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"On the Conflicts of Interest in the Corporate Scandals of 2001-2002"

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On the Conflicts of Interest in the Corporate Scandals of 2001-2002

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ABSTRACT

Contemporary economic sociology tends to underemphasize the role of interests in economic life and exclusively pay attention to social relations. One empirical case that lends itself in a natural way to a reintroduction of interests into economic sociology is that of the recent conflicts of interest in the corporate scandals of 2001-2002. I first present the way that the conflicts of interest in accounting and business analysis have been presented and analyzed in the public discourse (using Arthur Andersen and Merrill Lynch as examples). I then show how a sociological approach can improve the understanding of these two types of conflicts of interest. Of particular use in this type of study – and in economic sociology more generally - are the ideas about using interest as a *sociological* concept in the works of Coleman and Bourdieu. These argue that (1) interests can only be realized through social relations, and (2) that interests are socially constructed – two propositions that are of much importance to economic sociology.

During its recent revival, from the mid-1980s and onwards, economic sociology has very strongly emphasized the role that social relations play in the economy.[1] The networks that are involved when people look for jobs have, for example, been explored, and so have the networks that exist between and within corporations (for overviews, see e.g. Powell and Smith-Doerr 1994, forthcoming). One of the most popular expressions in recent economic sociology – *embeddedness* – expresses the ambition to explain economic phenomena by mapping out the social relations in the economy. Economists, it is often pointed out, focus exclusively on self-interest and tend to ignore the role of the social structure (e.g. Granovetter 1985, 2002).

It is the argument of this article that this exclusive emphasis on social relations in current economic sociology needs to be complemented with more attention to *interests.* A fuller analysis of economic phenomena demands that attention is paid to both interests *and* social relations. This type of advocacy, it should be noted, is not new, but can be found in the classics as well as in contemporary sociology. In the key theoretical chapter of *Foundations of Social Theory*, Coleman argues that interest should become *the* major category in sociological analysis, and he approvingly cites Helvétius' famous that the goal of analyzing the social world is to lay bare "the laws of interest" (Coleman 1990:28). Coleman, however, is very careful to point out that actors can only realize their interests by entering into relations with one another (Coleman 1990:29-31). For Bourdieu, the notion of interest is as central to the sociological analysis as the concepts of habitus, field

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[1]The author can be reached under his address, as cited above. For helpful comments and/or information I would like to thank Walter Mebane, Mabel Berezin, Robert Frank, Victor Nee, Alex Pradu, Nico Stehr and Mauro Zamboni. I am also grateful to Jonathan Rose for permission to cite his work. An early version of this paper was presented at the inauguration of the Society for the Study of Economy and Society at Cornell University on February 19, 2003.

and different types of capital (e.g. Bourdieu and Wacquant 1992:115-20). He warns, however, that interest must not be seen as something that is natural and somehow given by nature, something that is characteristic for the way that economists look at interest. In society, according to Bourdieu, interests are always socially created and defined; "anthropology and comparative history show that the properly social magic of institutions can constitute just about anything as an interest" (Bourdieu and Wacquant 1992:117).

The two points that Coleman and Bourdieu make about interest – (1) that interests can only be realized through social relations, and (2) that interests are always socially defined – inform the analysis in this paper. The value of both propositions will be illustrated by an analysis of one particular element of the corporate scandals of 2001-2002 in the United States, namely that which involves *conflicts of interest*. Legal analysis has for a long time understood the usefulness of conceptualizing certain phenomena in terms of conflicting interests (just as it very early cast certain phenomena in agency terms); and economic sociology may want to follow suit. Economic sociology, however, cannot accept the proposition of legal analysis that there just exist interests and that these are in conflict with each other. It is precisely at this point that the two propositions of Coleman and Bourdieu come into the picture and can be of help: interests are typically realized through social relations, and interests are socially defined. The purpose of this paper is to show that the conflicts of interest that took place in 2001-2002 - especially those that involved accounting and business analysis - need to be approached through an analysis that pays attention to *both* social relations and interests, along the lines suggested by Coleman and Bourdieu.

In the rest of this paper I will first look at the concept of conflict of interest and describe how it has its origin in legal analysis, and also how it during the last few years has been picked up in the public discourse, in which it has been extended to several new economic phenomena such as accounting and business analysis. Arthur Andersen will be used to illustrate the situation in accounting, and Merrill Lynch in business analysis; I will also present the various attempts to solve these conflicts of interest that were made in 2002. As my empirical source for how these events have been treated in the public discourse I have mainly relied on newspaper articles, the business press and official statements by key politicians during 2001-2002. The last section of the paper is devoted to an attempt to show how one can go beyond the insights of legal analysis and the public discourse on conflicts of interest by using a sociological approach to this phenomenon, along the lines of Coleman and Bourdieu. The paper concludes with a discussion of the need to pay more attention to the role of interests in economic sociology.

The Concept of Conflict of Interest in Legal Thought and in the Public Discourse of 2001-2002

The current edition of *Black's Law Dictionary* has the following entry for "conflict of interest":

> 1. A real or seeming incompatibility between one's private and one's public or fiduciary duties. 2. A real or seeming incompatibility between the interests of two of a lawyer's clients, such that the lawyer is disqualified from representing both clients if the dual representation adversely affects either client or if the clients do not consent. (Garner 1999:295)

An important element of conflict of interest legislation is the realization that misconduct will not take place in every case, where there is a conflict of interest, but in enough cases for there to be reason to interfere *before* anything goes wrong. Conflict-of-interest legislation is consequently prophylactic in nature; and what matters, to cite a Supreme Court decision from 1961, is not so much what "actually happened" as what "might have happened" (*U.S.* v. *Mississippi Valley Generating Company*; cf. Stark 2000:4).

The legal concept of conflict of interest has its own history, which is instructive but largely unwritten (e.g. Davis 2001:17). It has its origin in early legal thought, and there are those who argue that the idea of conflict of interest goes all the way back to the Middle Ages (e.g. Rose 1999). The term that was used during this time, however, was "ambidexterity", and it "literally referred to lawyers, 'ambidexters', who took money with each hand from different parties to a dispute" (Rose 1999:[2]). In 1789, during the first Congress in the United States, an act was passed according to which the holder of the newly instituted office of Secretary of the Treasury could not invest in government securities (Association of the Bar of the City of New York 1960:4, 27-8). Much

American conflict of interest legislation dates to the second half of the 19th century, and to the attempts to create an efficient government after the Civil War.

The legal *term* "conflict of interests" seems, however, to be considerably younger than *the idea* of such a conflict. When it first emerged is difficult to say and may vary depending on the area of application. By the 1950s conflict of interest was however a generally accepted legal term in the United States. Two standard works on the subject were also published around this time (Association of the Bar of the City of New York 1960, Manning 1964).

The great novelty with the use of the term conflict of interest during the last few years is that it became part of public discourse in describing several economic phenomena, to which it had not been applied before.[1] More generally, in describing the corporate scandals of 2001-2002, the concept of conflict of interest has been central from the very beginning. It can, for example, be found in many public speeches and articles by various public figures, including George W. Bush, George Soros and Joseph Stiglitz (e.g. Bush 2002a, Soros 2002, Stiglitz 2002). The term conflict of interest now also entered the vocabulary of the newspapers and television in their discussions of economic topics. Here it has been used in a fairly loose sense; and insider trading and rewarding CEOs with lucrative stock options are, for example, often mentioned as examples of conflicts of interest. The two economic situations where one can find the term used the most frequently, however, in the popular media as well as in the work of various official commentators, is in connection with *accounting* (especially when the same firm does accounting and consulting) and with *business analysts* (especially when these work for firms who also do investment banking). In the Sarbanes-Oxley Act of July 2002 these two phenomena were also officially discussedas examples of conflicts of interest.

