

## DOES ANALYST INDEPENDENCE SELL INVESTORS SHORT?

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*Regulators responded to the analyst scandals of the late 1990s by imposing extensive new rules on the research industry. These rules include a requirement forcing financial firms to separate investment banking operations from research. Regulators argued, with questionable empirical support, that the reforms were necessary to eliminate analyst conflicts of interest and ensure the integrity of sell-side research.*

*By eliminating investment banking revenues as a source for funding research, the reforms have had substantial effects. Research coverage of small issuers has been dramatically reduced—the vast majority of small capitalization firms now have no coverage at all. The market for research has become increasingly segmented; institutional investors have access to highly sophisticated and costly information sources, while retail investors are receiving less information than ever.*

*This Article argues that these consequences were predictable. Because research is a public good, and quality research cannot be produced at low cost, the basic business model of the research industry requires firms to subsidize their research operations—especially research that is widely distributed to retail investors—with other services. Analysts traditionally used investment banking revenues, trading commissions, and proprietary trading to fund their research. These services, in turn, created incentives for analyst optimism. Mandated independence does not change this market structure, and high-quality research cannot be provided to public investors on a cost-effective basis absent a source of funding.*

*This Article proposes an alternative to mandated independence: a disclosure-based mechanism to manage analyst conflicts of interest. The Article argues that the recent reforms should be replaced by a combination of analyst registration and a new model of analyst disclosure through a Securities and Exchange*

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*Commission Analyst Website (SECAW). SECAW would enable firms to subsidize research while providing the information necessary to allow researchers and investors to evaluate the quality of that research. At the same time, SECAW would respond to concerns about segmentation, information access, and non-investment-banking conflicts that have not been addressed by the Global Research Settlement or other regulatory efforts.*

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## INTRODUCTION

Several years ago, New York Attorney General Eliot Spitzer's revelations of widespread analyst misconduct,<sup>1</sup> coupled with the dramatic collapse of the technology bubble in the stock market, led to widespread calls for increased regulation of research analysts. The U.S. Congress, the U.S.

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1. Press Release, Office of N.Y. Att'y Gen. Eliot Spitzer, Merrill Lynch Stock Rating System Found Biased by Undisclosed Conflicts of Interests (Apr. 8, 2002), available at [http://www.oag.state.ny.us/press/2002/apr/apr08b\\_02.html](http://www.oag.state.ny.us/press/2002/apr/apr08b_02.html). The results of the investigation were detailed in Petitioner's Affidavit in Support of Application for an Order Pursuant to Gen. Bus. Law Section 354, at 10-13, *Spitzer v. Merrill Lynch & Co.*, No. 02-401522 (N.Y. Sup. Ct. Apr. 8, 2002), available at <http://www.oag.state.ny.us/investors/press/2002/apr/MerrillL.pdf>.

Securities and Exchange Commission (SEC), and the self-regulatory organizations (SROs) answered the calls by adopting extensive regulatory reforms.<sup>2</sup> The reforms included required certifications of the views expressed in analyst reports, a variety of disclosure requirements, and limitations on personal trading by analysts. Most important, the reforms mandated the formal separation of research from investment banking. The purpose of the separation was to reduce conflicts of interest, thereby increasing analyst independence.

The reforms are now in place, and the market has responded. Whether greater independence increases the reliability of analyst research and reduces biases is not clear. Preliminary studies suggest that analyst recommendations are less optimistic than they were at the height of the technology boom of the late 1990s. Analyst recommendations remain predominantly positive and optimistic, however. Buy recommendations still dominate the market, and sell recommendations are relatively rare. Moreover, the evidence on the quality of sell-side research, both prior and subsequent to the regulatory reforms, is far more equivocal, highlighting the distinction between research quality and optimism.<sup>3</sup>

Even if researchers ultimately can demonstrate that the regulations have improved the accuracy of analyst research, the structural changes imposed by the regulations have been costly.<sup>4</sup> Investment banks have reduced their expenditures on analyst research. Many analysts, particularly the most experienced, fled to investment banking, the buy side, and hedge funds. Analyst coverage, especially for smaller companies, has declined dramatically. Currently, 35 percent of public companies listed on the major stock exchanges have no research coverage at all.<sup>5</sup> That number increases to 83 percent for companies with market capitalizations of less than \$125 million.<sup>6</sup> This decline in research coverage is a critical problem for smaller companies, because a lack of research coverage increases capital costs. The initial public offering (IPO) market also has been affected; reduced information requires issuers to be larger and better established in order successfully to access the public capital markets. In addition, lack of coverage limits retail investor access to profitable investing opportunities.

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2. See *infra* Part III (describing the regulatory reforms).

3. See *infra* Parts II, IV (describing empirical studies).

4. See *infra* Part IV (describing market responses to the regulatory changes).

5. FINAL REPORT OF THE ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES TO THE U.S. SECURITIES AND EXCHANGE COMMISSION 65 n.126 (2006), [http://www.sec.gov/info/smallbus/acspc/acspc-finalreport\\_d.pdf](http://www.sec.gov/info/smallbus/acspc/acspc-finalreport_d.pdf) [hereinafter FINAL REPORT].

6. *Id.*

The existing research market has become increasingly segmented. Firms are offering new and enhanced services to large institutional clients and focusing less on retail investors.<sup>7</sup> Research firms are eschewing public or even widespread distribution of their research, moving to a business model in which information is limited to a small number of clients—often hedge funds—who may pay \$1 million a year or more for exclusive and customized research services.<sup>8</sup> Several organizations are attempting to fill the void by creating a model of research for hire, in which issuers pay for analyst coverage, but the viability of that model remains unproven.<sup>9</sup> Some critics claim that even the independent research mandate of the Global Research Settlement is of little value to investors<sup>10</sup>—although the program has clearly been a success for Morningstar, which is providing the lion's share of the research.<sup>11</sup> On the whole, it is uncertain whether increased analyst independence has benefited retail investors and the capital markets.

The existing reforms also contain significant gaps. Although widely billed as eliminating analyst conflicts of interest, the reforms focus almost exclusively on investment banking conflicts. True independence would require regulators to address brokerage conflicts, soft-dollar commissions, proprietary trading (including trading by affiliated mutual funds), and the differential treatment of institutional and retail customers. In addition, because most of the recent reforms were imposed through a combination of the terms of the Global Research Settlement<sup>12</sup> and rules adopted by the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE), they do not apply to all research providers. In particular, analysts who do not work for broker-dealers remain

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7. See *infra* notes 182–189 and accompanying text (describing research services targeted to institutional clients).

8. See, e.g., Monica Schulz, *New Firms Push Exclusive Research (Luring Hedge Funds)*, WALL ST. LETTER, Sept. 4, 2006, available at <http://www.westlaw.com> (search for citation 2006 WLNR 17089489) (stating that the growth of customized research costs as much as \$250,000 to \$350,000 per quarter and is aimed at hedge fund investors).

