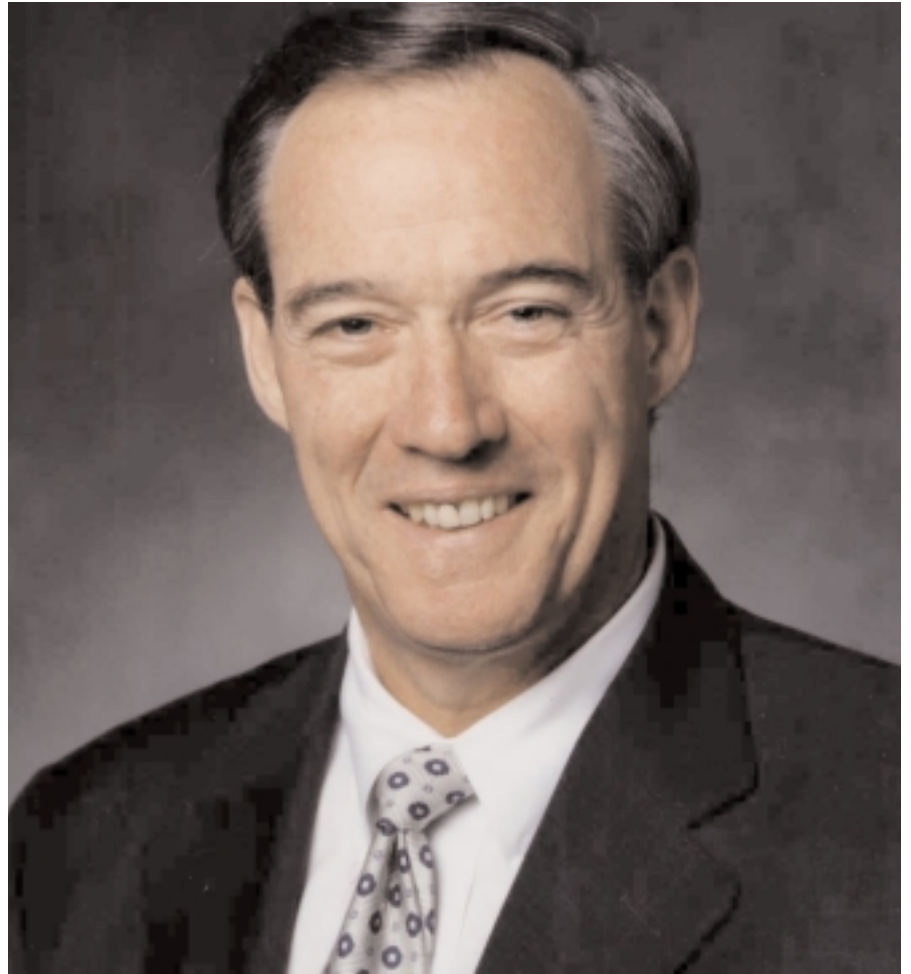


Purcell: "There is a significant problem, and we have to demonstrate that we get it. There is not a CEO of a major firm who would disagree with that."



Philip J. Purcell, chairman and CEO, Morgan Stanley

Cleaning house on Wall Street

The time is right for a fundamental change in the way business is done in the securities industry, says this financial services executive. And a renewed partnership between regulators and industry is the best way to restore investor confidence.

High above Times Square, Morgan Stanley CEO Phil Purcell's office is decorated with icons of the American West. From the Remington reproductions and the black and white Stetson hats to the Zane Grey first editions that line a bookshelf, the room suggests its occupant is as comfortable in the Wild West as he is on Wall Street. The sweeping view looks westward, across the nearby Hudson River. On a clear day it would be easy to imagine that there is nothing taller from there to the Wasatch Mountains, where the lanky Utah native grew up and where he maintains a mountainside retreat today.

It is also easy to imagine that there have been more than a few days recently when Purcell was glad to get back there and escape, if only briefly, the securities industry's protracted woes. Those include a three-year-long slump—revenues down 37 percent industrywide and a nearly 11 percent drop in employment, the largest since the 1970s—and the still-unfolding scandals that seem to snare a new firm every day.