Why There Were Conflicts of Interest in Accounting and Business Analysis, according to the Media

What drove the conflicts of interest in accounting and business analysis was according to the media the boom on the stock exchange in the 1990s. The rapid rise in the price of shares set off the type of behavior that led to conflicts of interest. A number of important institutional changes also took place during this decade, it is often added, which operated in the same direction. In 1996 the telecommunication industry was deregulated through the Telecommunication Act, and in 1999 the Glass-Steagall Act (1933) was formally repealed. Ordinary bank business could now be combined with investment banking, and so could ordinary brokerage business. As the stock market rose and the New Economy was ushered in, IPOs became increasingly common as well as an excellent source of income for these types of brokerage firms and banks.

During the 1990s, it is often noted in the public discourse, the stock exchange shot quickly upwards; Dow Jones quadruped and the Nasdaq increased by more than 800%. On January 14, 2000 Dow Jones Industrial reached the record high of 11722.98, and on March 10, 2000 Nasdaq Composite reached a peak of 5048.62. The 1990s also saw the birth of the use of derivatives on a mass scale, including the stock option which became a popular way to reward CEOs. This was particularly the case for startups in Silicon Valley, where profits often were non-existent during the first few years. Stock options, it was soon pointed out in the media, also had the advantage that they did not have to be registered as expenses by the corporations that granted them. By 2001 many CEOs received part of their pay in options, and for the first time in U.S. history it was now possible for CEOs to become extremely wealthy individuals (e.g. Krugman 2002). This was the period of "irrational exuberance", to cite a phrase by Alan Greenspan that has become a symbol for the decade of the 1990s.

An increasing number of Americans now started to buy shares, and by 2001 a little more than a majority of the population were shareholders, up from about a third a decade earlier. The most important conduit into the stock market for ordinary people was through the pension system, especially 401(k) plans which came into existence in 1982. By 2001, according to one estimate, 42 million Americans had invested 1.8 trillion dollars, mostly in mutual funds; and the average person with a plan of this type had $ 50,000 in it (Levitt 2002b:257). Having money in this type of funds did not only expose many small investors to the ups and downs of the stock market; a number of corporations also demanded that matching funds were invested in the shares of the company where the employee worked, something which tied the value of the future pensions directly to the fate of a single corporation.

In early 2000 the stock market started to decline, and a series of spectacular corporate meltdowns and bankruptcies soon took place which were given a huge place in the media. The first of these was Enron, which went bankrupt in December 2001, and the largest was WorldCom, which went bankrupt in July 2002. It soon also became clear, through information in the media, that a huge number of corporations had inflated their profits, with the help of accounting. Especially WorldCom's announcement in June 2002 that it had inflated profits by $ 3.8 billion caused fury in the media and among investors, and led to the passing of the Sarbanes-Oxley Act a month later. It has later been estimated in the press that WorldCom had publicly overstated its profits by more than $ 9 billion.

All in all, what mainly drove the conflicts of interest in accounting and business analysis, according to the media, was the boom on the stock exchange in the 1990s. This boom, according to public discourse, increased the temptation for individuals to make money quickly and set caution to the side. There was an outcry of anger when these wrongdoings were eventually found out, and this public outcry led to the passage of legislation in 2002 which forbid and criminalized this type of behavior.

Conflict of Interest # 1: Accounting vs. Consulting

Before presenting the way that the conflicts of interest at the accounting firm Arthur Andersen were presented in the public discourse, a few words need to be said about the general situation in the accounting industry, drawing on more conventional sources (e.g. Stevens 1991, Brooks 2001). According to the legislation that was created in the early 1930s, in response to the financial scandals that were associated with the Depression, the annual report of every publicly traded corporation has to be audited by a certified public accountant.[2] The reason for this requirement is that investors must be able to trust that the figures in annual reports of public corporations adequately reflect their economic situation. It was also decided that accounting should be carried out according to "generally accepted accounting principles", and that these were to be defined by the Securities and Exchange Commission. In practice, however, the accounting industries soon became self-regulating and responsible for generating as well as policing these accounting standards.

The accounting business gradually became increasingly concentrated, and by the 1970s eight accounting firms handled the audits of 90% of the corporations which were listed on the New York Stock Exchange (e.g. Stevens 1981, 1991). "The Big Eights", as these firms became known, can be described as huge multinational firms with an expertise in a number of fields, from accounting to taxation law and engineering. By 1980 about 60% of their aggregate income came from auditing, 25% from consulting, and 15% from work on tax issues. The fact that the same firm audited a corporation's books, sold it consulting services, and supplied it with tax advice was several times in the 1970s cited as a potential source of conflict of interests. According to the Metcalf Report from the late 1970s, for example,

> The management advisory services provided by Big Eight firms are intended to aid corporations in operating their businesses and necessarily involve Big Eight firms in the business affairs of their clients. Such involvement creates a professional and financial interest by the independent auditor in a client's affairs which is inconsistent with the auditor's responsibility to remain independent in fact and appearance. (Stevens 1981:200-201)

The 1990s with its boom in the stock exchange accelerated the tendencies for sharp conflicts of interest to emerge in the accounting industry. By the beginning of the 1990s the Big Eight had become the Big Six, and a few years later the Big Five, with an ironhold on the market. Income from auditing fees had shrunk to 31% of overall income in 1998 (Levitt 2002b:116). Many accounting firms were also advising the executives in their personal finances in firms that they audited, thereby creating new types of conflicts.

Attempts to control the situation through legislation and self-regulation in the 1990s were perceived as threats by the accounting industry, which countered with massive lobbying and huge contributions to politicians. In 1993 the accounting industry helped business interests in general to block a proposal that stock options should be counted as costs (and hence be deducted from profits); and in 1995 they similarly helped to push through legislation that limited the rights of investors to sue accountants and corporations. Any suggestion that consulting should be split off from auditing was fought with great energy.

As the 1990s progressed and the stock market exploded upwards, it became increasingly common for firms to overstate their profits through various forms of aggressive accounting. The accounting firms played along with this "numbers game", sometimes getting caught and sometimes not. SEC, under the energetic chairmanship of Arthur Levitt, tried to counter this development but could accomplish little (e.g. Levitt 1998, 2002b:105-43). This includes Levitt's attempt towards the end of the 1990s to stop conflicts of interest by splitting off consulting from accounting. In 2000 Levitt nonetheless succeeded in introducing a few reforms, including the requirement that accounting firms must state how much income they derive from consulting in their annual financial reports.

Case Study # 1: Arthur Andersen

Just as Enron has become the symbol for the corporate scandals of 2001-2002 through its spectacular meltdown in a few months, so has Arthur Andersen become the symbol in public discourse for the kind of accounting that helped to make these scandals possible. The picture of Andersen that was presented in the press during 2001-2002 was as follows. By 2001, it was often pointed out, Enron was the seventh largest corporation in the United States with an income of $ 101 billion. Its main business was trading in energy (oil, gas, electricity), and it had very successfully helped to support the efforts to deregulate this field. By all appearances Enron was a strong and healthy corporation with high profits till its sudden announcement on October 16, 2001 that it had made a loss during the third quarter of the year of $ 618 million. It quickly became clear that various accounting tricks had been used during a number of years to cover up huge losses. Three weeks later Enron was also forced to publicly admit that its income from 1997 and onwards was $ 586 million less than what had been stated; and two weeks later Enron had to repay $ 690 million in partnership debt. The stock market reacted swiftly to these news, and by the time of Enron's bankruptcy – which was announced on December 2, 2001 – the shares of Enron were worth less than $ 1, down from a high of $ 90 in the fall of 2000.