9. See *infra* notes 229–250 (describing issuer-paid research).

10. See Judith Burns, “Independent” Stock Research Hasn’t Been Must-See, WALL ST. J., Nov. 26, 2005, at B3.

11. See, e.g., Matthew Keenan, *Morningstar’s Net Soars as Research Takes Off*, INT’L HERALD TRIB., May 5, 2006, at 19 (explaining that six of ten Wall Street investment banks are buying research from Morningstar as part of their obligations under the Global Research Settlement).

12. See SEC, Fact Sheet on Global Analyst Research Settlements (Apr. 28, 2003), <http://www.sec.gov/news/speech/factsheet.htm> (describing settlement terms); Global Research Analyst Settlement Final Judgment Addendum A (approved on Sept. 24, 2004), available at <http://www.sec.gov/litigation/litrelases/finaljudgadda.pdf> (describing settlement requirements in more detail).

largely unregulated. Extension of the reforms would, of course, generate a substantially greater impact on the market.

This Article argues that the effects of the regulatory reforms were predictable. Mandated independence is inconsistent with the business model through which research is provided to retail investors and the public. Because of the high cost of quality research, and because research is a public good that offers firms limited ability to recoup its cost, analysts have traditionally subsidized research through other business operations, using trading commissions, investment banking revenues, and proprietary trading to generate profits. Investment banking operations, for example, emerged as a natural way to subsidize research on small public companies that would otherwise be unprofitable. Investment banking also provided information that analysts could incorporate into their research. The recent regulatory reforms have eliminated the ability of firms to subsidize research through investment banking. As a result, reducing the so-called analyst conflicts has the effect of eliminating a critical source of research funding. Even the temporary subsidy provided by the Global Research Settlement has not compensated for this effect.

At the same time, increased independence is unlikely to eliminate analyst optimism—the most visible result of investment banking influence. Fundamental components of the market for research create incentives for optimism, incentives that are fueled by the interests of analysts' institutional clients and reinforced by issuers. As a result, the capacity of research to mislead the retail investor remains substantial. Simply put, the independence mandate is problematic in terms of its effects on both the quality and quantity of information received by investors, particularly retail investors.

In other work with Stephen Choi, I have proposed an alternative source of funding for equity research.<sup>13</sup> As we noted in that article, it is possible to design structural reforms that allow research, and other services that provide value to investors and the market to be funded independently of business relationships that create potential conflicts.<sup>14</sup> In the absence of alternative sources of funding, however, mandated structural reforms to the research industry are problematic. In addition, subsidies directed exclusively to equity research pose challenges in identifying the optimal level of research. Without considering the relative advantages, in an ideal world, of the two possible regulatory approaches—structural change versus

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13. Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269 (2003).

14. *Id.* at 321–23.

improved disclosure—this Article develops a disclosure-based alternative to mandated independence.<sup>15</sup> The premise of this approach is that investors can be adequately protected through regulations that manage rather than eliminate conflicts of interest. Toward that end, the Article introduces a mechanism for increasing transparency through a combination of analyst registration and a dedicated research analyst website.

Retail investors currently have very limited access to reliable information about the analysts whose recommendations they receive through the Internet, the media, and other public sources. Although extensive information on research analysts is available, it is not readily accessible to small investors. The government has the ability to address this deficiency. The Article proposes that the SEC obtain information about equity analysts by imposing a registration requirement on all analysts who disseminate their research broadly to the investing public. The registration requirement would require analysts to disclose information about themselves and their employers, including personal holdings and potentially conflicting business relationships. In addition, analysts would be required to file publicly disseminated research contemporaneously with the SEC. The SEC would make this information available to the public by posting it on a newly created SEC Analyst Website, known as SECAW. SECAW would establish a single source through which investors, researchers, and the markets could obtain information about analysts' current and past recommendations and coverage decisions and evaluate that information in light of specific factors relating to analyst independence.

SECAW would dramatically expand the information available to the investing public. It would enable retail investors to verify research, identify potential conflicts of interest, and evaluate analyst performance. In addition, SECAW would serve as a resource for private service providers and others to compile information on analyst performance, to evaluate the effect of analyst conflicts, and more. In particular, SECAW would enable researchers to determine the extent to which independence is a good proxy for reliability. Importantly, SECAW would not be limited to addressing conflicts of interest, but would offer a new and centralized source of data on the overall quality of publicly distributed research.

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15. The approach developed in this Article is designed primarily to increase information flow in the capital markets and to protect retail investors. As the Article demonstrates, institutional and retail investors are not similarly situated with respect to analyst research. Institutional customers have sufficient sophistication to detect and evaluate conflicts of interest and to protect themselves by contract from conflicts that they view as harmful. As a result, there is no justification for regulators to impose structural limits on these marketplace transactions.

Although the filing requirement might seem burdensome, this Article argues that, under appropriate conditions, public disclosure of analyst research may serve the interests of an analyst's institutional and issuer clients. In addition, any burden is substantially less than that imposed by a restriction on research funding such as the mandated separation of investment banking from research. In sum, the proposal offers a return to a market-based mechanism for funding research coupled with the transparency that will allow the market itself to evaluate the reliability of that research.

The Article proceeds as follows. Part I describes the role of the research analyst and the business relationships that firms have used to subsidize the costs of research. Part II reviews the literature on analyst conflicts of interest and considers the extent to which such conflicts have been shown to bias analyst recommendations and affect research quality. Part III briefly describes the recent regulatory reforms. Part IV focuses on the effects of the regulatory reforms. Finally, in Part V, the Article describes its proposed alternative—analyst registration and SECAW—and demonstrates the superiority of this approach to the current regulatory regime.

## I. THE ROLE OF THE RESEARCH ANALYST

### A. Analysts and What They Do

Research analysts are financial professionals who research companies and create reports and recommendations that are used by traders in making investment decisions.<sup>16</sup> SEC Regulation Analyst Certification (AC) defines a research analyst as “any natural person who is primarily responsible for the preparation of the content of a research report.”<sup>17</sup> A research report is defined as “a written communication (including an electronic communication) that includes an analysis of a security or an issuer and provides information reasonably sufficient upon which to base an investment decision.”<sup>18</sup> Analysts are commonly employed by banks, brokerages, investment advisors, and mutual funds.

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16. See Jill E. Fisch & Hillary Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1040–43 (2003) (describing the role of the analyst).