While the economy has turned upward, Wall Street still faces the monumental task of rebuilding investor trust in the securities business. The collapse of the dot-com bubble, which brought down several high-profile securities analysts and investment bankers (though not at Morgan Stanley), mind-boggling fraud and mismanagement at a number of large corporations, trading irregularities at mutual fund companies, and serious lapses in governance at the New York Stock Exchange have all, fairly or unfairly, badly damaged the reputation of the financial services industry as a whole.

Morgan Stanley has dealt with these challenges—for example, it recently paid \$50 million to settle mutual fund disclosure issues, and it was one of 10 banks that were part of a \$1.5 billion “global settlement” of alleged conflicts of interest between research and investment banking—at a time when the company was already laboring in an increasingly competitive market.

On the investment banking side, the challenge has been especially keen from the universal banks, which have used their lending prowess to lever their way into more lucrative underwriting and advisory assignments. For example, according to

Philip J. Purcell

Chairman and CEO,
Morgan Stanley

Born: 1943, in Salt Lake City, Utah

Education:

B.A., University of Notre Dame

M.S., The London School
of Economics

M.B.A., The University of Chicago

Professional highlights:

1967: Joined McKinsey & Company

1978: Joined Sears, Roebuck and
Co. as vice president of planning
and administration

1981: Sears, under Purcell's guid-
ance, acquired Dean Witter

Reynolds Organization

1986: Named CEO and chairman of
Dean Witter Discover & Co.

1997: Became Chairman and CEO
of Morgan Stanley after merger
with Dean Witter

the Thomson Financial's standard league tables, as of November 30, 2003, Morgan Stanley was in second place in global M&A, right behind traditional rival Goldman Sachs. But Citigroup, at No. 4, had made a strong showing, with 150 deals completed, only 10 fewer than Morgan Stanley. And Citi was also right behind Morgan Stanley in equity underwriting, a longtime stronghold for the traditional investment banks. On the retail side, Morgan Stanley, like all brokers, is trying to attract individual investors who feel burned and deeply suspicious of Wall Street.

In bottom-line terms, this all translated into a more than 20 percent fall in revenues, from a 2000 peak of \$45 billion to an estimated \$34 billion for 2003.

So would Purcell have done anything differently? In a wide-ranging November interview, Purcell told *Outlook* Managing Editor Tish Burton that yes, with 20/20 hindsight, maybe he should have turned away business and hired fewer people; then perhaps he would not have been forced to make layoffs for the first time in his more than 20 years as a securities industry executive.

Nonetheless, Purcell was decidedly upbeat during the interview. He had just returned to New York from meeting Morgan Stanley clients in California, Asia and Europe. At each stop, local Morgan Stanley executives besieged him with requests to hire more staff to meet an upturn in business activity. And his company had just advised Fleet in its merger with Bank of America, the third-largest bank deal ever.

With the economy in the midst of a turnaround and the markets on a rebound, Purcell believes that several sectors in the industry are about

to take off, including new debt and equity underwriting, M&A, credit derivatives, commodities and securitizations. He also says Morgan Stanley has completely revamped its approach to equity research and will have a few surprises in store for the discount brokers, which have already raised the white flag, he says, by now offering research.

After the dust has settled in a few years, don't be surprised, Purcell says, if there are only four or five players left in the global capital markets business. He has, of course, every intention of making sure that Morgan Stanley is one of them.

Outlook: It's been a tough couple of years for the financial services industry in terms of damaged reputations and the erosion of public trust. What will the industry need to do to regain that trust?

Purcell: The first thing the industry has to do is to stop those events that legitimately cause questions on the part of the investors—things like late trading and market timing trades, and facilitating the Enrons, the WorldComs. You've got to work with the regulators to ferret all that out. Second, you need to partner with the regulators to ensure that the regulatory structure and approach are such that investors have more confidence, and believe that the industry is regulated in a way that protects the system from risks and protects investors from having their money being treated in ways it shouldn't be.

Despite Morgan Stanley's high profile during the late 1990s, the firm was absent from some of the bigger scandals you referred to. How do you account for that?