Once Enron's problems had become known, eyes in the media quickly turned to Arthur Andersen LLP, its auditor. SEC immediately began a preliminary investigation of Enron, and when this became known at Andersen, an intense effort to destroy Enron-related material began. On the order of the partner in charge of the Enron account at Andersen, David Duncan, at least 26 trunks filled with records and 24 other boxes of documents were destroyed as quickly as possible at Andersen's offices in Houston, Texas. Destruction of documents also took place in a number of other Enron offices, inside as well as outside the United States. As a result of these and other activities the Justice Department decided on March 14, 2002 to indict the whole firm on charges of obstruction of justice in the investigation of Enron. This indictment, for which Assistant Attorney General Michael Chertoff was primarily responsible, represented an extremely serious threat to Andersen since an accounting firm which has been convicted of a crime is not allowed to do business.[3]

Under the impact of the indictment Andersen quickly started to lose clients, and its worldwide operations began to disintegrate. Attempts were made by SEC and various individuals to find a solution which would allow Andersen to avoid prosecution and continue to exist - but all of these failed. On June 15, at a trial in Houston, Andersen was found guilty of obstruction of justice. By August 31, Andersen told SEC, it would cease to do business.

The rise and fall of Andersen was now often told in the press (e.g. Brown and Dugan 2002). Half a year before the fateful decision in Houston, it was pointed out, Andersen had had branches in 84 countries, $ 9.3 billion in revenues, 26,000 employees in the United States and 85,000 worldwide. The firm traced its origin to 1913, when a professor of accounting at Northwestern University named Arthur Andersen decided to go into business with some partners. Andersen's motto was "Think straight, talk straight", and for many years Andersen was seen as the leader in the industry when it came to honest accounting. After World War II Andersen also became a pioneer in introducing consulting into accounting. What set off this development was the invention by an Andersen engineer of a computer-based machine that would help with accounting (the "Glickiac", after the name of its inventor, Joseph Glickauf). Andersen soon began to pursue consulting in a very aggressive manner, and by 1984 it for the first time earned more from consulting than from auditing. Since the consultants felt that they were not paid as much as they deserved, however, they soon forced a decision to split the firm into an accounting part ("Andersen") and a consulting part ("Andersen Consulting").

When this split became final in 1997, the accounting part decided that it had to get into consulting on a large scale to make up for the loss of Andersen Consulting. An aggressive strategy was now designed and called "2X", since the idea was that each partner had to bring in twice as much in consulting as in auditing. It seems that Andersen, in this new corporate climate, quickly started to set aside many traditional accounting standards (e.g. Toffler 2003). The firm was soon embroiled in a number of scandals, which were handled in a cavalier manner. One of these that angered the federal authorities in particular involved a firm called Waste Management. In 1997 Waste Management had to admit that it had overstated its profits during the 1990s with $ 1.1 billion – the largest restatement in U.S. history (at this point). Without admitting or denying guilt, Andersen was fined $ 7 million by SEC and also agreed to an injunction against future misdeeds. Andersen's failure to honor its promise in the case of Waste Management was a major cause why the Justice Department in March 2002 decided to indict the whole firm (rather than some individuals).

Enron was one of Andersen's best clients. In 2001 the accounting firm received $ 25 million in fees for auditing and $ 27 million for consulting; and some people at Andersen believed that they would one day be able to charge $ 100 million in fees from Enron. According to an e-mail between Andersen employees, this hope for giant fees in the future was one of the reasons why Andersen put up with Enron's extremely aggressive and often deceptive accounting. At several times from the late 1990s and onwards, Andersen became aware of various wrongdoings at Enron but decided to let these pass. What also helped Enron to keep Andersen calm and continuously provide its seal of approval on its faulty accounting, was the fact that Andersen had rearranged its own structure so that its most competent and reliable accountants could easily be bypassed (the so-called "Professional Standards Group"). To this should be added the close relationship or symbiosis between Andersen and Enron, which made it hard for Andersen's people to stand up to Enron. According to *The Wall Street Journal*:

> Andersen's laboratory [for its attempts to reshape accounting in a less stringent direction] was Enron, an audit client since 1986. Andersen in the mid-1990s hired Enron's entire team of 40 internal auditors, added its own people and opened an office in Enron's Houston headquarters that was as big as some regional Arthur Andersen offices. With more than 159 people on-site, Andersen staff attended Enron meetings and helped shape new businesses, according to current and former Andersen and Enron employees. (Barrionuevo, Weil and Richards 2002:A6)

Conflict of Interest # 2: Business Analysis vs. Investment Banking

The second type of conflict of interest that has dominated the public discourse about the corporate scandals during 2001-2002 is the one that involves business analysts. More precisely, they are conflicts of interest that mainly involve the relationship of business analysts to investment banking. This relationship has grown stronger during the last few decades due to two institutional changes on Wall Street: the deregulation of commissions in 1975 and the *de facto* repeal of the Glass-Steagall Act from the late 1980s and onwards. The former made it much more profitable for Wall Street firms to do business with banks and institutional investors than with small investors; and the latter greatly increased the competition, especially for IPOs, since also commercial banks were now allowed to do this kind of business. Analysts, according to one observer, now "grafted themselves onto the investment banking team" (Levitt 2002b:66). Small investors from now onwards became much less interesting to brokerage firms, and were often treated with contempt. Buy and sell orders from individuals were, for example, referred to as "dumb order flow" by Nasdaq market makers since they had so little information that it was always easy to make money out of them (Craig 2002:C3).

During the 1990s the relationship between business analysts and investment banks intensified. Business analysts assumed the role of "an adjunct of investment banking", and their pay was often directly dependent on how much business they could drum up (e.g. Levitt 2002b:70). The financial firms publicly denied that any conflicts of interest existed and referred to "the Chinese Wall" that existed between investment banking and research. Business analysts were nonetheless very useful in helping out with IPOs, which were a major source of profit for investment bankers during this period; they also assisted conventional brokerage. The analysts helped to attract business through overly optimistic analyses; these overly optimistic analyses also helped to sell the IPOs. According to a study in the late 1990s, the long-run performance of IPO stocks which were recommended by analysts who worked for firms that lead the underwriting of these stocks, did significantly *worse* than stocks which were recommended by non-underwriting analysts. According to the authors of this study, "it is not the difference in analysts' ability to value firms that drives our results, but a bias directly related to whether the recommender is the underwriter of the stock" (Michaely and Womack 1999:683; similarly Hayward and Boeker 1998).

Many CEOs also leaked information about future earnings to analysts, in order to forewarn the market of what was to come. Uncooperative analysts got little information and were sometimes ostrasized. According to a famous internal memo from Morgan Stanley and Co (which was quickly disowned when it became public), "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" (Hayward and Boeker 1998:6; emphasis added).

Some business analysts now became superstars and could directly affect the market through their recommendations (e.g. StarMine, as cited in Der Hovanesian 2002). They appeared on television shows and wrote financial columns which reached a mass audience of small investors. The best analysts earned between $ 10 and 15 million, including bonuses, and the most famous of them all, Jack Grubman of Salomon Smith Barney, made $ 20 million per year. Grubman, who was an expert on the telecom industry, involved himself very deeply with the corporations he analyzed, and helped them out with strategy, mergers, and sometimes even attended board meetings. In a much quoted interview from 2000 he said,

> What used to be a conflict [of interest] is now a synergy. Someone like me who is bank-intensive, would have been looked at disdainfully by the buy side 15 years ago. Now, they know that I'm in the flow of what's going on. (Rosenbush et al 2002:34).

This development toward a symbiotic relationship between business analysts and investment banking meant that the interest of the small investors was set aside. Business analysts sometimes said one thing in private, to the initiated few, and another in public. Grubman et al issued practically no ‘sell’ recommendations during the 1990s and often recommended investors to buy shares in corporations until these were close to bankruptcy. Grubman, for example, did not stop recommending WorldCom till April 2002, when its shares had lost 90% of their value.

By the end of the 1990s it was apparent to many observers that business analysts were getting careless and irresponsible in their analyses (e.g. Sernovitz 2002). The big players fiercely opposed any intervention by SEC, including its efforts to stop CEOs from leaking information to analysts who they were close to. Nonetheless, in late 2000 SEC succeeded in getting through a very important piece of legislation called “Regulation Fair Disclosure”. The main point of RFD is that relevant economic information must be made available to everyone – not just a select few. This regulation has made immensely more information available to small investors. The attempt by SEC to get business analysts to behave more responsibly on public television, on the other hand, failed, largely because of the resistance of the television companies.

