al., 2010). Over-reliance on embedded ties can be harmful because it distorts the flow of information (Uzzi, 1996). Further, dense and embedded networks within the financial services industry led to the formation of cliques, with members circulating and basing their decisions on the offshoots of the same information.

Role conformity (Zuckerman, 1999) and “herding” (Carruthers and Kim, 2011) within the analyst community led to isomorphic pressures which discouraged other analysts to counter the valuations generated by the few high profile analysts. To illustrate, Grubman’s picks were circulated through a daily radio show Salomon Smith Barney (hereafter SSB) broadcasted to its sales force across the USA. The resulting echo effect (Burt, 2005) – selective disclosure
through informal relationships – reinforced opinion and predisposition into data and fact. Stock brokers and financial analysts at various firms were influenced by Grubman so much that they simply reiterated his projections instead of conducting individual research and projections (Gasparino, 2005). Grubman’s reach and influence via the daily radio broadcast was vast and widespread as the repeated transmission of his research among investors and analyst teams created an erroneous sense of market certainty and financial gain.

Identity and status also fueled the market frenzy as high-profile analysts represented high-status investment banks, e.g. SSB, Morgan Stanley, and Merrill Lynch. To the extent that status is a signal of quality and legitimacy (Podolny, 1993), an endorsement from a high-status analyst or brokerage firm spoke volumes in generating market hype and amplifying the echo. In the midst of the euphoria, a “buy” recommendation for a new tech company triggered market contagion. To illustrate, after the collapse it was divulged that Henry Blodget added his name to research reports done by several other analysts at Merrill Lynch. Adding Blodget’s name gave the illusion of his approval and increased legitimacy which encouraged investors to buy even though he had done none of the research presented.

At annual telecom conventions, analysts developed relationships with the executives of corporations to which they would award the coveted “buy” or “outperform” recommendation. Indeed, when a buy recommendation was given the respective company’s stock price jumped, as recommendations were interpreted as a sign of legitimacy and endorsement (Zuckerman, 1999). While the buy recommendation ideally is based on a formalized and mechanized process, in several instances it depended more on the social process or actor’s subjectivity. As Rona-Tas and Hiss (2010) suggest, the formalization process is dominant in financial decision while expert judgment adds legitimacy and validity to a firm’s financial activity. However, inappropriate relationships with executives frequently resulted in biased projections, research, and advice to investors.

The relationships that analysts established with executives of large telecommunications companies were legal, but highly unethical, given the structural location as a broker and profession as a research analyst. Throughout the 1990s, the Federal Reserve Bank and the Treasury Department changed regulations made by the Glass-Steagall Act of 1933. Sandy Weill, CEO of Citigroup at the time, organized a powerful lobby group that included influential individuals from Morgan Stanley, Merrill Lynch, MetLife, and Prudential, to pressure the Clinton administration to weaken Glass-Steagall (Madrick, 2011). Glass-Steagall, among other things, required that financial services offered by investment and commercial banks were provided by two legally independent corporations. The Gramm-Leach-Bliley Financial Services Modernization Act of 1999 fully reversed the stipulations set by Glass-Steagall. The changes allowed for financial conglomerates, such as Citigroup, to provide a wider range of financial services, e.g. stock and loan underwriting, financial loans, stock analysis, insurances, and investment advice to one corporate client (Prechel and Morris, 2010). The variety of services investment bankers were able to provide multiplied the potential conflicts of interest.

The changing political-economic structures at the corporate level also created possibilities for conflicts of interest. A single firm could provide advising and financing for a corporate merger, for example, while analysts at the same firm promote the merger in financial markets. A “buy” recommendation often served as a stamp of approval for carrying out financial advice given to a company’s executive team or board of directors or simply in order to maintain the firm’s banking services. For example, Grubman advised executive management at WorldCom to merge with the second largest long-distance carrier, MCI. After the merger was initiated, Grubman upgraded WorldCom’s stock recommendation to “buy” even though the company had accumulated billions of dollars of new debt. SSB consulted and advised the financial matters on the merger, on which
Grubman, Bernie Ebbers, and Scott Sullivan worked closely. After the merger was completed, SSB collected over $47 million in advising fees and a related bond deal, and Grubman was rewarded with a salary increase that made him the highest paid analyst on Wall Street (Gasparino, 2005). In another instance, Grubman countered market expectations and gave a “buy” recommendation to AT&T. It was later revealed that the recommendation came amidst a complicated web of interlocking directorates at AT&T and Citibank in exchange for personal favors for Grubman; namely, to get his children admitted into the prestigious private school 92nd and Y. After his children were admitted, Grubman adjusted the AT&T rating downward (Argandona, 2003).

In other instances, analysts chose not to change their buy recommendation because of the inevitable financial loss the banking side of their firm would experience. Blodget was reported to never have changed a buy recommendation even when research gave clear evidence of a decrease in share value. Mary Meeker recommended companies that would maximize profits for Morgan Stanley, even when she acknowledged the poor long term investment choices (Gasparino, 2005). In short, the buy recommendation was often given to companies in which it was not financially prudent to invest, but instead offered the highest return to the analyst and the investment bank. The political-economic structures at the time created incentives to feed misguided and conflicted advice that would exploit investors while creating additional profits for the analyst, the investment bank, and the company involved.