17. Regulation Analyst Certification, 17 C.F.R. § 242.500 (2005).

18. *Id.*

The literature has focused particular attention on the sell-side analyst.<sup>19</sup> The term “sell-side analyst” is used to describe securities analysts employed by the research departments of full-service investment firms such as broker-dealers and investment banks.<sup>20</sup> The key point—and one that is essential to this Article—is that research produced by sell-side analysts is generally available to the public, although institutional investors commonly use sell-side research, and sell-side analysts may provide different or more timely information to their institutional clients. In contrast, buy-side analysts, who are typically employed by a mutual fund, hedge fund, or other institutional investor, produce research exclusively for the benefit of their employers.<sup>21</sup>

Analysts offer many types of information. They may cover small-capitalization or newly public companies. They may specialize in an industry or sector. They use a variety of financial models to assess company fundamentals. They may use industry experts to evaluate new products or trends. Ultimately, the analyst acts as an information intermediary, acquiring and analyzing information and then transmitting that information to the marketplace.

The information provided by the analyst actually consists of three discrete components. First and foremost, an analyst provides coverage. Although this component of the analyst’s product is often overlooked, simply by covering a stock, an analyst dramatically increases its visibility to the investing public. For small- and mid-cap companies, analyst coverage can make a significant difference in both liquidity and price. For larger companies, the level of analyst coverage conveys important information about the efficiency of the market for that company’s stock.<sup>22</sup>

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19. See IOSCO TECHNICAL COMM., STATEMENT OF PRINCIPLES FOR ADDRESSING SELL-SIDE SECURITIES ANALYST CONFLICTS OF INTEREST 1 (2003), <http://www.iosco.org/pubdocs/pdf/IOSCOPD150.pdf> [hereinafter IOSCO PRINCIPLES] (identifying conflicts faced by sell-side analysts as posing “special problems with respect to investor protection”).

20. IOSCO TECHNICAL COMM., REPORT ON ANALYST CONFLICTS OF INTEREST 3 (2003), <http://www.iosco.org/pubdocs/pdf/IOSCOPD152.pdf> [hereinafter IOSCO REPORT].

21. *Id.* at 3–4. Some analysts produce and sell information on a fee or subscription basis, primarily to institutional clients. These analysts are sometimes described as independent analysts, *see id.* at 4, although the nature and scope of this category varies depending on the particular issue involved. For example, regulators have generally interpreted as independent, for purposes of the Global Research Settlement, any analyst who is not employed by a firm that engages in investment banking business. Ann Davis & Susanne Craig, *Analyze This: Research Is Fuzzier Than Ever—‘Independent’ Label Becomes a Mantra After the Crackdown, but Conflicts Have Emerged*, WALL ST. J., Apr. 26, 2004, at C1.

22. See, e.g., *Stuebler v. Xcelera.com (In re Xcelera.com Sec. Litig.)*, 430 F.3d 503, 511 (1st Cir. 2005) (identifying the number of analysts covering an issuer as one factor to be considered in determining whether the market for the issuer’s stock was efficient (citing *Cammer v. Bloom*, 711 F. Supp. 1264, 1286–87 (D.N.J. 1989))).



Consequently, issuers regularly provide detailed information about analyst coverage to their investors.<sup>23</sup> In addition, coverage may operate as a signal of issuer quality. Analysts convey negative information to the market by terminating coverage of an issuer. Traditionally, analysts whose business interests limited their willingness to issue sell recommendations used coverage decisions as an alternative mechanism for conveying negative information.<sup>24</sup>

Second, the analyst issues a report. An analyst combines both original research and publicly available information and translates that information into a format that is usable by investors and enables investors to compare companies. The comparison process is facilitated by the use of objective benchmarks such as earnings forecasts and price targets. Earnings forecasts are one of the most salient pieces of information contained in the report and, because they are objectively verifiable, are the focus of many empirical analyses of analyst performance.

Comparison of companies is aided by the third category of information provided by the analyst: the recommendation. Analysts generally rate each covered security in terms of attractiveness, using a scale consisting of three to five categories or ratings. Analyst recommendations have generated considerable controversy, largely because they have been heavily skewed toward the buy or strong buy categories, with very few investments rated as sell. This bias has changed slightly in light of the analyst scandals of the late 1990s<sup>25</sup> and the regulatory response, which includes a requirement that firms provide both an explanation and a distribution of their ratings.<sup>26</sup> As a result, analysts now issue more sell ratings. Researchers found, however, that even before those changes, although the optimistic bias reduced the information content of the ratings in absolute terms, analyst ratings and ratings changes conveyed significant information.<sup>27</sup>

The market for analyst research is complicated by the public good problem.<sup>28</sup> An analyst can sell his or her research only if it contains information

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23. See, e.g., Delta, Analyst Coverage, [http://www.delta.com/about\\_delta/investor\\_relations/analyst\\_coverage/index.jsp](http://www.delta.com/about_delta/investor_relations/analyst_coverage/index.jsp) (last visited Aug. 8, 2007) (listing names, firm affiliations, and phone numbers of individual analysts covering Delta); Onyx Pharmaceuticals, Analyst Coverage, <http://www.onyx-pharm.com/wt/page/analyst> (last visited Aug. 8, 2007) (listing names of analysts and their firms).

24. See *infra* Part II (discussing analyst optimism).

25. See *infra* note 136 and accompanying text.

26. See *infra* Part IV (citing statistics on analyst recommendations).

27. See *infra* Part II.

28. See Robert Cooter & Thomas Ulen, *LAW AND ECONOMICS* 40 (2d ed. 1977) (defining public goods as characterized by nonrivalrous consumption and nonexcludability of benefits); see also Choi & Fisch, *supra* note 13, at 279, 286 (describing the consequences of the public good problem for the provision of analyst research).

that is not already in the public domain.<sup>29</sup> It is difficult, however, to prevent securities information from being leaked to investors other than those who have produced or purchased the information. This causes the information's value to dissipate rapidly. Indeed, once an investor has traded, it is often in his or her interest to leak the information to others.<sup>30</sup> Because others cannot readily be excluded from using the information, it is difficult for an analyst to capture the full value of his or her research by selling it.<sup>31</sup>

Quality research is also costly.<sup>32</sup> By definition, efficient markets rapidly incorporate publicly available information into market price. Only by uncovering material that is not widely known or by bringing an original insight to existing data can analysts offer investors an informational advantage, but uncovering such material is difficult. As a result, research is widely recognized as a cost center at Wall Street firms rather than a source of profits.<sup>33</sup> One study reports that Wall Street firms spent \$9.1 billion producing research in 2003 but were only able to receive \$5.91 billion for selling that research.<sup>34</sup> The costly nature of analyst research coupled with the inability of analysts to finance their research through independent market transactions has led to a variety of mechanisms for subsidizing the cost of that research.<sup>35</sup>

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29. As the U.S. Supreme Court noted in *Dirks v. SEC*, 463 U.S. 646 (1983), “[i]t is the nature of this type of information [that is contained in an analyst’s reports], and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation’s stockholders or the public generally.” *Id.* at 659.

30. John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 725 (1984).

31. *Id.* at 726.

