

Can stock analysts' conflicts of interest benefit investors?

Communication by Other Means

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THE SECURITIES INDUSTRY HAS COME under considerable fire in recent years. Industry practices, particularly in initial public offerings (IPOs), appear to rig the game in favor of insiders and the investment banks that underwrite the securities. Preferential allocations of “hot” IPOs, massive first-day run-ups in price, and the questionable valuation methods used to bring embryonic and profitless companies to market all have a whiff of fraud about them, though it has been difficult to determine whether anything amounting to fraud actually occurred.

Of particular concern has been the role of the equities research analyst in the underwriting process, where allegations of fraud seem to have a more solid foundation. Research analysts are the folks behind the familiar stock report, a publicly distributed document that gives a cursory rundown of a public firm’s business and prospects, along with the analyst’s opinion as to the value of the firm’s securities as an investment (often put as a buy or sell recommendation or a price target). Conventional wisdom holds that in the 1990s these analysts were “captured” by investment banks’ underwriting departments, becoming tools in the quest to win lucrative underwriting business rather than fulfilling their ostensible role as independent and unbiased advisers to all public investors.

Analysts’ incentives were undoubtedly skewed toward generating investment banking business. A 1998 study found that more than 70 percent of analyst pay derived from equity sales. Oftentimes, practices were even more direct, with explicit quid pro quos of positive research in return for underwriting business. For instance, Shelby Fleck, then a star electronics analyst for Morgan Stanley, promised Viasystems

Group bullish coverage in return for granting to Morgan Stanley the lead underwriter mandate for its \$924 million IPO (which ultimately generated over \$50 million in fees and commissions). On the flip side of the coin, bad recommendations served as punishment: Ashok Kumar, an analyst for Piper Jaffray, downgraded eMachines upon losing an underwriting mandate and even went so far as to dub the computer maker “Sucker.com.”

Congress, which held two separate hearings on the issue of analyst conflicts of interest in 2001, discovered to its horror that these practices were endemic. The professed ignorance of the Congressional Subcommittee on Capital Markets is itself interesting—and alarming!—because the role of the research analyst was well-reported in the financial media over the prior decade.

Investor losses from the tech-stock decline fueled the fires of political reform. Congress passed the sweeping Sarbanes-Oxley Act, which, as implemented by the SEC and exchanges, prohibits research quid pro quos, requires additional analyst conflict disclosure, and substantively limits the role that analysts may play in public offerings. (For instance, analysts and investment bankers cannot actually be in the same room without a legal compliance officer present.) The Securities and Exchange Commission—after purging itself of its pro-business chief Harvey Pitt—and New York Attorney General Elliot Spitzer pursued their investigations into investment banker malfeasance, resulting in a settlement of some \$600 million against 10 investment banks and two individual securities analysts. More broadly still, numerous securities class action lawsuits commenced against issuing firms and their investment bankers, with nearly every firm that went public toward the end of the bubble getting sued. All of this action was premised on the notion that the investment banks had been using their analysts to systematically defraud the market, publishing bogus research reports in order to push lousy firms’ shares, and boosting stock market prices to unsustainable levels.

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A SURPRISE?

