Available online at www.sciencedirect.com
ScienceDirect
Geoforum 38 (2007) 710–719
GEOFORUM
www.elsevier.com/locate/geoforum

Knowledge makes the money go round: Conflicts of interest and corporate finance in London's financial district

Sarah Hall

Department of Geography, Loughborough University, Loughborough, Leics LE11 3TU, United Kingdom

Received 2 March 2005; received in revised form 9 November 2006

Abstract

This paper argues that the conflicts of interest cases brought against Wall Street investment banks in the early 2000s were neither geographically nor institutionally isolated events. Rather, by combining recent work on financial knowledges in both economic geography and the social studies of finance with the growing interest in topological spatial imaginaries, I explore how *London's* corporate finance industry was unable to distance itself from both the conflicts of interest allegations and the ensuing regulatory changes of the 'Global Settlement' in the US. Analysis of 36 semi-structured interviews conducted in London in the early 2000s is used to explore how a range of individual interests, institutional demands and structural changes within London's financial district affected analysts' ability to produce 'objective' research. As well as pointing to the problematic nature of certain aspects of knowledge rich 'communities of practice' [Wenger, E., 1998. Communities of practice: learning, meaning and identity. Cambridge University Press, Cambridge], I explore how the resulting contingent and situated nature of research practice is at odds with a weakly defined notion of 'objective' research that underpins the Financial Services Authority's regulatory response.

Keywords: Corporate finance; Investment banking; London; Global Settlement; Financial knowledges; Economic geography

1. Introduction

Investment banks, and their corporate finance departments in particular, were thrust into the media and regulatory spotlight in the early 2000s following a series of conflicts of interest cases bought against their research functions in the US. The most well publicised case was that mounted against Merrill Lynch by New York Attorney General Eliot Spitzer in April 2002 (Scheiber, 2002). Here it was alleged that Merrill Lynch had presented its research to the public as objective, when in fact it was biased because analysts were encouraged to produce favourable valuations of certain companies that were clients of other departments of investment banks. Settlement was reached when Merrill Lynch agreed to pay $100 million in fines as well as implementing structural changes aimed at more thoroughly managing communications between investment bankers working in different departments of the bank. The regulatory interest in investment banks sparked by this case continued with the 'Global Settlement' of April 2003 in which ten Wall Street investment banks (including Merrill Lynch) agreed to collectively pay a total of $1.4 billion whilst not admitting to any wrongdoing within their research departments and practices (Securities and Exchange Commission, 2003). $450 million of this payment was 'ring-fenced' to pay for independent research (conducted outside investment banks). As part of this 'Global Settlement', any overlap between research departments and the rest of corporate finance was deemed a regulatory infringement. This settlement was in addition to the Sarbanes-Oxley Act of 2002 that required US-based investment banks to more rigorously manage and disclose any conflicts of interest.

The significance of these regulatory developments for investment banks in the US has been keenly debated within

E-mail address: S.J.E.Hall@lboro.ac.uk

0016-7185/$ - see front matter © 2006 Elsevier Ltd. All rights reserved.
doi:10.1016/j.geoforum.2006.11.023

both policy and press circles (see, for example, Swedberg, 2004). Some commentators have suggested that the fines and structural changes within banks are relatively superficial (Augar, 2005). For instance, under claims that the disclosure of potential conflicts of interest have been significantly strengthened, research reports simply have to include a statement that there may be conflicts of interest involved in the production of the report (Wells, 2004). However, others have suggested that the changes amount to a more substantial 'regulatory blizzard' (Parker, 2004), with research departments not only being required to be physically separated within investment bank offices, but also to have separate reporting lines, budgets and legal and compliance staff. Indeed, it appears that the significance of the Global Settlement lies less in the nature of the specific organisational changes demanded by the SEC but more in the increasingly stringent regulatory landscape more broadly that it has heralded (Wolkoff, 2004). This is exemplified by the emergence of a nascent 'regulatory industry' with management consultants specifically offering services to assist financial institutions meet the new regulatory requirements (see, for example, CapGemini, 2004). However, economic geographers, and social scientists more generally, have comparatively neglected the implications of the conflicts of interest and the concomitant regulatory changes *beyond* the confines of Wall Street.