32. See Caren Chesler, *Back to the Drawing Board; Independent Research Firms Are Still Struggling to Find a Model That Will Put Money in the Bank*, INVESTMENT DEALERS’ DIG., Mar. 27, 2006, at 26, 29 (citing a 2004 Integrity Research Study showing that some big investment banks spend as much as \$600 million a year to run their research departments). *But see* Ann Davis, *Increasingly, Stock Research Serves the Pros, Not ‘Little Guy’—In the Wake of Spitzer Pact, Wall Street and Upstarts Are Catering to Elite Few—Ordering ‘Bespoke’ Reports*, WALL ST. J., Mar. 5, 2004, at A1 (reporting annual research budgets ranging from approximately \$150 to \$300 million). Some commentators have argued that by reducing selective information flow from issuers to analysts, the adoption of Regulation Fair Disclosure (FD) has made the generation of quality research substantially more costly, particularly for small issuers. See, e.g., Armando Gomes et al., *SEC Regulation Fair Disclosure, Information and the Cost of Capital* (Working Paper, July 8, 2004), available at <http://w4.stern.nyu.edu/emplibrary/Gomes.pdf> (empirically studying the effect of Regulation FD on information flow).

33. See Chesler, *supra* note 32 (stating that “[i]t’s no secret that providing research on its own is a money-losing proposition for the big banks”).

34. *Id.*

35. See Karen Richardson, *Why Does Tech Teem With Analysts? Despite Settlement, IPO Fees Still Lure*, WALL ST. J., May 25, 2006, at C1 (quoting Scott Cleland, president of the research firm Precursor, as stating that Wall Street research “isn’t necessarily driven by where the best investment opportunities are . . . It’s driven by what coverage areas they can get paid for”).

## B. Funding Research Through Other Business

Analyst research can be funded in several ways. It can be sold directly to investors. It can be paid for, directly or indirectly, through brokerage commissions. It can be subsidized by investment banking revenues. Or, its costs can be covered through proprietary trading by the analyst or his or her firm.

A number of research firms provide neither brokerage nor investment banking services, and sell their research directly to investors. These analysts are traditionally characterized as “independent” analysts.<sup>36</sup> The customers for this research are almost exclusively large institutional investors for whom the benefits of purchasing research justify the substantial cost. Because the value of research dissipates quickly as it is disseminated, it must be sold to a limited number of investors. One empirical study found, for example, that profitable trading opportunities persisted for “roughly two hours following the pre-market release of analyst recommendation changes to clients.”<sup>37</sup>

Alternatively, research can be bundled with trading commissions. Traditionally, analyst research was subsidized by brokerage commissions.<sup>38</sup> Brokerage firms attracted trading customers through their ability to provide high-quality research. Customers paid for that research by trading through the broker. Because fixed commission rates prevented brokers from competing on commission rates, research was one way for a firm to distinguish itself from its competitors. Moreover, the inability of one brokerage firm to undercut another by charging reduced trading fees eliminated any incentive for a customer to obtain information from one broker and then trade through a different broker.

The SEC’s elimination of fixed commission rates in 1975 substantially reduced the ability of securities firms to finance research through brokerage commissions.<sup>39</sup> The low cost of Internet trading has caused commissions to drop still further.<sup>40</sup> Nonetheless, securities firms continue to use brokerage

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36. *But see infra* Part IV (identifying conflicts of interest at so-called independent firms).

37. T. Clifton Green, *The Value of Client Access to Analyst Recommendations*, 41 J. FIN. & QUANTITATIVE ANALYSIS 1, 23 (2006). In contrast, “profit opportunities dissipate within seconds” following a release to the public through a medium such as a television broadcast. *Id.* at 2 (citing J.A. Busse & T.C. Green, *Market Efficiency in Real Time*, 65 J. FIN. ECON. 415, 435 (2002)).

38. See Choi & Fisch, *supra* note 13, at 286–87 (describing the history of subsidizing research through fixed brokerage commissions).

39. *Id.* at 287.

40. See, e.g., Davis, *supra* note 32, at A1 (stating that the average commission has dropped from fifteen cents per share in the early 1990s to five cents per share).

commissions from institutional investors to subsidize their research. The mechanism for doing so is known as “soft-dollar commissions.”<sup>41</sup> Soft dollars enable firms to bundle the cost of research with the cost of executing trades. The resulting commissions charged by the securities firm are typically far greater than the cost of the trades.<sup>42</sup> The difference between the trading cost for the firm and the actual commission represents payment, indirectly, for the research.

The soft-dollar structure is particularly attractive to fund managers because, by incorporating the cost of research into commissions, the costs of research are paid by the fund (and its beneficiaries) rather than by the investment advisor.<sup>43</sup> Soft dollars are explicitly authorized under § 28(e) of the Securities Exchange Act of 1934.<sup>44</sup> Nonetheless, they have come under attack.<sup>45</sup> One concern is that mutual funds have often used soft dollars to purchase things such as computer equipment and office supplies, that should be paid for by the investment advisor, not the fund.<sup>46</sup> In addition, some commentators argue that fund managers should choose brokers on the basis of quality of execution rather than allowing execution to be bundled with research.<sup>47</sup> Finally, soft dollars enable fund managers to mask their true cost structure because research paid for with hard dollars is included

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41. Soft dollars are the use of brokerage commissions to pay for research products and services. Letter from Matthew P. Fink, President, Inv. Co. Inst., to William H. Donaldson, Chairman, SEC, Request for Rulemaking Concerning Soft Dollars and Directed Brokerage (Dec. 16, 2003) [hereinafter Request for Rulemaking], available at <http://www.sec.gov/rules/petitions/petn4-492.htm>.

42. According to the *Wall Street Journal*, soft dollars can have the effect of doubling the commissions paid by mutual funds. See Charles Gasparino, *Mutual-Fund Investors Risk Bite From ‘Soft-Dollar’ Deals*, WALL ST. J., Sept. 16, 1998, at C1 (quoting financial adviser Robert Levitt as stating that money managers typically pay around six cents per share for soft-dollar commissions and three cents per share for commissions that do not include soft dollars).

43. NASD REPORT OF THE MUTUAL FUND TASK FORCE, SOFT DOLLARS AND PORTFOLIO TRANSACTION COSTS 3 (2004), [http://www.nasd.com/stellent/groups/rules\\_regs/documents/rules\\_regs/nasdw\\_012356.pdf](http://www.nasd.com/stellent/groups/rules_regs/documents/rules_regs/nasdw_012356.pdf).

44. 15 U.S.C. § 78bb(e) (2000). The statute was adopted, in connection with the elimination of fixed commissions, to protect mutual fund managers who paid more than the lowest possible commission. NASD REPORT OF THE MUTUAL FUND TASK FORCE, *supra* note 43, at 2.

45. See Request for Rulemaking, *supra* note 41 (calling for SEC rulemaking to address abuses in the use of soft dollars).