Traditionally however, investment banks intended to keep separate those who were privy to insider information and those who influenced investment decisions. This information barrier, known as a Chinese wall, was important in maintaining the independence within investment banks. Investment bankers successfully pressured the research analysts to give “buy” ratings even if the analyst knew the projected earnings would inevitably decrease. For example, in April 2001 after Winstar’s bankruptcy Grubman desired to downgrade several other telecom companies (XO Communications, Focal, Adelphia, and RCN Communications). However, when the head of investment banking at SSB heard this information he called Grubman and told him not to downgrade because doing so would hurt the investment banking business (SEC, 2003). Similarly, a Merrill Lynch fund manager asked Blodget what was so great about www.GoTo.com besides banking fees, to which Blodget responded, “Nothin.” Yet the company was not downgraded (Gasparino, 2005, p. 123).

In 1997, the Wall Street Journal commented on the “dual role” analysts were playing, stating that it was fraught with potential for conflicts of interest and that legitimacy depended on the analysts’ integrity (Raghaven, 1997). The changing political-economic arrangements allowed analysts to act simultaneously as an advisor, banker, and consultant, making unregulated movement from one side of the wall to the other acceptable. Regarding the new legitimated relationship, Grubman proclaimed, “what used to be a conflict is now synergy” (Feldman and Caplin, 2002). The “synergy” made objective research undesirable and seemingly uninformed. As seen in Figure 3, Grubman brokered the relationship between investors and executive managers. The bi-directional arrows represent consistent and open flow of information with executives while the unidirectional arrows on the other side of the network chasm represent the filtered or optimistic information presented to the investors.

The conflicting relationships analysts created with executives and their banking counterparts resulted in biased research that demanded optimistic results in the markets. The relationships became so conflicted and problematic that when bankers sold their services to up and coming tech companies they could practically guarantee that their analysts would give positive recommendations to investors. On one occasion, Meeker refused to give Microstrategy a buy recommendation even under the pressure of
senior management. Arguably, the decision to remain objective was the beginning of her being phased out as lead analysts at Morgan Stanley. Unlike Grubman and Blodget, Meeker voiced great concern about the unreliable highs in the high-tech and telecom markets. As much as anyone else’s, though, her concern was criticized by eager investors who were caught up in the market euphoria.

In the Global Settlement of 2003, Grubman was ordered to pay $15 million in disgorgements and penalties and, along with Henry Blodgett, was censured and permanently barred from associating with a broker, dealer, or investment banker. These analysts were able to use their network location to create strategic relationships resulting in extraordinary financial gain at the expense of investors. After the crash, Meeker, Grubman, and Blodget they were regularly accused of selling out investors for their own personal gain.

The current state of Chinese walls: continuing problems on Wall Street?
In the late 1990s, investors trusted analysts to release impartial and unbiased information about the potential earnings of investing in specific corporations. However, “professional go-betweeners, such as investment and business brokers, are the least [...] trusted channels for information” (Baker and Faulknner, 2004, p. 92). As a result of the conflicted investment system outlined above, in October of 2000 the SEC adopted Regulation Fair Disclosure (Reg FD) which was meant to address conflicts of interest in financial markets[1]. In April 2003, the SEC added supplementary regulation analysts certification (Reg AC) which requires analysts to include certifications that research reports accurately reflect their personal views and, more importantly, disclose whether or not they received compensation or other payments in connection with the recommendation[2]. In April 2003, federal prosecutors settled with ten of Wall Street’s biggest investment banks and Grubman and Blodget in which they would re-erect the Chinese walls separating investment bankers and analysts (Carney, 2013). However, a study conducted by Brown et al. (2015) suggests that ten years after the Global Settlement, significant portions have been ignored.
In their study, Brown et al. (2015) conducted surveys of over 350 sell-side analysts who published an equity research report in Investext between October 1, 2011 and September 30, 2012. The responses suggest that Chinese walls have not been re-erected and the problematic relationships exploited by analysts are a continuing problem on the Wall Street. To illustrate, over half of the respondents reported having direct contact with the CEO or CFO of the firm they cover at least five times a year, and 98.4 per cent reported having such contact at least once. Respondents also suggested that management has become more accessible since the time directly following Regulation FD. One analyst stated, “Regardless of Reg FD, investors value analysts’ direct contacts with management more than anything. As an analyst, if […] I’m able to say, ‘Hey, by the way, we were able to spend 20-30 minutes talking to senior management,’ boom! Their ears are just straight up” (Brown et al., 2015, p. 16).

The current state of Chinese walls between analysts and investment bankers augments the relevance of this study. The analyst-turned-investment-banker that straddles Chinese walls increases their potential to present biased information to investors. As seen above, there is an increased potential for financial loss to the investor when analysts work in confidence with corporate management. The Brown et al.’s (2015) survey additionally asked analysts to rate how important a number of factors are to the analyst’s compensation. Accuracy of earnings forecasts was reported as the least important and just under half of the respondents answered that generating underwriting business or trading commissions is very important to the analyst’s compensation. This response suggests that analysts are still engaged in conflicting professional roles in investment banks.