Case Study # 2: Merrill Lynch

During 2002 a number of investigations were started that tried to establish that serious cases of conflicts of interest existed in a number of securities firms; and the U.S. media has followed these with great interest. Many of these investigations were initiated at the state level since SEC, now under the Levitt’s successor, Harvey Pitt, was reluctant to take action. The pioneer among these investigations, and also the most spectacular in many ways, was the one that involved Merrill Lynch in the state of New York (e.g. Scheiber 2002). On April 8, 2002 Attorney General Eliot Spitzer announced publicly that he had issued a court order requiring immediate reforms in Merrill Lynch, the largest brokerage firm in the United States. What was at issue, according to Spitzer, “was a shocking betrayal of trust by one of Wall Street’s most trusted names” (Office of New York State Attorney 2002:[i]).

Spitzer made his charges against Merrill Lynch based on state legislation known as The Martin Act of 1921. This law, it is often noted in the press, has two important advantages over SEC legislation and federal law. For one thing, it allows the attorney general to bring criminal charges; and in the case of Merrill Lynch a criminal conviction would have meant its death sentence, just as it did for Arthur Andersen. And second, the Martin Act, as opposed to federal law, allows you to proceed without establishing intent, which is typically hard to do. At the time when the case against Merrill Lynch was presented, Spitzer also announced that several other firms were under Martin Act subpoena to produce evidence about possible conflicts of interest between investment banking and research activities.

The evidence presented by Spitzer to the media on April 8 was based on a ten month long investigation of Merrill Lynch, which involved some 30,000 documents and thousands of e-mails. The basic charge against Merrill Lynch was that its research had been presented to the general public as objective, while in reality it was biased by the fact that it had been produced in close association with investment banking. While noting that "tension between various departments in a single [brokerage] firm is nothing new", and that "this tension is usually addressed by the establishment of a 'Chinese Wall'", it was also emphasized that this arrangement had failed in this particular case (*ibid*.:14). According to the affidavit, Merrill Lynch had on a regular basis misled investors in the following ways:

> (1) the ratings in many cases did not reflect the analysts' true opinions of the companies; (2) as a matter of undisclosed, internal policy, no 'reduce' or 'sell' recommendations were issued, thereby converting a published five-point rating scale into a de facto three-point system; and (3) Merrill Lynch failed to disclose to the public that Merrill Lynch's ratings were tarnished by an undisclosed conflict of interest: the research analysts were acting as quasi-investment bankers for the companies at issue, often initiating, continuing, and/or manipulating research coverage for the purpose of attracting and keeping investment banking clients, thereby producing misleading ratings that were neither objective nor independent, as they purported to be. (*ibid*.:3)

The main focus of Spitzer's investigations was directed as Merrill Lynch's so-called Internet Research Group, led by well-known analyst Henry Blodget. E-mails that were made available to the media revealed, among other things, that stocks that were publicly said to represent a sound investment (a "2"), were in private e-mails described as a "piece of shit" and a "piece of crap" (see Table1). Blodget wanted the analysts to devote 50% of their time to research and 50% to banking; and he described his own work as "85 % banking, 15 % research" (*ibid*.:15).

/Table 1 about here/

Blodget and his staff were well aware that their involvement with investment banking would lead to biased research. According to one e-mail from a person on his staff, "we bend backwards to accommodate banking", and according to another, "the whole idea that we are independent of banking is a big lie" (*ibid*.:17). At one point Blodget noted that going against the wishes of Merrill's banking clients in the analysis would lead to "temper-tantrums, threats, and/or relationship damage" (*ibid*.:19). This, however, did not present him from publicly pretending that the research that the Internet Research Group produced was objective. It was also noted in the affidavit that during 1999-2000 Blodget had made more than 120 appearances on public television, such as CNN and CNBC.

On May 21, 2002, after several weeks of discussions, a settlement was reached between Merrill Lynch and Spitzer. What exactly went on during these negotiations was not reported in the media and is currently not known. Nonetheless, since some 30% of the revenue of Merrill Lynch comes from retail investors and the firm has become known as "a symbol of middle-class investing", it is often noted that that the firm may have been very sensitive to accusations that it had mistreated small investors (e.g. Scheiber 2002:18). According to the press, Spitzer also threatened to indict Merrill Lynch, which would have meant the end of the company (*New York Times* November 4, 2002:B6). Spizer later noted that, "We could have indicted, convicted and destroyed Merrill [but] that would have been insane" (*Business Week* October 7, 2002:43). Some observers also feel that the quick drop in the stock of Merrill Lynch, as a result of Spitzer's investigation, was a further reason why Merrill Lynch chose to settle.

Without denying or admitting guilt, Merrill Lynch agreed to pay $ 100 million in fines (Levitt 2002b:82-3). Much more importantly than the fine, however, was that Merrill Lynch now also had to introduce a number of structural changes into its ways of doing business, as dictated by Spitzer, to prevent conflicts of interest in the future. It was, for example, decided that an independent committee should be established at the firm to monitor the communications between the investment bankers and the analysts. The investment bankers would also have no say in issues pertaining to the compensation of the analysts; and the analysts would exclusively get paid on the basis of how well the stocks that they picked performed.

Attempts to Solve the Conflicts of Interest

A large number of proposals for how to solve the conflicts of interest involving accounting and business analysis have been made in response to the scandals that started with Enron and have been closely followed by the media. The most important piece of legislation that that has been used to deal with these issues is the Sarbanes-Oxley Act, which was signed into law in July 2002. Much attention has also been devoted in the media to Eliot Spitzer's "global solution" that was initiated in the fall of 2002 and completed by the end of December. Of the many other proposals a special mention should be made of Paul Volcker's effort to solve the conflicts of interest at Arthur Andersen in the spring of 2002 since he was trying to develop a model for the whole accounting industry and for a while it seemed to have had a chance to succeed.

There is a distinct complexity to the various proposals for how to solve the many conflicts of interests in the economy that occupied so much of the media's attention in 2001-2002, and it may therefore be useful to introduce a simple typology. All of these proposals can be sorted into four categories depending on their stance whether to use law or self-regulation, on the one hand, and whether to assign different economic activities to different organizations or allow these to coexist in the same organization but separated by a "Chinese Wall". The most common outcome has been a strengthening of the "Chinese Wall" through self-regulation, which also represents the traditional way for the securities industry to handle conflicts of interest (see Table 2 for the different alternatives).

/Table 2 about here/

Attempts to solve the conflicts of interest began as soon as Enron collapsed and it became clear that investors – including major pension funds - had lost billions of dollars. Some politicians advocated legislation to quickly put an end to conflicts of interest in accounting for good; and in early 2002 several proposals were made in Congress to forbid accounting and consulting from being carried out in one and the same organization; to let the state take over auditing through the creation of a Federal Bureau of Audits; and the like (e.g. US House of Representatives 2002, US Senate 2002a).

Proposals for legislation of this type, however, had little chance of resulting in something tangible, either in the House (controlled by the Republicans) or in the Senate (controlled by the Democrats). Especially the Republicans were reluctant to use legislation and would not budge "unless the waters are crimson with the blood of investors" (Phil Gramm, as cited in Levitt 2002b:193). From the very beginning of the crisis the accounting industry also launched a heavy lobbying effort to preserve the self-regulation of the industry and minimize the impact that any new legal measures might have; and the lobbying arm of the accounting industry is known as one of the most effective in Washington. The Bush administration was clearly sensitive to the public outcry over the scandals but reluctant at this point to address the issue of conflicts of interest. The new chairman of the SEC, Harvey Pitt, had earlier in his career worked very closely with the major firms in the accounting industry and looked upon the idea of a creating a permanent divide between accounting and consulting by assigning them to two different organizations as a "simplistic solution to a complicated problem" (Hamilton 2002:C6; cf. Pitt 2002).