46. *Id.* Indeed, the SEC found examples of institutional investors using soft dollars to pay for travel, entertainment, and limousine services. SEC, Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds (1998), <http://www.sec.gov/news/studies/softdolr.htm>.

47. MUTUAL FUND DIRECTORS FORUM, BEST PRACTICES AND PRACTICAL GUIDANCE FOR MUTUAL FUND DIRECTORS 17–22 (2004), [http://www.mfdf.com/UserFiles/File/best\\_pra.pdf](http://www.mfdf.com/UserFiles/File/best_pra.pdf). The Forum reasoned that its “guiding principles—that brokerage commissions are an asset of a fund, that best execution is the most important factor and that transparency is important—weigh strongly in favor of abandoning soft dollar arrangements involving fund assets.” *Id.* at 20–21.

in a fund's expense ratio, which is disclosed separately to investors, while research funded with soft dollars is not, even though it has the same effect of reducing the fund's return to investors.<sup>48</sup>

Last year, in response to these concerns, Fidelity Investments announced its decision to stop using soft dollars to pay for research.<sup>49</sup> Although some experts predicted that many other firms would follow,<sup>50</sup> to date, other asset managers continue to use soft dollars.<sup>51</sup> Additionally, although regulators recently considered banning soft-dollar commissions,<sup>52</sup> they ultimately retreated from the ban, perhaps in response to industry pressure.<sup>53</sup> Instead, in July 2006, the SEC issued interpretive guidance explicitly reaffirming the legality of bundling research payments and brokerage commissions.<sup>54</sup>

It might seem that firms could also charge retail investors for research by charging higher brokerage commissions. In the same way that brokers use soft dollars to bundle research and trading costs, full-service brokerage commissions bundle those costs for retail customers. In theory, retail customers should be willing to pay these commissions to gain access to the brokerage firm's research. Since the elimination of fixed commissions, however, retail commissions are highly ineffective as a method of

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48. NASD REPORT OF THE MUTUAL FUND TASK FORCE, *supra* note 43.

49. Richard Beales, *Fidelity Hardens Its Stance on Soft Dollars: Fund Manager Has Decided to Pay Lehman Brothers Separately for Research*, FIN. TIMES (London), Oct. 24, 2005, at 20.

50. See, e.g., Jessica Papini, *Fido/Lehman Move May Squeeze Analyst Comp*, WALL ST. LETTER, Oct. 31, 2005, available at <http://www.westlaw.com> (search for citation 2005 WLNR 19182391) (quoting Morgan Stanley analyst Chris Meyer describing the move to unbundling as "a strong trend because soft dollars are too dangerous").

51. See Chesler, *supra* note 32, at 30 (describing Fidelity Investments as the only firm to have unbundled research payments from commissions and reporting results of a January 2006 Integrity Research survey of asset managers finding that 85 percent "say they still pay for research with soft dollars").

52. See, e.g., Judith Burns, *Business Isn't Bustling as SEC May Move to Curb Soft-Dollar Arrangements*, WALL ST. J., Sept. 20, 2004, at C15 (describing possible SEC ban); Serena Ng, *'Soft Dollars' Flow to Independent Researchers—Hedge Funds Give Firms a Boost With Commissions Frowned on by Regulators*, WALL ST. J., June 17, 2005, at C3 (describing the SEC task force created to examine the use of soft dollars). The U.S. Congress also held hearings on the use of soft dollars and considered legislation that would have made their use illegal. See Mutual Fund Reform Act of 2004, S. 2059, 108th Cong., 2d sess. § 311 (2004) (proposing ban on soft dollars).

53. See, e.g., Arden Dale, *Wall Street Makes 'Soft Dollar' Pitch—Brokers, Money Managers Urge SEC to Tread Lightly in Overhaul of Fee Deals*, WALL ST. J., July 11, 2006, at C3 (describing efforts by brokers and research firms to dissuade SEC from the ban). Industry insiders warned that a soft-dollar ban would seriously impact independent research firms. See, e.g., Burns, *supra* note 52, at C15 (describing a 2004 survey of independent research firms by Investorside Research Association reporting that "70% said they would consider quitting the business if the SEC bans soft-dollar transactions").

54. SEC, GUIDANCE REGARDING CLIENT COMMISSION PRACTICES UNDER SECTION 28(E) OF THE SECURITIES EXCHANGE ACT OF 1934, at 3–4 (2006), <http://www.sec.gov/rules/interp/2006/34-54165.pdf>.

subsidizing research, because commission rates are subject to intense competition, and retail customers have no obligation to trade exclusively with a full-service broker. Investors can obtain research from Merrill Lynch and then trade on that research through Charles Schwab or TD Ameritrade, effectively avoiding paying Merrill Lynch for its research.<sup>55</sup> Moreover, it is unclear that investors should be willing to pay brokers for research. Empirical research suggests that the information value of research dissipates rapidly; such research is unlikely to have investment value by the time it finds its way into the hands of retail investors.<sup>56</sup> Moreover, because retail investors are under no obligation to maintain the confidentiality of the information that they receive, distribution to them is tantamount to distribution to the general public, which has the effect of reducing to zero the firm's ability to charge for the information.

Nonetheless, a substantial percentage of retail investors continue to trade through full-service brokers,<sup>57</sup> which are increasingly offering investors accounts in which fees are a percentage of assets rather than commission-based, as well as a host of nontrading financial services including banking and insurance.<sup>58</sup> It is unclear whether the decision to use a full-service broker is based on the availability of these bundled financial services; whether investors benefit from more generic investment advice regarding issues such as diversification, life-cycle planning, taxation, or identification of alternative investment strategies including hedging; or whether using a full-service broker is simply irrational.<sup>59</sup>

The limited ability of firms to subsidize research through transactions with retail investors means that research is funded largely if not exclusively by the firm's institutional customers. As a result, institutional investors are properly understood as the analysts' true clients. This perspective is

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55. TD Ameritrade, for example, charges a commission of \$9.99 for an online equity trade. See TD Ameritrade, <http://www.tdameritrade.com/welcome1.html> (last visited Aug. 8, 2007).

56. See, e.g., Brad Barber et al., *Can Investors Profit From the Prophets? Security Analyst Recommendations and Stock Returns*, 56 J. FIN. 531, 562 (2001) (demonstrating that, although in theory brokerage research has investment value, implementing analyst recommendations requires high transaction costs and that, after accounting for those costs, research is unlikely to generate positive abnormal returns).

57. See Eleanor Laise & William Mauldin, *Hook the Right Broker*, SMARTMONEY, Aug. 2005, at 2, available at [http://www.edwardjones.com/cgi/getData.cgi?file=/pdf/SmartMoney\\_Reprints\\_FINAL.pdf](http://www.edwardjones.com/cgi/getData.cgi?file=/pdf/SmartMoney_Reprints_FINAL.pdf) (stating that 28 percent of U.S. households use a full-service broker).