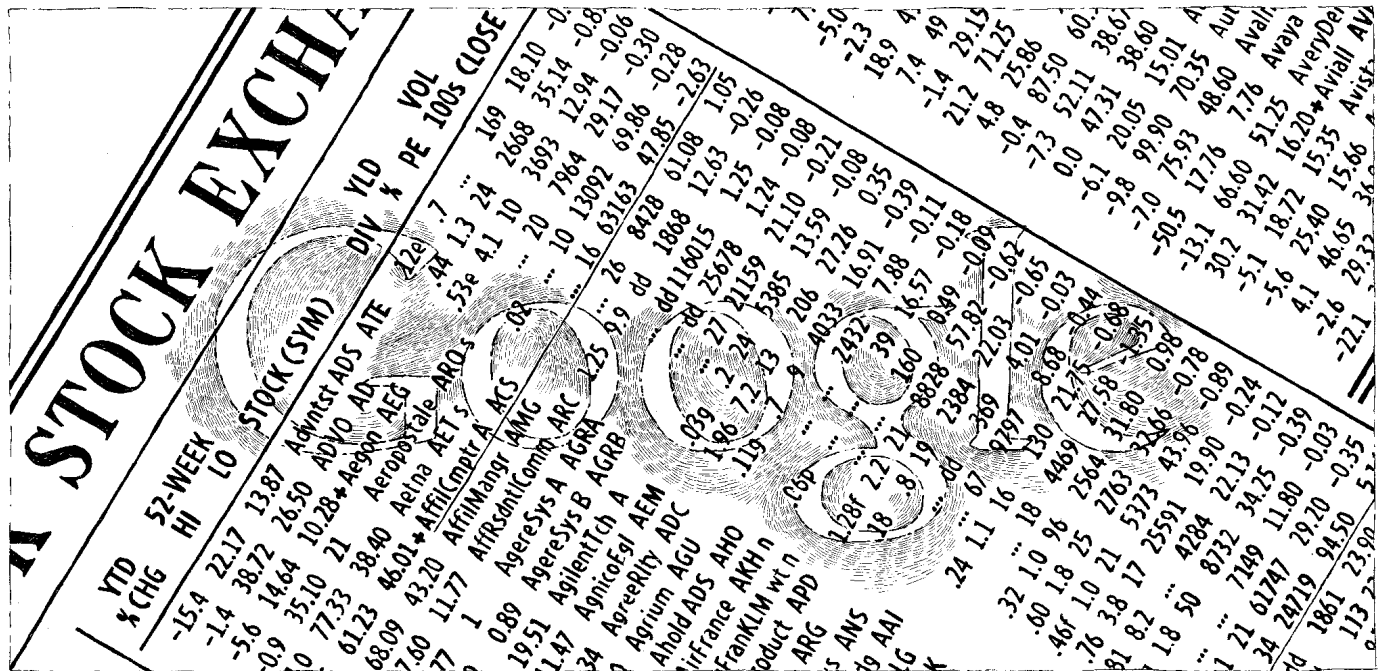
But does this story really add up, and are these reforms really constructive? As unseemly as some of the analyst practices may have been, and while it is without doubt that some fraud occurred (Jack Grubman's upgrade of AT&T in return for the admittance of his daughter to an elite Manhattan preschool is a good example), there is good reason to doubt that the analysts were really taking the market for a ride. First of all, in order to defraud someone, there needs to be an actual deception—but the analyst practices were known and could hardly be said to be fooling anyone. Analyst conflicts had to be disclosed in each report; National Association of Securities Dealers rules required, as they do now, that the research report contain a disclosure of whether the analyst's investment bank had underwritten the subject company's securities. (At least one major class action was dismissed on this basis alone.) Media and academic comments on analyst practices go back at least to the early 1990s. And the regulatory authorities were, of course, well aware of what was going on.

Even if conflicts of interest did lead to overly optimistic research reports, we might suppose that competitive pressure

has been distorted by the securities laws. An issuing firm that has good information about itself—which would encourage investors to buy—effectively cannot communicate it to the market under current law. As we will see, analyst research provided a sort of end-run around the disclosure rules of the securities laws, allowing issuers to communicate inside information to the market and lowering the cost of capital.

A FAILURE TO COMMUNICATE

In order to understand the function that analyst research served, one needs to understand rules governing the disclosure of information in the public offering process. The Securities Act of 1933—and the byzantine labyrinth of rules, regulations, and case law promulgated thereunder—is, at its heart, concerned with disclosure of information by firms that wish to sell securities to the public. The legislation erects substantial barriers to disclosure. Any communications outside of statutorily sanctioned channels—the “registration statement” or “prospectus,” and, to a very limited extent, oral communications with institutional investors—subjects the firm to automatic liability for



in the analyst industry would correct it. Rankings of analyst stock-picking ability were available, and presumably nonconflicted analysts could have leapt up in the rankings if conflicted analyst research was consistently biased. The fact that independent analysts did not rise to prominence but instead maintained only a marginal position may well reflect the market's quite rational belief that independent analysts, without access to nonpublic information, could add little value. Quite to the contrary, the market demanded analyst support on the public offerings, and the quality of an investment bank's research team (and the degree of support it could commit to provide) became one of the key factors in choosing an underwriter.