Under the impact of new scandals that kept happening one after the other during the spring and the summer of 2002, the Bush administration decided to take measures. The signing into law on July 30 of the Sarbenes-Oxley Act was the major result of this resolve. According to Bush, this law represented "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt" (Bush 2002b).

From the Sarbanes-Oxley Act and various speeches by Bush it is clear that the U.S. government's perception of the crisis of 2001-2002 was primarily in terms of individual responsibility (e.g. Bush 2002b). According to the new law, CEOs must vouch for the annual financial statements of their firms. The penalty for white-collar crimes, which have been committed by those in charge of a corporation, was dramatically increased to a maximum of twenty years. From around July it also became increasingly common in the U.S. media to see managers being lead away in handcuffs – another indication that the Bush administration wanted to let the public know that it had gotten tough with those who were engaged in "corporate corruption" (Bush 2002b). This tendency continued through the fall of 2002, and in his state of the union-address in early 2003 Bush again lashed out at "corporate criminals" (Bush 2003).

But even if the Sarbanes-Oxley Act to a large extent has been shaped by the need for what Bush and his administration termed "a new ethic of personal responsibility in the business community", it also contains several paragraphs expressly devoted to more structural issues such as conflicts of interest, in accounting as well as in business analysis (Bush 2002a). Bush was well aware that many average Americans owned shares and had been badly hurt by the meltdown of corporations such as Enron and WorldCom. "More than 80 million Americans own stock, and many of them are new to the market", as the President noted in a major speech in early July of 2002 (Bush 2002a).

According to the new law, business analysts cannot be forced to submit their analyses for clearance, before publication. The power of brokers and investment bankers to decide salaries for business analysts, and in general supervise their work, has also been limited. The goal of the legislation, when it comes to business conflicts of interest, is as follows: "[to] improve the objectivity of research and provide investors with more useful and reliable information" (US Congress 2002:47). The authority in charge of this task, as well as of other rules for business analysts, will be the SEC.

As to accounting conflicts of interest, the law basically argues for the erection of a stronger "Chinese Wall" between consulting and accounting, and the creation of a new institution that will oversee the accounting activities of major corporations, the so-called Public Company Accounting Oversight Board. The general purpose of the Board is described in the following way: "to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audits" (US Congress 2002:6). The Board has the power to either itself create standards of accounting and auditing, or adopt existing ones from self-regulating agencies.

While the passing of the Sarbanes-Oxley Act in late July may have given the general public the impression that a stern law now existed, with which to fight corporate misbehavior and corruption, it was soon pointed out in the press that its paragraphs on conflicts of interest were very flexible and could be interpreted in many different ways – either leniently or harshly. As an example of this it can be mentioned that it will be up to the new Accounting Oversight Board if it wants to change how things are done in accounting and auditing ("generally accepted principles") or whether to assign this task to self-regulatory agencies. The failure to appoint a chairman to the Board in the fall of 2002 further made the press note the inefficiency of the new legislation.

It may well have been the failure of the Bush administration to handle the conflicts of interest in a more decisive manner that made Eliot Spitzer, the combative attorney general of New York State, to act on his own. Spitzer's most ambitious attempt to set things right has been his attempt during the fall of 2002 to push through a general or "global solution" to the tendencies in the brokerage industry to misled investors through faulty information. Instead of going after the major brokerage firms one by one, Spitzer decided to get them all together in one room and negotiate a general settlement. Soon SEC also supported Spitzer's plan.

According to the press, Spitzer initially attempted to get SEC to agree to a clear separation between investment banking and business analysis. This, however, was not accepted by SEC, and it was instead agreed that the existing "Chinese Walls" inside each brokerage firm should be strengthened, beyond the provisions in the Sarbanes-Oxley Act. The firms were also to be fined for their wrongdoings. The most innovative part of the plan, however, had to do with the attempt to get the firms to finance independent business analysis. One early version of this effort was to have the brokerage firms finance a board that was to buy research from some twenty already existing independent analyst firms, such as Value Line. This purpose was, however, rejected by the brokerage firms.

Spitzer tried very hard to push through an agreement before the national elections in early November 2002. This did not succeed, and the fact that also the Senate now passed into republican hands encouraged the security firms to lobby Congress for support against the Spitzer plan, especially the idea of a panel dispensing money for independent research. On December 20 it was nonetheless announced that an agreement had been reached, probably due to Spitzer's threat to otherwise proceed with criminal charges (e.g. McGeehan; 2002 Morgenson and McGeehan 2002). The thrust of the agreement as a strengthening of the "Chinese Wall", in relation to the Sarbanes-Oxley Act. The major brokerage firms on Wall Street also agreed to pay $ 900 million in fines and an additional amount of $ 535 million over five years to finance independent stock research ($450 m) and educate investors ($85 m).[4] For these years, the agreement says, each firm has to buy independent research from at least three sources that do not have any ties to an investment bank; and it also must make this research available to its customers. According to a statement by Spitzer, when the settlement was announced, "the objective throughout this investigation has been to protect small investors by ensuring integrity in the marketplace" (Morgenson and McGeehan 2002:C5).

Finally, an effort to find a solution to the kind of conflicts of interest that involve accounting was made by Paul Volcker in the spring of 2002. Despite its failure, Volcker's attempt to save Arthur Andersen is interesting in its own right, and so is its fate. Volcker was hired by Andersen in early February 2002 to affect changes in the firm, but did not get a general mandate till early March when it was clear that the firm would probably be indicted. After this had happened – on March 14 – Volcker's power increased considerably; and he was now more or less free to proceed as he wished.

Volcker essentially wanted to split off consulting from accounting in Andersen, and thereby end the possibility for conflicts of interest once and for all. He also had high hopes that this way of proceeding would become a model for the rest of the industry. Volcker's plan can be called self-regulation by example (as opposed to Spitzer's efforts, which can be called self-regulation by coercion). Since Andersen, however, refused to plead guilty, and since the Justice Department refused to withdraw its indictment, Volcker's plan was more or less doomed to fail. Volcker would later say that he had received no support for his efforts from corporate America and that the whole thing, in hindsight, "was a dream, like Don Quixote" (Labaton 2002).

A Sociological Approach to the Conflicts of Interest

Up till this point an account has been given in this paper of the conflicts of interest in accounting and business analysis, as these have been presented in the public discourse, mainly in the press but also in some key public statements, such as those by George W. Bush. Through the passing of he Sarbanes-Oxley Act in July 2002 it is also correct to say that the legal concept of conflicts of interest has been extended to cover this type of events to a much larger extent than they had earlier done.

While it is clear that a full account of the conflicts of interest in 2001-2002 would have to draw on such sources as the press and legislation, neither of these have as their goal to present a full analysis of these conflicts - and this is where sociology comes into the picture. At the outset of this paper it was noted that especially two propositions in sociology can be helpful in this enterprise - that (1) interests can only be realized through social relations, and (2) that interests are socially defined.

The first of these propositions can be used to go beyond the general insight that it was the boom of the 1990s that drove the conflicts of interests in accounting and business analysis. This proposition is usually understood as follows: self-interest or greed made many actors in corporations like Arthur Andersen and Merrill Lynch set aside accounting standards and objective standards in business analysis. A more sociological approach, in contrast, would be to try to map out the various social relations through which self-interest had to travel in order to be realized during the boom. Therere were, at one level of the process, over-optimistic investors who drove up the prices on the stock exchange during the 1990s. And at the other end there were CEOs who felt a need to present ever better results (cf. Jensen and Fuller 2002, Cassidy 2002:75). The decision to grant CEOs stock options operated in the same direction. Pressure was then transmitted through the individual firms to business analysts and accountants. The latter also had economic reasons of their own for giving in to the pressure and set aside the rather abstract general interest of the investor public. The accountants often did consulting as well as auditing for a firm; and the business analysts were paid according to how much business they helped to bring in.