58. See, e.g., *id.* (describing the services and accounts provided by full-service brokers).

59. Many retail investors purchase mutual funds through full-service brokers, for example, despite empirical evidence demonstrating that broker-recommended funds have higher fees and inferior performance. Daniel Bergstresser et al., *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry* (HBS Finance Working Paper No. 616981, Mar. 15, 2005), available at <http://ssrn.com/abstract=616981>.

reflected in the differential treatment that institutional clients receive from analysts, relative to retail investors or the general public.<sup>60</sup> Analysts systematically release information to their institutional investors prior to its public release.<sup>61</sup> This both prevents dissipation of the value of the information and assures that by the time the information is released to the public, its value has already been incorporated into stock prices. As Peter Lynch has observed, investors are least likely to make money by following recommendations on stock with large institutional ownership because the smart money gets there first.<sup>62</sup> In addition, retail investors often receive incomplete information from analysts. For example, analysts may release their recommendation but not the underlying report or financial analysis supporting that recommendation, which contains the majority of the valuable information.<sup>63</sup>

Investment banking provides an alternative source of funding for analyst research. Analyst research complements a firm's investment banking business in several ways. Research departments cultivate relationships with institutional investors to whom the firm, acting as underwriter, can sell new securities issues. Underwriters compete, in part, based on their ability to get the deal done and their ability to maximize selling price for the issuer; both types of services are enhanced by a strong institutional client base. Analyst participation in the underwriting process, in turn, provides comfort to institutional clients that the investment bank will support the offering through and beyond the underwriting process. The liquidity risk associated with new issues, particularly from small-cap companies, is greatly reduced by the assurance of continued analyst coverage.

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60. See Green, *supra* note 37, at 1–3 (describing the fact that institutions pay for prior access to analyst recommendations and that these recommendations have investment value, but that the investment value has dissipated by the time the information is released to the general public).

61. See Gayle Essary, Financial Research: State of the Industry, Keynote Address at Institutional Investors Forum 2004 (Feb. 25, 2004) (transcript available at [http://www.investtrend.com/Admin/Topics/Articles/Resources/688\\_1128883186.doc](http://www.investtrend.com/Admin/Topics/Articles/Resources/688_1128883186.doc)) (criticizing this practice and arguing that analyst upgrades and downgrades are material information that should be equally available to all investors).

62. PETER LYNCH, ONE UP ON WALL STREET (1989).

63. Essary, *supra* note 61 (describing the “long-established industry practice of announcing ‘upgrades’ or ‘downgrades’ to the general public while making the full research report . . . available only to a select group of clientele”).

During the 1990s, investment banks increasingly drew analysts into the underwriting process.<sup>64</sup> Prior to the recent regulatory reforms, investment banks commonly used analysts to vet prospective offerings, review and opine on investment banking deals, and help pitch the firm to prospective investment banking clients.<sup>65</sup> Analysts were sent on roadshows to assist in marketing the securities to prospective clients,<sup>66</sup> and were also sent on nondeal roadshows to maintain interest in the securities of existing or prospective clients.<sup>67</sup> A handful of analysts achieved such prominence that they became media celebrities, receiving huge compensation packages in return for generating investment banking business.<sup>68</sup> Perhaps best known was Salomon Smith Barney's (SSB) Jack Grubman, who became the guru of the telecommunications industry. SSB earned more than \$790 million in investment banking revenue from telecommunications companies covered by Grubman.<sup>69</sup> In return, Grubman received \$67.5 million in compensation.<sup>70</sup>

Finally, firms can subsidize research by using it in their proprietary trading and asset management activities. Similarly, analysts can, if their

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64. Investment banks may also use merger and acquisition (M&A) fees to subsidize analyst research. As Adam Kolasinski and S.P. Kothari explain, "in every year since 1994, M&A fees in the U.S. have been at least as large as equity underwriting fees and in recent years significantly larger." Adam Kolasinski & S.P. Kothari, *Investment Banking and Analyst Objectivity: Evidence From Analysts Affiliated With M&A Advisors* 7 (MIT Sloan Sch. Working Paper No. 4575-06, Mar. 2007), available at <http://ssrn.com/abstract=499068>. Kolasinski and Kothari describe the incentives for analyst bias based on M&A business, *id.* at 35, and report findings that M&A affiliates and analysts bias their recommendations in ways that benefit their M&A clients, *id.* at 29–30.

65. SEC Complaint paras. 16–19, SEC v. Henry Blodget No. 03 CV 2947 (S.D.N.Y. Apr. 28, 2003), available at <http://www.sec.gov/litigation/complaints/comp18115b.htm> [hereinafter Blodget Complaint] (describing how Merrill Lynch analysts assisted in investment banking deals); Randall Smith & Aaron Lucchetti, *Analysts' Picks of Enron Stock Face Scrutiny*, WALL ST. J., Feb. 26, 2002, at C1 (explaining how analysts met "with chief executives and chief financial officers of companies that are preparing initial public offerings of stock, vetting the companies so their firm doesn't agree to underwrite an IPO [initial public offering] they can't recommend").

66. Smith & Lucchetti, *supra* note 65, at C1 (explaining that analysts "routinely" attended pre-IPO roadshows "often helping company executives schedule 'one-on-one' meetings with institutional investors that might buy the stock").

67. Blodget Complaint, *supra* note 65.

68. See, e.g., Martin Sosnoff, *Analyze This*, FORBES, March 6, 2000, at 188 (describing how Wall Street's "celebrity analysts . . . lasso investment banking clients, then hawk the clients' stocks 30 days after an initial public offering").

69. SEC Complaint para. 40, SEC v. Citigroup (S.D.N.Y. Apr. 28, 2003), available at <http://www.sec.gov/litigation/complaints/comp18111.htm>.

70. *Id.* para. 41; see also Complaint for Dep't of Enforcement at 4, Dep't of Enforcement v. Quattrone, No. CAF030007 (Mar. 6, 2003), available at <http://news.findlaw.com/hdocs/docs/csfb/nasdquatt30603spincmp.pdf> (stating that Quattrone earned compensation of more than \$200 million from July 1998 to the end of 2001).



employer permits, use their research to engage in profitable personal trading. Trading covered securities can be profitable both because it enables traders to use research information before it is broadly disseminated and because the mere publication of a research report or recommendation can have an effect on stock price, creating a trading opportunity.