But if it was not fraud, then how does one explain the industry behavior that occurred? At least part of the answer may lie in the way in which the flow of information to the marketplace

having made an illegal offer to securities holders. The penalty for making such an illegal communication is rescission: purchasing shareholders have the right to force the issuer to repurchase the shares at the offering price (in other words, a “put” option). For instance, when Google's founders gave an interview to *Playboy* in advance of their IPO, readers of the interview were probably the recipients of an illegal offer, meaning that they would have the right of rescission for at least a year after the offering. (Fortunately for Google, the share price has gone up since then.)

As draconian as the penalty for an illegal offer is, we might suppose that it does not matter because the prospectus allows the firm to disclose whatever it wants. However, prospectus disclosure is far from a free ride for issuing firms. A strict standard of liability threatens the firm with financial ruin for any sig-

nificant inaccuracies. Under the Securities Act, the issuer is liable for damages arising out of any “material misstatements or omissions” contained in the prospectus, whether or not the firm knew that it was making a material misstatement or omission. What this means is that a firm with the best of intentions can nonetheless find itself liable down the road when something goes wrong and the prospectus failed to anticipate and state the possibility that that particular thing might go wrong.

It is not enough to warn investors that we are living in an uncertain world; the firm must warn about the particular dangers that arise. Among other things, this leads firms, and their highly paid corporate lawyers, to exercise extreme creativity in attempting to describe absolutely everything that might possibly go wrong. (For instance, one prospectus of an Indian information technologies company, prepared by a blue chip New York law firm, predicted in 2000 that the flight of the 17th Karmapa, master of the Karma Kagyu sect of Tibetan Buddhism, from Tibet into India could lead to a border war with China—eventually having a negative impact upon the firm’s business.) But one cannot predict every contingency, and when new, unfavorable information does eventually emerge and the share price declines by a large enough amount, the firm is almost always sued. Those suits are almost always settled out of court for a significant sum. (One study finds that settlement values average about 32 percent of market losses.)

One immediately observable effect of this regulatory system is that disclosure from firms selling securities to potential investors has become a difficult and risky process, and firms have—quite understandably—been loathe to disclose more positive information than is absolutely necessary. Prospectuses are instead filled with vague and noncommittal language regarding current trends and future prospects. What is more, prospectuses contain pages and pages of dire “risk factor” warnings that the sky may, indeed, be falling.

The value of these prospectuses as informative documents is consequently quite dubious. More than 30 years ago, Professor Homer Kripke, a vociferous critic of the SEC, observed that making an informed investment decision from prospectus disclosure alone is surely impossible. Despite attempts by the SEC and Congress to encourage more meaningful information—such as creating a safe harbor for management’s projections and mandating a “discussion and analysis” of management’s views—disclosure is probably still in just as miserable a state. All the dire warnings and the same absence of meaningful projections suggest that the informational deficit is as present today as in Kripke’s day.

SILENCE AND SECURITY

But this poses something of a puzzle: If prospectuses are so devoid of useful information, how is it that firms who wish to sell securities are able to do so? We would expect that investors would be unwilling to purchase securities in a market where no credible communication of information can take place. This is the familiar “lemons” problem (the description of which helped win economist George Akerloff the Nobel Prize) where possession of inside information by sellers of goods, and an inability to communicate that information to the buyer cred-

ibly, leads to the collapse of the market. For example, suppose we live in a world that has no rule against fraud. If I offer to sell you a car, you would reason that, if it were a good car, I probably would not want to sell it. On the other hand, if it were a lemon, I would be eager to pawn it off on you. So, you would lower the price that you would be willing to pay, which means that I would be even less willing to sell you a good car. This type of recursive effect leads to the removal of all but the very worst goods from the market; only lemons would ever be sold, and for lemon prices. Because of their inability to communicate their private information credibly, holders of high-quality cars—or securities of a firm—would be unable to sell them for more than a lemon price, and they would leave the market. The economic rationale for having fraud penalties in place is to avoid precisely this sort of breakdown of the markets.