Many of these events were also played out at an institutional level. For those involved with accounting, it was primarily a question of opening up and accommodating their firms to a series of new types of activities, especially consulting, over a fairly long period of time. For business analysis, what mattered were primarily changes in investment banking, due to the erosion of the Glass-Steagall Act and the increased competition between existing firms.

Institutionalized interests are very hard to challenge; and in this case the actors who created the conflicts of interest on an everyday basis were firms – not individuals - doing billions of dollars in business. The behavior of powerful actors is usually self-legitimizing to some extent, especially in a case like this where transgressions were not prosecuted by the legal authorities (until 2002). Just as greed may be infectious, if we are to believe Greenspan, so can the side-stepping of law if strong enough interests are involved. It is, for example, clear that business analysts were involved in conflicts of interest for years before something was done to stop them. Star analyst Jack Grubman flaunted this fact publicly when he in 2000 boasted about the "synergy" that came from mixing business analysis with investment banking.

Social rules and social institutions are also involved when it comes to various attempts to separate two interests and activities related to these, be it in the form of a "Chinese Wall" or through the creation of two different organizations, one for each type of activity. Different social mechanisms are involved when activities in the same building have to be separated from each other, and when they are carried out in two different firms. In all of these situations, social holes (in Ronald Burt's sense) must somehow be *maintained* rather than bridged (as in entrepreneurship). Network analysis, it would seem, would constitute a perfect tool for SEC to monitor if "Chinese Walls" indeed are effective.

At Enron a series of activities were mixed which should have been separated. One reason for this was that many former employees of Andersen worked for Enron. Andersen had also physically moved one of its offices straight into Enron's Houston office, which dramatically facilitated the communication between Andersen auditors and Enron people. Finally, Andersen had changed its control structure so that lower officers, who were in close contact with clients, could decide on issues that were normally handled by higher ups ("Professional Standards Group").

The second sociological proposition about interests – that these are socially defined - can be illustrated by looking at the changes that the notion of the public interest of investors was going through in the 1990s. A public interest is by definition what is of interest to a large group of people, as opposed to their interests as single individuals. What this general interest is, however, is not something that is given by nature. There always exist different public interests, and it is a useless exercise, as Schumpeter has made clear in *Capitalism, Socialism and Democracy,* to try to define the one and only public interest. "There is…no such thing as a uniquely determined common good that people could agree on", Schumpeter argues. "To different individuals and groups the common good is bound to mean different things" (Schumpeter [1942] 1975:250 ff.). A public interest, in other words, always has to be *constructed.* As part of this process, a public interest typically also needs to be recognized as *legitimate*.

Similary, and closely related, general interests need to be rooted ("embedded") in social relations in order to survive and triumph. General interests that are embedded in durable social relations – in institutions, in brief – are extra well protected and also tough to challenge. What adds to their general strength is also the fact that these typically are legitimate. General interests that are less firmly anchored are easier to fight and to uproot, even if it usually is hard to totally eliminate an interest.

Schumpeter's point about the multiplicity of potential public interests helps to illuminate what went on in the 1990s and led to the corporate scandals of 2001-2002. Both accounting and objective business analysts are in the general interest of the investors – but the structure of the investor public changed quite a bit during the 1990s. The number of small investors grew very strongly, and these had typically no inside information about Wall Street but were dependent on public information of the type that is contained in accounting reports and reports from business analysts.

The more legitimate a public interest is, the stronger it will naturally tend to be. The problem for the increasing number of small investors, however, was that their public interest was not much acknowledged in the 1990s; it was not yet seen as *the* public interest, and it was not protected in legislation. There was an obvious collective action problem involved in this type of situation; and until this had been solved, various people and institution felt that they had to step in and represent small investors. This is what Arthur Levitt tried to do during his chairmanship at SEC in the 1990s; and this is also what Eliot Spizer was trying to do in 2002: "I've got a job, and it's to protect small investors" (Traub 2002:41).

When one switches from a general reasoning about the small investors and their public interest to an examination of empirical data about them, it quickly becomes clear that there is much less information about them than one would wish. This may reflect the fact that there is a general lack of data in the United States on wealth, which in its turn may be related to the fact that American authorities collect very little information of this type because of the way that taxes are structured. According to one of the few sociologists who has studied “wealth inequality”, the only time when the authorities need to find out exactly how much an individual is worth is when she dies, since in this case detailed estate tax returns have to be filled out (Keister 2000:27).

Whatever the reason may be for the lack of empirical data on wealth and the small investors in the United States, the most comprehensive and widely used type of information that does exist comes from the triennial surveys which are administered by the Federal Reserve Board, the so-called Surveys of Consumer Finance (SCF).[5] According to these, in 2001 a little more than half of all American families owned stocks (51.9%) – that is individual stocks, mutual funds, retirements accounts and what is known as “other managed assets”. This figure can be compared to the one from 1989 which was 31.6 % (Kennickell, Starr-McCluer and Surette 2000:15).[6] Together these stocks accounted for nearly three fourths (72.8%) of families’ financial assets in 2001, up from one half (48.4%) in 1989. The median value of stocks for families in 2001 was $ 34,300, as opposed to $ 13,000 in 1992. It should also be noted that it was considerably more common to own stocks as part of one’s retirement account than to own single stocks. All in all, it is clear that stock ownership, measured in several complementary ways, increased sharply in the United States during the1990s – but also that Volcker is wrong in his assertion that all Americans are shareholders (“a nation of shareholders”; cf. Volcker 2002).

But even if it is granted that only about half of all American families own stock, all of these families surely do not fall into the category of “small investors”. A first step in addressing this issue may be to draw a line between what we may term the elite and the rest of the population, with the former being defined (in SCF categories) as families in the 90-100 percentile of income, and the latter as all other families (or in the less than 20 to 89.9 percentile). According to this way of reasoning, “the small investor” would be defined as a residual and theoretical category. Among the elite families, the data show that 60.6 % owned individual stocks in 2001, while the equivalent figure for the rest of the shareholding population of families ("small investors") ranged from 37% in the 80-89.9 percentile to 3.8 % in the less than 20 percentile. The median value of the former's stock holdings was $ 50,000, and that of the latter between $ 20,000 in the 80-89.9 percentile and $ 7,500 in the less than 30 percentile. If we include ownership of stocks to also include mutual funds and retirement accounts, the differences are in the same direction.

But even if this way of drawing a line between the elite and "the small investor" is accepted, it is still an open question what the public interest of the latter would be. One factor that reminds us of this dilemma is the fact that there also exists a clear ethnic division in the investor community. According to the survey for 2001, it is for example twice as common for "white non-Hispanic families" to own individual stocks (24.5 %), than for "non-white or Hispanic families" (11.0 %). The median value of the former's holding was $ 22,000 and that of the latter $ 8,000. If we extend ownership of stock to also mean mutual funds and retirement accounts, the differences are roughly the same. In other words, what the public interest of "the small investor" is, does not in some natural way emerge from social reality, as it might if small investors constituted a homogenous group. It very definitely has to be *constructed*.

Before leaving the issue of how many investors there are in the United States, one further issues that need to be addressed. This has to do with the fact that the rapid growth in the number of shareholders that occurred in the 1990s, took place during a period when overall wealth of Americans remained dramatically unequal (and when wealth inequality even slightly increased; e.g. Wolff 2000). In 1998 the top 20% of the population controlled 83.4% of all wealth, the next two fifths 16.4%, and the remaining two fifths 0.2 % (Wolff 2000:16). While the number of investors increased during the 1990s, there was no equivalent shift in ownership – only a change in what *type* of wealth people owned. If we use "ideology" in its original Marxist sense of a set of ideas that conceal the nature of the economic "base", the popular notion of "the small investor" in the 1990s falls naturally into this category.[7]

Concluding Discussion

The attention given to conflicts of interests in the corporate scandals of 2001-2002 represents a good opportunity for sociologists to turn to a topic they have not paud much attention to (see, however, Shapiro 2002). Sociologists who follow in the footsteps of Bourdieu and Coleman, I argue, are well equipped for an effort of this type since both of these assign an important role to interests in social life and also suggest various ways for how these can be introduced into a sociological analysis. The latter, to recall, is basically to be done by following two propositions: (1) interests have to be socially constructed; and (2) interests are embedded in social relations.