An ownership interest by an analyst or his employer in covered securities might not seem particularly problematic—after all, the analyst is merely “putting his money where his mouth is.” Indeed, investors might view an analyst recommendation as more credible if they know that the analyst is investing in accordance with his public advice. Analysts and their firms, however, may profit from the market effect of their public recommendations rather than from the underlying research that supports those recommendations.<sup>71</sup> Indeed, analysts have engaged in personal trading contrary to their public recommendations.<sup>72</sup> Securities firms may trade ahead of an analyst’s buy recommendation, effectively front-running the firm’s own public statements.<sup>73</sup> In some cases, the firm goes on to unload the stock ahead of the investing public. In 2000, for example, the *Wall Street Journal* reported that it was becoming increasingly common for Wall Street banks to take multimillion dollar equity stakes in covered companies.<sup>74</sup> Although these stakes created a possible synergy between the bank’s trading activities and its research arm, they also created the risk that banks would distort their analyses to increase their trading profits. In fact, the *Journal* reported that the banks often sold their stakes at the same time that the banks’ analysts were maintaining buy or strong buy ratings.<sup>75</sup>

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71. Trading on the market effect of an investment recommendation is known as front-running or scalping, which is prohibited by the Investment Advisers Act. 15 U.S.C. § 80b-6 (2000); see also *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963) (interpreting scalping as a fraudulent practice under the Investment Advisers Act). Most analysts, however, are not covered by the Act. Fisch & Sale, *supra* note 16, at 1057.

72. See Jessica Sommar, *Red-Faced SEC Targets Two-Faced Analysts*, N.Y. POST, May 24, 2002, at 41 (reporting that an SEC investigation found widespread personal trading by analysts contrary to their public recommendations). In February 2006, the National Association of Securities Dealers (NASD) fined Sanford C. Bernstein & Co. and analyst Brad Hintz a combined \$550,000 for personal trading by Hintz contrary to the firm’s published recommendation. Susanne Craig, *Moving the Market: Brokerage House, Analyst Are Fined in Conflict Case*, WALL ST. J., Feb. 9, 2006, at C5.

73. See, e.g., IOSCO REPORT, *supra* note 20, at 9 (reporting on how a firm “may take advantage of pending research and position themselves ahead of its publication”).

74. Mark Maremont, *Raising the Stakes: As Wall Street Seeks Pre-IPO Investments, Conflicts May Arise*, WALL ST. J., July 24, 2000, at A1.

75. *Id.*

## II. THE QUALITY OF ANALYST RESEARCH AND THE EFFECT OF THE CONFLICTS

### A. Analyst Incentives for Optimism

Do the business interests and relationships described in Part I affect the quality of analyst research? In theory, research quality should be controlled by market forces. Investors should be unwilling to pay for or trade on the basis of poor-quality research. Reputational constraints, particularly those imposed by institutional clients, should limit the ability of analysts to bias their research out of self-interest. On the other hand, informational asymmetries may limit the effectiveness of market checks. Moreover, investors, particularly unsophisticated retail investors, may not respond rationally to analyst reports and recommendations.<sup>76</sup>

The business relationships described above create obvious incentives for analyst optimism. Brokerage firms earn commissions when their customers trade. By definition, buy recommendations have a larger target audience of potential traders—the entire investing community. In contrast, the market for sell recommendations is limited to current shareholders and short sellers.<sup>77</sup> As a result, an analyst who issues buy recommendations will generate more commission revenue for his or her employer. The incentives may also affect the analyst's choice of which securities to cover. Stocks with greater market capitalization, as well as growth and momentum stocks, are likely to have greater trading volume.<sup>78</sup>

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76. See generally Jill E. Fisch, *Regulatory Responses to Investor Irrationality: The Case of the Research Analyst*, 10 LEWIS & CLARK L. REV. 57 (2006) (evaluating the extent to which investor reliance on analyst research may be irrational); Michael B. Mikhail et al., *When Security Analysts Talk, Who Listens?* (Working Paper, April 2005), available at <http://ssrn.com/abstract=709801> (finding that sophisticated investors respond differently to analyst releases than unsophisticated investors).

77. See Fisch & Sale, *supra* note 16, at 1045 (explaining the effect of analyst incentives on recommendations). Although the availability of short selling would appear to mitigate the incentive for optimism generated by brokerage commissions, a variety of impediments to short selling limit the ability of investor to profit from negative information. See, e.g., Eli Ofek & Matthew Richardson, *DotCom Mania: The Rise and Fall of Internet Stock Prices*, 58 J. FIN. 1113, 1118–20 (2003) (explaining the costs to institutional investors of shorting Internet stocks during the dot-com bubble); Lynn Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 DUKE L.J. 701, 728–32 (1999) (describing regulatory restrictions that limit short selling). In addition, analysts who have generated information used by short sellers have been subject to some high-profile instances of issuer and regulatory pressure. See *infra* notes 89–90 and accompanying text (discussing Gradient Analytics).

78. Empirical research supports this conclusion. See Narasimhan Jegadeesh et al., *Analyzing the Analysts: When Do Recommendations Add Value?*, 59 J. FIN. 1083, 1083 (2004) (finding that analysts favor “glamour” stocks over value stocks).

Because the goal of investment banking is to sell securities, investment banking relationships create similar incentives for analyst optimism. Institutional clients, after all, are unlikely to purchase securities unless those securities receive a favorable recommendation. The underwriters' sales are boosted by a positive analyst report, as are any efforts to stabilize the price of the securities during the offering process. Analysts can both contribute to the hype associated with a hot public offering and provide credible support for the underwriters' valuation. Notably, although it is obviously important that analyst coverage not be negative, the mere fact of coverage, particularly with the promise of continued coverage, heightens the visibility of the securities and increases their liquidity. This link is borne out by studies showing increased research coverage of industries, like technology, with a high number of IPOs, even when that industry's performance over time is poor.<sup>79</sup> Analyst incentives to support their employers' underwriting business are, of course, increased when analyst compensation is tied directly to underwriting success.<sup>80</sup>

Analysts' relationships with their institutional customers can create incentives for optimism even after the IPO process is complete. An institutional client is likely to feel betrayed if it purchases securities based on a favorable analyst recommendation and the analyst subsequently lowers his or her recommendation, leaving the client to bear the loss. Of course, an analyst can privately advise institutional clients of a revision or a change in recommendation prior to a public announcement; but lock-up restrictions, liquidity constraints due to the size of an institution's position, and the response of traders to institutional sales are likely to prevent the client from exiting fully before the stock price falls.<sup>81</sup> Accordingly, investors themselves create pressure for analysts to maintain positive recommendations even when those recommendations may not be warranted. Institutions, company officials, and sometimes the investment bank itself may also purchase securities in the offering pursuant to lock-up agreements, in which they agree not to resell the securities for a designated period of time—typically six months. The promise of continued analyst support substantially reduces

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79. See Richardson, *supra* note 35, at C1 (citing report by Francois Trahan, chief investment strategist at Bear Stearns, showing that analyst coverage is "cluster[ed] around industries that yield the greatest volume of IPOs and brokerage fees").

80. Interestingly, however, at least one study has found that analyst optimism does not increase the firm's likelihood of obtaining underwriting business. Alexander Ljungqvist et al., *Competing for Securities Underwriting Mandates: Banking Relationships and Analyst Recommendations*, 61 J. FIN. 301 (2006).