I don't know that I want to try. That's not how we think about

where we are and the rest of the industry is right now. I think the entire financial services industry realizes that the cumulative effect of all of the scandals and problems, irrespective of who was involved with what, is undifferentiated damage to all of our reputations. There is a significant problem, and we have to be seen to be changing, demonstrating that we get it. There is not a CEO of a major firm who would disagree with that. So I think the environment is right for fundamental change.

Right now, people in financial services and other professional services businesses are generally rewarded for their sales, not for turning business away. Is it possible that this is the wrong kind of incentive mechanism? Do you think there is a need to reward people who keep you out of trouble—who say, “This is not the kind of company we do business with or the kind of deal we do”?

Yes, one example at our firm is that we reward people for risk management. And in many cases, turning down business is your first defense in terms of risk management. With the Internet IPOs, for example, we turned down 19 for every one we did. People were rewarded for that in a number of ways. One, if you become regarded by the issuer as having the highest standards, then the very best issuers want to do business with you, so you get a different caliber of issuers. Second, the buyers, if they know you have a reputation for very high standards of underwriting, prefer to buy your IPOs rather than other people's.

So it's not true that there's never an economic reward for turning down business. It's a matter of good risk management that ends up being a more profitable way to do business than to be too hungry for business.

How are the new regulations on the role of research affecting your business model?

First, we are more focused on what I would consider to be the high-value-added part of research, which is the analyst—someone who really knows the industry, really knows all the forces at work in the industry and can provide valuable insights. A research analyst may end up giving great insight by looking at the industry and looking at what's happening to currency rates, and saying, “These are the companies that will benefit; these are the ones that won't.” To give real insight as to what's going on in businesses—rather than forecasting earnings—has the potential of making research more valuable, not less valuable.

The other effect is that you will see less emphasis on company coverage and more emphasis on industry coverage. Instead of trying to maximize the number of companies that we cover, I think you will see better, more standardized modeling of company and sector performance, and much more time spent on the industry and what's really going on in there, which will give us longer-term perspectives and potentially bigger investment ideas.

How will you pay for the research?

Increasing what we would call the insight and value-added of the analyst for the buy side [should result in] more commission business. And that will be the primary source of the revenues needed to pay analysts. I would think that on an industry-wide basis, it's going to level out with fewer analysts, but those who remain will be excellent. But the excellent analysts will be rewarded as well as they ever were, and the rewards will be from the buy side business, not from the investment banking business.

“In research, you will see better, more standardized modeling of company and sector performance, and much more time spent on what's really going on in the industry.”

"The window for the universal banks' balance sheets to be an effective competitive advantage has closed."

What's to stop someone from opening a Morgan Stanley account for a small amount of money, getting your research but then giving all his trades to a discount broker?

There's never been any way for us to stop that on the retail side, and there never will be. But that kind of phenomenon is really insignificant to our business.

There are other reforms under way in your industry as well. What do you think about John Reed's proposals for the New York Stock Exchange?

I think that the selection of John Reed as interim chairman and CEO was inspired. He has moved very quickly to get a very different governance structure that will ensure that the regulatory part of the New York Stock Exchange is governed only by independent directors. That will go a very long way to reassuring the public that the New York Stock Exchange is going to be governed properly.

Do you think the Exchange should continue to use specialist firms—or move to an electronic format?

All of the trends in our business on the equity side have been towards lower and lower cost per transaction. And in general, there has been a trend towards greater pools of liquidity that make for tighter spreads. All of this is very positive for the clients. In general, electronic processing and electronic execution of trades look like the way of the future, and I would think that the New York Stock Exchange will adapt to that and have much more of the trading done in that fashion.

You recently told a group of institutional investors that you saw room for no more than five companies in the global capital markets business. How did you come up with that number?

I think of a global capital markets

firm as one that is capable in Asia, Europe and the United States and that can serve the capital markets needs of any client, whether they are issuing or trading. And it takes a lot of resources in each of those regions to be fully capable. Right now, you've got probably nine firms that are pursuing that strategy. But not all of them have capabilities in each region. Most of them are strong in one, okay in another and nonexistent in a third.