Executive management also arranged avenues to leak information to analysts through paper forms submitted to the SEC. The SEC permits managers to carry on privately with analysts as long as the information shared is divulged through the 8-K form. The 8-K essentially legitimates divulging insider information to analysts and other brokering individuals. By submitting the 8-K, corporate managers wave liability to charges of leaking insider information.

Regarding the status of the Global Settlement and re-erecting the Chinese wall, Barbara Roper, the Director of Investor Protection at the Consumer Federation of America stated: “The analyst settlement never did as much as it could or should have done to bring real analyst independence. The SEC never fully embraced it, didn’t adopt rules to enforce its principles, and didn’t implement it in a way that really changed practices” (quoted from Carney, 2013). Furthermore, in May 2013 Grubman stated that since the Global Settlement in 2003 nothing has changed regarding analysts’ strategies and motivations. Any changes that have occurred have been in “form and not substance” (quoted from Belvedere, 2013).

Conclusion and extension of research
In this paper, we apply network theory and network brokerage to analyze the structural position and role of security analysts in financial markets. We argue that analysts, acting as network brokers, contributed to the telecommunication market collapse in the early 2000s by brokering relationships with top management and members within their firm, both of which led to biased and conflicted research analysis. In contrast to the efficiency view (Fama, 1965), which undermines the role of market intermediaries in financial markets, our contribution using a network theoretic approach reveals that security analysts can significantly influence the market through the selective disclosure of information and the echo mechanism (Burt, 2005). The network view highlights that the information transmitted through the social structure is more easily accessed by key individuals in strategic structural positions in social structure (Burt, 1992). Furthermore, similar to the literature on opinion leaders and attentive publics (Converse, 1964; Devine, 1970; Krosnick and Telhami, 1995), financial intermediaries who are dedicated to one specific domain present
information to an attentive (investing) public. Due partially to the structural location of the intermediary, there is an increased potential for the analyst to distort information and influence others’ investing behavior. Furthermore, because of the erosion of Chinese walls in banking at the time, it was likely increasingly difficult to provide independent research reports. The structural location of the broker only further complicates the independence (or at least its outward appearance) of banking and investing.

A final note from their research increases the generalizability of this study. Brown et al. (2015) report that industry-specific knowledge is the most important indicator of the analyst’s compensation. In any industry, intermediaries may use industry-specific jargon to persuade investors to buy a company’s stock in which the analyst is structurally overembedded. The analyst then puts on the banking hat and profits through underwriting and other financial services fees. The conflict of interest coupled with the dual role of the analyst creates an environment of increased financial risk in an already unstable and volatile environment. In situations such as these, the Banking Act of 1933 (Glass-Steagall) that separated commercial and investment banking should be reconsidered (Rona-Tas and Hiss, 2010).

We propose and outline here that social network theory can effectively and innovatively identify the sources of corporate malfeasance and other inefficiencies within financial markets. According to several leading scholars in economic sociology (Abolafia, 1996; Baker, 1984; Fligstein, 2001; White, 2002), financial markets are composed of informal and formal network relationships which merit a thorough application of network mechanisms. Additionally, market actors are prone to act in their own best interest and some individuals act opportunistically (Williamson, 1975). Criminological theory suggests that deviant behavior is learned from an individual’s peers, or is an outcome of network influences, at least partially (Sutherland, 1947). These statements are widely accepted within economic sociology and the deviance literature, suggesting that there is sufficient opportunity for researchers to apply network theory more critically.

This paper has significant implications for public policy and investors alike. As investment banks have become increasingly influential in finance capitalism, regulations like Reg FD, Reg AC, and the Global Settlement are important to safeguard profits and ensure market stability. However, regulations to monitor the interaction of intermediaries and investors must be enforced effectively. Without effective and enforceable regulation, market intermediaries may continue to exploit brokerage locations for their own financial gain and the other negative potentials of market actors may be brought to light. Current theories of markets largely assume frictionless markets, anonymous actors, sufficient information, and efficiency, and overlook important network characteristics of market actors and structures. Elaborating theoretical explanations and frameworks of financial market should reflect what has been emphasized here and by others (e.g. Abolafia, 1996; Acemoglu et al., 2015; Baker, 1984); that financial transactions do not operate in a vacuum, but are influenced by social interactions, existing relationships, and larger social forces.

Notes
1. Reg FD is a ruling passed in August 2000 which states that if or when an individual or publicly traded company discloses nonpublic information to select individuals or entities, that information must be disclosed publicly. The purpose is to promote fair and full disclosure (see www.sec.gov/answers/regfd.htm).

2. Reg AC requires that analysts and other researchers include a report certification that states the information in the report reflects his or her personal views. Also, Reg AC requires that the analyst report any compensations or payments of any kind in connection to their report (see www.sec.gov/rules/final/33-8193.htm).
References


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Further reading


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