But this type of lemon effect can occur not just where penalties for inaccurate disclosure are nonexistent, but also where penalties for inaccuracy are too high. Suppose that the penalty for fraud in the sale of a car is public disembowelment. How willing would I be to make disclosures about the car’s quality? Not very—even if I attempt to tell the truth, there is still the possibility of making a mistake that, in hindsight, would appear fraudulent. That means that if I try to give any signal about my car’s quality, I face the nontrivial possibility of disembowelment. Such a penalty would have a chilling effect upon even truthful disclosure—sellers would stay mum—leading to exactly the same breakdown of the market as where no penalty exists.

FRIGHTENED FIRMS While an IPO firm’s founders and managers are not yet subject to disembowelment (though enhanced penalties and jail terms under Sarbanes-Oxley are a step in that direction), liability in the public offering process is still quite onerous. Under the material misstatement or omissions standard, the firm must guess as to what may go wrong in the future. If the firm guesses incorrectly, it is liable to shareholders purchasing in the public offering for the decline in value of their shares. In an uncertain world where predicting the future is difficult or impossible to do, this liability regime makes firms act as insurers, writing the shareholders an indemnity policy against subsequent declines in share price without regard to bad action or intent. Numerous studies do, in fact, document that litigation follows on the heels of significant price declines, without regard to objective evidence of malfeasance.

Consider the effect that this would have upon the firm’s decision-makers—the founders and others, such as management, who owned pre-IPO shares and generally maintain large shareholdings after the offer. (One study finds that insiders of sued firms retain 49.2 percent of the equity post-offering.) All of these decision-makers find risk costly to bear. When the firm experiences bad fortune, is sued, and has to pay out to IPO purchasers, the payout effectively comes out of the pockets of the decision-makers because only the shareholders purchasing in the IPO can recover their stock market losses. So, the flow of money from the firm to the new shareholders occurs at the expense of the decision-makers’ equity stakes. What this means is that the firm’s pre-IPO shareholders—founders and man-

agement—are subject to a tremendous degree of risk, and given their often concentrated holdings in the firm’s securities, this is risk that they are unable to diversify. (In contrast, the firm’s shareholders should be able to bear the risk of poor firm performance quite cheaply and well, simply by maintaining a diversified portfolio of investments.) While it can be optimal to allocate some amount of risk to management, as in the form of stock options and performance incentives, this wholesale allocation of risk actually destroys value in the firm. Thus, one way of looking at the Securities Act is that it shifts risk from shareholders, who would be able to diversify at little or no cost, to founders and managers, whose stakes are too concentrated to diversify completely. The disclosure rules of the Securities Act serve to negate the optimal risk allocation bargain between founders and new shareholders that would maximize firm value. This means, of course, that there exists the potential for value creation simply by getting around the inefficient disclosure rules.

But, assuming firms have only the prospectus disclosure option open to them, it would seem like the Securities Act puts an IPO firm in something of a Catch-22: if it does not disclose information about the firm’s prospects and potential profitability, the firm will be unable to sell its shares to investors for more than a lemon price. On the other hand, if the firm does disclose adequate information about itself and its prospects, the firm’s founders and other pre-IPO stockholders face a tremendous degree of costly risk in the form of litigation under the Securities Act—despite making a full and fair attempt to disclose accurately. How does a firm facing such a dilemma react?

COMMUNICATION BY OTHER MEANS

Perhaps a more specific question to start with is this: Does overbearing liability chill disclosure, and does it result in a lemons market? As we have seen already, the answer appears to be “yes” to the first question—the information contained in the average prospectus does not appear adequate to make an informed decision. Despite the best efforts of the SEC, firms doing public offerings are not forthcoming with much in the way of meaningful forward-looking statements, and they are certainly not volunteering the types of projections and forecasts that management uses in its decision-making.