These propositions have been applied to two of the conflicts of interest that have received the most political and media attention in 2001-2002, namely conflicts of interest in the accounting industry and in the brokerage industry. In both of these cases, according to the public discourse, self-interest got out of hand during the boom in the stock market in the 1990s. The public interest was set aside, and the scandals were a fact. In contrast to this type of analysis, which is ultimately psychological in nature with its focus on the greed of the individual actor, I try to show that social relations and institutions played a key role in channeling and directing various interests into conflict with one another. The way that the actors with their various interests were situated in the social structure is of crucial importance in order to understand how they tried to realize their interests during the boom of the 1990s. I also argue that one of the reasons why the public interest of the investors was vulnerable during this period was that it was undergoing a redefinition, as a result of the rapid growth in the number of small investors. These latter were especially vulnerable to various wrongdoings since they had little access to alternative information.

By looking at interests in this manner, the analysis in this paper not only differs from the greed-centered analysis that can be found in the public discourse, it also goes counter to much of contemporary economic sociology in that it assigns a central role to *interests*. My argument on this particular point is that interests have to be part of the sociological analysis, and this is something they tend *not* to be, when the focus is exclusively on social relations. The main reason for taking this stance in favor of including interests in the sociological analysis is that interests drive human behavior, in the sense that they constitute the basic forces of motivation of the actor. Or to cite a line from Max Weber's famous passage about the switchmen of history: "*action is pushed by the dynamic of interest*" (Weber 1946:182; emphasis added). Simmel, Marx and many other of the early sociologists, it can be added, basically agree with Weber on this point (e.g. Simmel 1908 [1971], Small 1905). It is first in modern sociology that interests many times are left out of the analysis.

Another issue that needs to be raised in these concluding remarks is the following: would it be possible to use the concept of conflict of interest as a distinct sociological concept of its own and, if so, what would such a concept look like? The general reason for wanting to have a sociological concept of conflict of interest is that while sociology has indeed a long tradition of taking interests into account, this tradition needs to be updated and reinvigorated since it has been neglected for quite some time. Just as the concept of role, for example, has been complemented with concepts such as role-set and role conflict, the argument can be made that it would be useful to add to the number of new concepts that are related to the sociological concept of interest.

It is clear that the sociological concept of conflict of interest would only address a subset of the many social actions that involve interests that are in conflict with on another. One definition that would seem to capture the essence of what went on in the corporate scandals of 2001—2002, and which also has some generality to it, is the following:

> *conflicts of interest are social situations or relationships in which there exists a distinct probability that the actor may experience a conflict between her private interest and a general interest which she has been set to guard*.

While there exist some similarities between this particular way of defining a conflict of interest, and the one that is currently to be found in legal thought, the two do not totally overlap. While both, for example, assign a role to the subjective dimension of the actor, the sociological definition explicitly states that a conflict of interest constitutes a specific kind of *social situation or relationship.*

Conflicts of interest that take place in economic life are naturally of special importance to economic sociology, and something needs therefore be said about these, in relation to the definition that has just been presented. The reason for labeling a social situation as a potential conflict of interest is usually to *encourage* as well as to steer a certain type of economic (social) action in a special direction, rather than to outright forbid it. On this point conflicts of interest may be contrasted to a very different kind of social actions that are forbidden in all cases, according to the legal system. Theft would be one example. Here you essentially police the situation by having a special organization involved (a court), while this is *not* the case when it comes to conflicts of interest legislation which is primarily prophylactic in nature.

Both accounting and business analysis, to stay with the two examples of this paper, can be seen as social devices or structures that owe their existence to the fact that they make it possible for business to be carried out in a more efficient manner – and that this can only be done if a small subcategory of these economic actions are forbidden. Typically, all of the actors, with the exception of a small minority, are allowed to carry out a certain type of social action, say buying and selling stocks. In the case of business analysts, however, the analyst's private interest in the stock market stands in potential conflict with her task of making objective judgments about the stock market to other investors, and it is therefore cast as a conflict of interest.

The desire to construct a social situation as a conflict of interest, it may finally be noted, grows out of the insight that self-interest often needs to be tempered with a certain dosage of values, if society is not to be harmed. When Tocqueville traveled in the United States in the early 1830s he noticed that many Americans felt that it was in their self-interest to be honest and forthright; they could only achieve what they wanted in business, they told him, if they behaved in a decent manner. Tocqueville was very impressed by this phenomenon which he saw as one of the reasons why the Americans had succeeded in developing such a powerful commercial culture. He even coined a special term for it: "*self-interest properly understood*" (Tocquevuille 1945, 2:129-35). This expression, as I see it, is part of the same economic culture that nearly two centuries later extended the concept of conflict of interest, as a result of the conflicts of interest in 2001-2002. And all that it takes to make Tocqueville's expression sociological, is to add the proposition that interests are typically pursued through social relations and that interests are always socially defined.

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Table 1: The Disparity between Private and Public Ratings of Analysts at Merrill Lynch, 1999-2001 – Selected Cases

Company	**Date**	**Contemporaneous Analyst Comments**	**Published Ratings**
Aether System (AETH)	03/15/01	"might have announced next week …which could pop stick…but fundamental horrible" (ML82578)	3-1
Excite @home (ATHM)	12/27/99 12/29/99	"we are neutral on the stock" Six months outlook is "flat", without any "real catalysts" for improvement seen (ML37899; ML37956)	2-1
Excite @home (ATHM)	06/03/00	"such a piece of crap" (ML51453)	2-1
GoTo.Com (GOTO)	1/11/01	Nothing interesting about company "except banking fees" (ML03806)	3-1
InfoSpace (INSP)	7/13/00	"this stock is a powder keg, given how aggressive we were on it earlier this year and given the 'bad smell' comments that so many institutions are bringing up" (ML06413)	1-1
InfoSpace (INSP)	10/20/00	"piece of junk" (ML06578)	1-1
Internet Capital Group Inc. (ICGE)	10/05/00	"Going to 5" (closed at $12.38) (ML63901)	2-1
Internet Capital Group Inc. (ICGE)	10/06/00	"No hopeful news to relate…We see nothing that will turn around near-term. The company needs to restructure its operations and raise additional cash, and until it does that, there is nothing positive to say." (ML64077)	2-1
Lifeminders (LFMN)	12/04/00	"POS" (piece of shit) (ML60903)	2-1
24/7 Media (TFSM)	10/10/00	"piece of shit" (ML64372)	2-2

Source: Office of New York State Attorney General, *Affidavit in Support of Application for an Order Pursuant to General Business Law Section 354*, p. 13.

Comment: This table comes from the affidavit of Attorney General of New York State Eliot Spitzer on April 8, 2002, against Merrill Lynch; and it shows the disparity between what Merrill's Internet Research Group said in public about certain stocks and what it said in private. E-mails, according to a 1997 decision, have to be retained for three years in the security industry.

The published ratings (in the right hand column) are based on Merrill's 5-point system, with "1" meaning "Buy"; "2", "Accumulate"; "3", "Neutral"; "4", "Reduce"; and "5", "Sell". Further differentiation was accomplished in the following way: 2-1 would e.g. mean "Accumulate/Buy"; 2-2, "Accumulate/Accumulate"; and so on. One of the charges of the Office of the Attorney General was that the analysts at Merrill Lynch never used a "4" or a "5"; when stocks dropped too low, they were simply not rated at all.