So you will see people who are strong in one region and weak in another combine with someone who is strong where they're weak and weak where they're strong. And that leads me to the conclusion that you'll have fewer but stronger competitors. Whether it's four or five, I don't know, but I do not believe it will be seven, eight or nine.

Now, I've been predicting this for some time, and I haven't been right yet. One would have thought it would have happened in this three-year downturn, but it didn't. But I still believe that it will. And I don't know what will trigger it, but something will.

Morgan Stanley provides loans to its investment banking clients to match competition from universal banks like Citigroup and Bank of America. And it's offering them not just to cater to established clients but also to bring in new business. For the most part, you lose money on these loans. How sustainable is this strategy?

We lend where it makes business sense. But as margins decrease in all of these businesses—which they are doing and will continue to do—it is going to be less appealing to use capital that way. So I think the window for that to be an effective competitive weapon has closed. It was very effective for the last four years.

But what has happened is the traditional investment banks have responded, and it is no longer a balance sheet disadvantage for the Goldman Sachs, the Merrill Lynch or the Morgan Stanleys.

Why isn't it a disadvantage?

With the development of the credit derivative and syndication markets, lenders can make these loans and then either hold, hedge or sell them. They don't necessarily have to keep them on the balance sheet. In the old days, the advantage for the banks was that they had such big balance sheets, they could make the loan and keep the loan. And we didn't have the balance sheet to do that. We used our balance sheet for trading, not for loans.

In today's environment, because we are able to transfer the credit risk of that loan through the marketplace, we can hedge our balance sheet. But if the loan is made at a below-market price, we have to take a hit on our income statement. That makes it a business proposition, and you make client by client decisions: Do you want to make a loan to have a client relationship stay with the firm? And if the whole relationship stays profitable to the firm, then you're willing to do that.

I think that takes away the banks' real competitive advantage. With the declines in margins, they're going to be less willing to take losses on the loans. And eventually, the loans are going to be done at market prices, in which case everybody's on an even playing field. That's where I think that will end up. We compete with talent and innovation and creativity, not with the size of our balance sheet.

How would you describe the current business environment?

I just returned from a trip from San

Diego to Germany to China and back to New York. Everywhere our people are talking to me about why they need to add people. Now, we haven't said it's okay to do that, except in very rare instances. But right now the level of activity in many areas is greater than our ability to respond. So I would think that the next trend in employment in the securities industry is going to be up, because I believe activity has improved. And unless something happens to the economic turnaround in the United States, it will continue to improve over the next year or two.

Which segments are the hottest?

The hottest have been fixed income and commodities. But right now the equity market is coming back, and so there are some strains there. But if I had to pick the hottest, it would continue to be fixed income, credit derivatives and commodities. But of course, nothing stays the same forever.

What will be hot in six months?

I would guess it's going to be the equity business and probably mergers and acquisitions. I think we'll see a real turn, where in six months, it won't be fixed income, it will be the equity businesses.

I also think stronger growth will be back. We definitely will end up having to add people, and that's a good thing. It's very hard to get in that state of mind, because everybody has been so committed to cutting costs.

But when you're building a business and you're serving clients right, you are adding employees. Adding employees is a very good thing as long as you still maintain your economic model and you're producing the kind of returns on equity and returns on revenues that you should. So I am looking forward to hiring.

A nice change from the past two years.

Well, in my whole career, I've never had a cutback, and I've had a long career. Then came 2001. If you run your business right, you shouldn't have to cut back. If you look at all the trend lines in our business, the aberrations were '99 and 2000. If you do a 15-year trend line, 2003 is probably going to be right on the trend line, and 2002 was not far off.

Is there anything you wish you had done differently?

I wish I hadn't staffed quite as much coming into '99 and 2000, although at the time we were killing our people. People were working 14 hours a day, 7 days a week. They weren't taking days off, they weren't taking vacations.

With perfect hindsight, you would have forgone revenues, hired fewer people, done fewer things, and not increased your revenues nearly as much. Then you would not have had to cut back. But it's not a perfect world, and we don't get mulligans in business; we have to do it once. But I feel very, very good about how we came through that bubble, and I feel very, very good about how we're positioned now. And we look forward to the competitive environment.

What are you expecting?

To win.