But then, strangely enough, to the second question—does the paucity of prospectus disclosure result in a lemons market?—the answer seems to be “no.” Taking a quick look at the U.S. public capital markets, we are not suffering the sort of extreme “lemons” market problem that economic theory would predict. Good firms do go public, and do often receive good value for their shares. Very rare is it that a large, high-quality company chooses to remain in private hands. Somewhere and somehow in the public offering process, investors are getting the message that these are firms worth purchasing. The information has to be coming out in some fashion, and in a way that is credible enough for investors to believe it. How, exactly, does that happen, and through what conduits does the information flow?

While the Securities Act presents a formidable obstacle to meaningful disclosure, there are a few ways around the dis-

closure rules. First and most obviously, issuing firms do have the opportunity to talk to select groups of investors during the “roadshows” (so-called because the issuer and its underwriters actually go on the road to talk to big, important potential investors around the country or, sometimes, globe). At the roadshows, the issuing firm is allowed to make oral statements (including slide presentations, though issuers must be careful not to distribute any written materials) that can conceivably convey information that the prospectus itself does not. So, a company may well be able to disclose positive information, such as a promising new product line, in the roadshow meetings that it would not be willing to disclose in its prospectus. (Google provides an interesting counter-example; according to news reports, Google was punished by institutional investors for failure to make adequate disclosures in its roadshows.)

But roadshows do have one important drawback: They are still subject to the same strict liability as prospectus disclosures, and the disclosures themselves are only observable to the corps of institutional investors in attendance, not to the wider market.

An additional possibility is that the issuing firm will attempt to “signal” its high quality by using reputable underwriters. Because the underwriters are repeat players, they are mindful of their reputations and may choose not to foist a bad offering of securities onto the market lest the underwriters become unable to attract investors in the future. Issuing firms, in contrast, may be one-shot players and thus may have no reputational capital to protect. Issuing firms must “borrow” the underwriter’s reputation. So, if JPMorgan Chase has a great reputation while Dewey, Cheatem & Howe Securities has a poor one, a high-quality issuer can signal its quality by retaining JPMorgan Chase, who would be unwilling to underwrite a bad firm. One could construct a similar reputation story about other third parties to the securities offering, such as auditors or venture capitalists: good auditors and venture capitalists would be unwilling to sign off on bad companies. At the extreme, the firm would have to disclose no information, relying exclusively on the underwriter’s reputation for pricing offerings fairly.

Obviously, things do not work this way in reality, and the effectiveness of reputation as a communication mechanism is seriously limited. Notably, many studies attempting to link measures of underwriter reputation to measures of offering quality have failed. Also, while it is easy to say (and to an extent undoubtedly true) that reputation matters, it is hard to say how much it matters. Measuring reputation based on offering quality is very difficult to do, for academic researchers as well as for market participants. One cannot simply compare share performance willy-nilly; one must control for factors such as industry, risk, and size when measuring, and the methodology used to measure and compare across firms and over time greatly affects the results. (This is the reason why there is disagreement among finance experts whether IPOs systemically under-perform non-IPO stocks over the long run.) Another concern, though, is that underwriters are not competent to price a security without recourse to a market test. That is, in order to price information accurately, a market mechanism is required to digest the information. In any event, relying on rep-

utation by itself appears to be an incomplete solution at best, and something is needed to augment its effectiveness.

ANALYSTS' ROLE What we need is a way for the firm or underwriter to tell the market that it has positive information about the issuer's prospects, information that is not contained in the prospectus. This is where, finally, the analyst comes in: The analyst research report provides a way to communicate the possession of positive information. The underwriter commits beforehand to publish a favorable research report on the issuer after the IPO is done. Once investors learn of this commitment, then they can infer the underwriter is in possession of information that gives the underwriter confidence to issue a positive research report.

Analyst research reports are, and always were, subject to antifraud liability under the Securities Exchange Act. If an underwriter's analyst goes so far as to lie, stating that the firm has above-market prospects when, in fact, the analyst knows that there is no additional good information to support her research recommendation, the analyst and underwriter risk fraud liability. This is, however, not as onerous a liability burden as strict liability for prospectus disclosure, and under the fraud rule, issuers and underwriters are willing to disclose more information to the market. In essence, relying on analyst research reports to get out the message is a form of liability arbitrage, where the market has found a way to replace an inappropriate and suboptimal measure of liability with a better one.