Table 2: Different Ways of Handling Accounting and Analysts' Conflicts of Interest

	"Chinese Wall"	**different functions in different firms**
law	1	2
self-regulation	3	4

Comment: Conflicts of interest can either be handled through legislation or self-regulation; and the two activities can either be allowed to coexist in the same firm ("Chinese Wall") or be assigned to different firms.

As the next few pages will establish, the Sarbanes-Oxley Act of 2002 contains legislation about Chinese Walls and allows for many forms of consulting and accounting (# 1). A few suggestions for radically separating the two activities were made in Congress early in 2002 as well as by people such as Eliot Spitzer and Arthur Levitt (# 2). Before the Sarbanes-Oxley Act most conflicts of interest of brokerage firms on Wall Street were handled through self-regulation, typically in the form of a Chinese Wall (# 3). Self-regulation in combination with assigning different functions to different firms was suggested by Volcker in the spring of 2002 for the whole accounting industry, using Andersen as his model (#4).

Appendix: "Data from the Surveys of Consumer Finance about Stockholders in the 1990s".

Table 3. Direct and Indirect Family Holding of Stock, by Selected Characteristics of Families, according to the Consumer Finance Surveys of 1992, 1995, 1998 and 2001 (percent).

Family characteristics	Families having stock, direct or indirect**				Median value among families with stock holdings (thousands of 2001 dollars)			
	1992	1995	1998	2001	1992	1995	1998	2001
All families	**36.7**	**40.4**	**48.9**	**51.9**	**13.0**	**16.9**	**27.2**	**34.3**
Percentile of income								
Less than 20	7.3	6.5	10.0	12.4	9.9	4.3	5.4	7.0
20-39.91	20.2	24.7	30.8	33.5	4.9	7.3	10.9	7.5
40-59.9	33.6	41.5	50.2	52.1	6.2	7.2	13.1	15.0
60-79.9	51.1	54.3	69.3	75.7	10.1	14.6	20.4	28.5
80-89.9	65.7	69.7	77.9	82.0	17.3	28.9	49.0	64.6
90-100	77.0	80.0	90.4	89.6	58.8	69.3	146.5	247.7

**Indirect holdings are those in mutual funds, retirement accounts, and other managed assets

Note: In providing data on income and assets respondents were asked to base their answers on the calendar year preceding the interview.

Source: Ana Aizcorbe, Arthur Kennickell and Kevin Moore, "Recent Changes in U.S. Family Finances: Results from the 1998 and 2001 Survey of Consumer Finances", *Federal Reserve Bulletin* January 2003:16.

Table 4. Family Holdings of Stocks, according to the 2001 Survey of Consumer Finances

Family characteristic	Stocks	Mutual Funds[2]	Retirement Accounts[3]	Other Managed Assets[4]
	Percentage of families holding assets			
All families	**21.3**	**17.7**	**52.2**	**6.6**
Percentile of income				
Less than 20	3.8	3.6	13.2	2.2
20-39.9	11.2	9.5	33.3	3.3
40-59.9	16.4	15.7	52.8	5.4
60-79.9	26.2	20.6	75.7	8.5
80-89.9	37.0	29.0	83.7	10.7
90-100	60.6	48.8	88.3	16.7
Race or ethnicity of respondent				
White non-Hispanic	24.5	20.9	56.9	8.2
Nonwhite or Hispanic	11.0	7.2	37.3	1.8
Median value or holdings for families holding assets (thousands of 2001 dollars)				
All families	**20.0**	**35.0**	**29.0**	**70.0**
Percentile of Income				
Less than 20	7,5	21.0	4.5	24.2
20-39.9	10.0	24.0	8.0	36.0
40-59.9	7.0	24.0	13.6	70.0
60-79.9	17.0	30.0	30.0	60.0
80-89.9	20.0	28.0	55.0	70.0

[2] Excluding money market funds and funds held through retirement accounts; can be held in stocks or bonds.
[3] These may be invested in virtually any asset, including stocks, bonds, mutual funds, options and real estate.
[4] These include assets such as annuities and trusts with an equity interest and managed investment accounts.

90-100	50.0	87.5	130.0	112.0
Race or ethnicity of respondent				
White non-Hispanic	22.0	40.0	35.0	70.0
Nonwhite or Hispanic	8.0	17.5	10.0	45.0

Source: *Source*: Ana Aizcorbe, Arthur Kennickell and Kevin Moore, "Recent Changes in U.S. Family Finances: Results from the 1998 and 2001 Survey of Consumer Finances", *Federal Reserve Bulletin* January 2003:13.

[1] Depending on one's definition of conflict of interest, its application to economic phenomena will vary. It may, for example, be argued that interlocks – first discussed around the turn of the century in the United States – constitute an example of conflicts of interest. The analysis of conflicts of interest in the professions, including economic professions, also goes far back (e.g. David and Stark 2001).

[2] It is sometimes argued that conflicts of interest come into being the very moment when an auditor is paid by the corporation whose accounting she is to check. In this paper I will not discuss this type of conflicts of interest. See, however, the work of scholars such as George Loewenstein and Max Bazerman, who have carried out a series of experiments that show that a bias is automatically introduced into an accountant's work simply by the fact that she is being paid by some actor (e.g. Bazerman, Morgan and Loewenstein 1997; Bazerman, Loewenstein and Moore 2002; cf. Babcock and Loewenstein 1997). The accountant is typically unaware of this fact and believes that she is perfectly impartial in her work. This type of behavior is said to constitute a version of "self-serving bias". Loewenstein and some associates have also recently started to do research which shows that even if people know that the advice they get is biased, say because of a conflict of interest, they tend to ignore this fact (e.g. Surowiecki 2002).

[3] At auditor failure, the basic rule is that the individual auditor is held responsible, not the whole firm. According to Stephen Cutler, the director of SEC's enforcement section, "It is time to adopt a new enforcement model – a new paradigm: one that holds an

accounting firm responsible for the actions of its partners; one that reverses the current presumption against suing firms for audit failures. The current practice of suing individual auditors without also charging their firms may not adequately reflect, at least in some cases, the role and responsibility of firms in these matters" (Labaton 2002:C2).

[4] It is still not clear how to what extent these sums are tax deductable and to what extent they will be covered by insurance firms.

[5] For a general introduction to the Survey of Consumer Finance, see e.g. Fries, Starr-McCluer 1998; Keister 2000:24-7; and for a discussion of similarities and differences between this and other surveys of wealth in the United States in the 1990s, see e.g. Wolff 2000:11-13. It should also be noted that the longest historical time series on stock ownership in the United States has been published by the New York Stock Exchange. Drawing on this latter type of data, as well as some other sources, James Burk has attempted to estimate the number of individual shareholders between 1927-1980. In 1927 there were 4-6 million shareholders or 3.4%-5.0% of the population, according to Burk (1988:260-67), and in 1985 47.0 million or 20.2 %.

[6] The figures that are cited in this and other passages that come from SCF (apart from 1989) can be found in Tables 3 and 4 in the Appendix, "Data from the Surveys of Consumer Finance about Stockholders in the 1990s". On the assumption that each of the two adults in a family (or the only adult) does own shares, this means that something like 55 % of the (adult) U.S. population were shareholders in 2001 (cf. the calculation based on the 1998 figures in Poterba 2001: 1-2, 11).

[7]Another issue that deserves to be noted in this context has to do with the fact that political power in the United States is built on voting - a fact that makes it important to know how many of the voters are also shareholders. I have not been able to find any reliable information on this point. One figure that circulates in the press, however, often together with the correct assessment that half of the American population owns shares, is that two thirds of the voters are own stock (e.g. Scheiber 2002:16, Stevenson 2003:A1). People who are shareholders, in other words, have more say in the appointment of politicians than their mere number would indicate.