In response to this oversight, this paper uses fieldwork conducted in London's corporate finance industry (see Appendix) to suggest that the conflicts of interest cases brought against Wall Street investment banks in the early 2000s were neither geographically nor institutionally isolated events. I combine work on financial knowledges in both economic geography and the social studies of finance with recent work on 'relational proximity' (Amin and Cohendet, 2004) and topological spatial imaginaries more broadly (Amin, 2002; Murdoch, 1998) to make two related arguments. First, I suggest that it was the nature of research practice within investment banking research communities that prevented the conflicts of interest being scripted as solely affecting US based investment banks. This is in contrast to earlier crises that have affected London's financial services industry such as the collapse of Barings Bank (Tickell, 1996) and Robert Maxwell's use of the Mirror Group's pension plans to support his own business ventures (Clark, 1997). In these cases, individual actors (be they people or firms) were labelled by the industry (with varying degrees of success) as scapegoats who were not symptomatic of more widespread practices. Second, I consider how these relational geographies are also important in understanding the regulatory response to the conflicts of interest cases. Here, I explore how the Financial Services Authority (FSA) felt compelled to take seriously the regulatory changes and allegations made in the US whilst simultaneously continuing London's historic commitment to maintaining a 'soft touch' regulatory environment. The result is a regulatory commitment to 'objective' and 'impartial' research that is seemingly at odds with the highly contingent and situated nature of contemporary corporate finance research practices uncovered by my fieldwork.

My argument is developed over five further sections. First, I detail the nature of the conflicts of interest, underscoring the significance of the investment banking organisational model to their existence. Second, I consider the central role of trans-Atlantic financial 'communities of practice' (Wenger, 1998) to these conflicts of interest cases, before third, using this theoretical framework to explore how London's corporate finance industry was unable to distance itself from the conflicts of interest in the US, either geographically or institutionally. Fourth, I outline the problematic nature of the Financial Services Authority regulatory response before finally considering how the research reported in this paper contributes to understandings of the economic geography of financial services and the 'knowledge based economy' more broadly.

2. Placing London in the conflicts of interest cases

To understand the wider significance of the conflicts of interest cases beyond Wall Street demands an appreciation of the organisational structures of investment banks and particularly the use of research by banks' corporate finance departments on the one hand, and their securities trading operations on the other, since this relationship lay at the heart of the allegations. Corporate finance can be divided into two broad activities, both of which are underpinned by banks' research activities (Clarke, 2001). First, it involves advisory work in which corporate financiers suggest ways of maximising shareholder returns to clients, typically through corporate restructuring such as mergers and acquisitions (M&A). Second, banks make loans to clients to facilitate M&A. In advisory work, research is used to identify potential takeover targets and to suggest prices that might be paid for them. In the second part of the corporate finance transaction, research is drawn on to estimate the likelihood of default on loans (and hence the interest rate and general terms of the loan) – this decision being made in conjunction with the ratings assigned to companies by international credit rating agencies (see Sinclair, 1994). Meanwhile, in securities trading, brokers research and trade securities (paper certificates of electronic records denoting ownership of equities and/or bonds) for investors (Valdez, 2000).

Corporate finance and securities trading departments come together when a corporate finance client needs to issue securities. When this situation arises, the brokers in securities trading use their contacts with investors to distribute or sell the securities. A conflict of interest arises in this situation because research produced by the investment bank is being used by the two departments simultaneously to advise buyers and sellers in the same transaction. Consequently, in the conflicts of interest cases bought by Eliot Spitzer discussed above, it was alleged that research analysts were being encouraged to rate particular securities as 'buy' to potential buyers when their research did not support