This does, in fact, appear to be what happened in the bull market of the 1990s. Underwriters entered into quid pro quos with issuers, where issuers gave the investment banks their lucrative underwriting business partially in exchange for the promise, on the part of the investment bank, to issue a positive analyst research report post-offering. According to studies, the quality of analyst support became one of the key factors in determining to whom an issuer would give its underwriting business. Banks would often deliver the first draft of a research report when they pitched the IPO to the client. Analysts themselves were often involved in the public offering, even at the point of sourcing potential IPO candidates, as well as participating in roadshows. Investment banks remunerated their analysts based on the success of the underwriting business, and often based on the particular success of individual offerings that the analyst covered. Investors welcomed the news that a stock offering was to be supported by an investment bank's star analyst and, conversely, they would be reluctant to purchase an issue that was not.

An added benefit, from the issuer's perspective, of the commitment to publish the analyst research report is that it helps to solve a problem of conflicting incentives between the issuer and the underwriter. The conflict arises from the fact that the issuer receives most of the proceeds from the offering (the underwriter's commission is customarily limited to seven percent), while the underwriter incurs most of the selling effort and expense, utilizing its selling network and reputational capital to attempt to place the issuer's securities. Given that state of affairs, the underwriter would prefer to exert less effort and expend fewer resources relative to what the issuer would like.

As a further complication, to the extent that the underwriter sells the issuer's securities for less than fair value, the underwriter may be able to recover some portion of the underpricing in the form of kickbacks from the initial purchasers. For example, when Credit Suisse First Boston's Frank Quattrone (formerly of Morgan Stanley and then Deutsche Bank) doled out underpriced shares to valued clients in return for future business or other consideration, the issuing firm suffered from the underpricing while Quattrone and his employer profited handsomely.

Ideally, then, the issuer and underwriter would want to be able to contract up front for a higher level of effort, resulting in a higher offering price. But because price cannot be specified until the market itself has priced the securities, and because the underwriter's effort may be largely unobservable to the issuer (the issuer cannot monitor all the underwriter's phone calls to its selling network, for instance), this contract may be impossible to write and enforce. Ordinarily, this results in the breakdown of the business relationship (i.e., the issuer would be unwilling to employ the underwriter, or at least the employment relationship would lose much of its intrinsic value), but the ability to commit up front to publish positive analyst research allows the underwriter to incur a significant selling effort and expense, putting its money where its mouth is. In fact, analyst research became one of the principal ways in which investment banks bid for underwriting business, with each bank competing to offer the most favorable research report from the most influential analyst. Because the reports are costly (the underwriter can incur both reputational and legal liability) and valuable (the reports disseminate information to the market with the underwriter's imprimatur, resulting in a higher offering price), this bidding market among underwriters may have helped make the underwriting industry more competitive, resulting in a transfer of welfare from investment banks to issuing firms.

Another way of looking at this is that it binds the underwriter to the mast, so to speak. If an underwriter backs out of its positive research report commitment, or backs out of the offering altogether, this breach is seen by the issuer and the market as a whole, and the underwriter suffers a significant hit to its reputation. The market will not be able to tell whether the underwriter backed out because of some opportunistic motive on its part or because the issuer proved to be of low quality, which would render a positive research report fraudulent. From the issuer's perspective, this precommitment strategy is a good one. From a social perspective, however, its effect is somewhat ambiguous. While it does lower the risk of opportunistic behavior by the underwriter, allowing some good issuers access to the market that would not otherwise have it, it does provide an additional incentive to underwriters to go through with—and provide aftermarket support to—an offering that they know to be of poor quality.

Thus, when interpreting the analyst signal, the market should take into account this possibility and discount the signal's value accordingly. The signal is somewhat noisy, and in certain circumstances its meaning may be ambiguous. That notwithstanding, the overwhelming evidence shows that the

market not only knowingly tolerated analyst conflicts of interest, but actively demanded them. As a market solution to the problem of the Securities Act's general embargo on information, the value of the analyst signal as a disclosure device seems significant indeed.

But the question that remains is whether there exists a better methodology for disseminating information to the marketplace, given the possible noisiness of the analyst signal. Here, the answer is a definite "yes." The best of all possible worlds would be one in which issuing firms could disclose their information without the circumlocutions of channeling information through an equities research analyst—that is, where the regulatory regime is not so prohibitive that even good, honest firms are afraid to give potential investors the straight story. Direct disclosure of information, subject to a fraud or negligence rule, as opposed to the current standard of liability without regard to fault or negligence, would go some way toward improving the allocative efficiency of our capital markets.

MAKING MATTERS WORSE

So, given the apparent regulatory inefficiencies in the marketplace and the distortions of behavior that they cause, has the approach of regulators been to relax the regime? Certainly not. As noted at the outset of this article, the response to the most recent securities scandals was for the media, regulators, and academics to demand, and Congress to supply, laws barring conflicts of interest outright. The rationale is that if the analyst is paid on the basis of the success of the offering, then the analyst's impartiality is compromised and her report will be, by that fact, fraudulent. Get rid of the conflict, goes the logic, and you have gotten rid of the problem.

But following this logic to its ultimate conclusion would require prohibiting virtually every sort of communication related to a commercial transaction. Any seller or seller's agent—say, a real estate agent—has a vested interest in making the sale, and her interest conflicts, sometimes directly, with that of the buyer. This does not mean that we prohibit home listings or "for sale" signs, or that we prohibit commissions on the sale of real estate. To the contrary, in general we suppose that when a consumer sees advertising for a home, which makes such claims as desirability of the location, modern appliances, and stylish decor, the consumer can take such advertising with a grain of salt. Furthermore, the advertisements or other disclosures are subject to fraud liability; if the seller or the seller's agent lies, the consumer has access to the courts, who can penalize the seller and agent for deception.

Similarly, in the case of analyst conflicts of interest, those

conflicts were well known to the market. In fact, the market demanded the conflict by requiring an analyst presence in the offering. The simple fact is that the analyst research report, and the promise to issue the report prior to the time of the offering, allowed the underwriter and issuer a means to communicate an underlying degree of confidence to the marketplace. The underwriter was putting its money on the line by committing ahead of time, on the basis of what it knew before the offering, to a positive recommendation. The threat of fraud liability under the Exchange Act, and damage to the underwriter's reputation, provided a check upon untruthful disclosures in those communications. Disclosure of the nature of the conflicts of interest—which were required by National Association of Securities Dealers rules well before the recent analyst scandals—provided the market with the information it needed to evaluate and discount the analyst reports accordingly. While some fraud did occur (the smoking gun e-mails of Jack Grubman and Henry Blodgett provide clear evidence of that) and should be punished in order to preserve the integrity of marketplace disclosure, by and large this arrangement seemed to work pretty well.

As a final thought, consider side-by-side the now-extinct conflicted research analyst report against its nonconflicted cousin, the independent research analyst. For all Congress's worry that biased and conflicted analysts might crowd out the independent analyst, the market appears to place approximately zero value on the independent analyst's product, while placing great value on that of the conflicted analyst. An independent analyst who has no inside information about the firm's prospects has no insight that the market would not already take into account; as over 70 years of empirical research demonstrates, one might as well throw darts at a dartboard as listen to a professional stock-picker. In contrast, the conflicted analyst actually had access to inside information, and thus the conflicted analyst's report had the potential to convey valuable information to the marketplace.

Now that the conflicts have been eliminated along with the analyst's access to inside information, the research analyst is fast disappearing from the institutional landscapes. Apparently recognizing their imminent extinction, the SEC has recently (as of the time of this writing) announced it will not eliminate institutional investors' "soft dollar" payments for analyst research, because doing so would kill off analyst research by eliminating a last remaining source of funding. Because the recent reforms have already cut the guts out of any potential for analyst value-addition, this seems but an empty gesture. The public institution of the research analyst is no longer worth preserving. **R**