81. An analyst may also jeopardize the credibility of his or her future stock picks by frequent downward revisions.

the risk associated with this holding period. Indeed, it had been common for analysts to issue new positive reports, or “booster shots,” shortly before the expiration of these lock-up agreements, a practice that facilitated the sale of the securities once the lock-up expired.<sup>82</sup>

Business concerns can affect analyst incentives in other ways. Prior to the SEC’s adoption of Regulation Fair Disclosure (FD), it was widely believed that analysts traded favorable coverage of an issuer for superior access to information. Analysts expressed concern that issuers would respond to reports of negative information by failing to invite them to analyst conferences, refusing to respond to telephone inquiries, and so forth. Although Regulation FD attempted to respond to this concern by prohibiting selective disclosure by corporate officials, the media continues to describe instances of issuer retaliation for unfavorable coverage.

One well-known example was the suit by LVMH Moët Hennessy Louis Vuitton S.A. against Morgan Stanley in France.<sup>83</sup> Morgan analyst Claire Kent had published negative information about LVMH.<sup>84</sup> LVMH argued that Kent’s research was motivated by a desire to curry favor with Morgan’s investment banking client Gucci Group, an archrival of LVMH. A French court found that Kent had defamed LVMH and fined Morgan €30 million.<sup>85</sup> Incidentally, Institutional Investor had ranked Kent as the number one analyst in her sector nine years in a row.<sup>86</sup>

Despite regulatory reforms, the media reports that punitive actions continue against analysts who produce unfavorable research.<sup>87</sup> For example, Biotech analyst Matt Murray claims that he was fired in March 2006 by Rodman & Renshaw because of his efforts to downgrade the

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82. See Fisch & Sale, *supra* note 16, at 1050–51 (describing “booster shots”).

83. See CFAI-NIRI *Guidelines Not Nearly Tough Enough, Comments Independent Research Provider*, FINANCIALWIRE, May 24, 2004, <http://financialwire.net/articles/article.asp?analystId=0&id=8823&topicId=160&level=160> (describing the LVMH suit as one of “a spate of lawsuits and threats, mostly in France . . . designed to squelch professional criticism”).

84. John Carreyrou, *Stock Analyst Ruled Too Critical*, WALL ST. J., Jan. 13, 2004, at C1.

85. Rodney Dalton, *Analyst Thumped by French Handbag*, AUSTRALIAN, Jan. 26, 2004, at 28.

86. *Id.*

87. See, e.g., Matthew McClearn, *Legal Weapon*, CAN. BUS., Feb. 16, 2004, at 23 (quoting Jonathan Boersma, vice president of professional standards of the Association for Investment Management and Research, as stating that some firms are “either suing or threatening to sue analysts for negative coverage”); *Stockgate: Greenberg Suggests Hambrecht Analyst Forced Out Over Overstock Downgrades*, FINANCIALWIRE, Jan. 23, 2006, available at <http://www.investtrend.com/articles/article.asp?analystId=0&id=22279&topicId=160&level=160> (reporting allegations that analysts were fired for producing negative research about Overstock.com).

stock of an investment banking client.<sup>88</sup> Recently, two issuers, Biovail and Overstock.com, sued research firm Gradient Analytics, claiming that Gradient conspired with hedge funds to produce false negative research so that the hedge funds could engage in profitable short selling.<sup>89</sup> The issuer accusations also led the SEC to initiate investigations against Gradient for market manipulation and illegal short selling.<sup>90</sup> Even if Gradient successfully defends itself, the litigation will cause the research firm to incur significant legal costs.

## B. Empirical Analyses of Research Quality

Do analysts respond to these incentives? Extensive empirical research has been directed to the question of whether analyst research is tainted by analysts' business interests. As a threshold matter, the studies are hampered by limitations on available data.<sup>91</sup> Independent research firms need not and often do not disclose their recommendations publicly.<sup>92</sup> Similarly, limited disclosure of proprietary trading and other business relationships impedes the ability of researchers to test the effect of conflicts of interest.<sup>93</sup> In any event, the results of the empirical studies are unclear. Although the studies find that analyst recommendations are optimistic, it is less clear that this optimism misleads investors or detracts from the informativeness

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88. See, e.g., Robby Boyd, AG, *SEC Looking Into Analyst's Firing*, N.Y. POST, Oct. 4, 2006, available at [http://www.nypost.com/seven/10042006/business/ag\\_sec\\_looking\\_into\\_analysts\\_firing\\_business\\_rodny\\_boyd.htm](http://www.nypost.com/seven/10042006/business/ag_sec_looking_into_analysts_firing_business_rodny_boyd.htm) (describing ongoing investigations into allegations).

89. See Brooke A. Masters, *2 Firms Claim Conspiracy in Analyst Reports; Short-Sellers and Researchers Colluded, the Companies Say*, WASH. POST, Apr. 26, 2006, at D1 (describing allegations in the lawsuits and pending SEC investigation).

90. See, e.g., Kara Scannell, *SEC Subpoenas Research Firm*, WALL ST. J., Mar. 27, 2006, at C3 (describing the SEC investigation).

91. Many studies use the Institutional Brokers Estimate System (I/B/E/S) database maintained by Thomson Financial, which contains a substantial amount of data, but relies on information voluntarily submitted by analysts. Researchers recently claimed that data in I/B/E/S had been manipulated and that names of poorly performing analysts had been removed. See Christopher Brown-Humes, *20,000 Analyst Names 'Missing'*, FIN. TIMES, Nov. 8, 2006.

92. See, e.g., Alistair Barr, *Signs of Success Scarce for Global Research Settlement*, INVESTOR'S BUS. DAILY, Oct. 24, 2005, available at <http://www.investors.com/breakingnews.asp?journalid=32406560&brk=1> (quoting Investars Chief Executive Kei Kianpoor as stating that "[b]ecause all independent firms . . . aren't forced to make [their stock ratings] public, any analysis and ranking of their stock-picking performance is compromised"). As a result, independent recommendations and forecasts often constitute a small percentage of the data in empirical studies. See, e.g., Amanda Cowen et al., *Which Types of Analyst Firms Are More Optimistic?*, 41 J. ACCT. & ECON. 119, 121 (2006) (explaining that less than 0.5 percent of the forecasts studied were provided by independent analysts).

93. The SEC Analyst Website (SECAW), the disclosure mechanism advocated by this Article, would directly address these information limitations.

of the analysts' research. More importantly, the studies fail to make the case that investment banking conflicts result in lower-quality research.

Studies clearly demonstrate that analyst research is optimistic in the sense that buy recommendations greatly outnumber sell recommendations.<sup>94</sup> The SEC reported survey results from 2000 showing that less than 1 percent of all analyst recommendations were sell recommendations.<sup>95</sup> A study by Brad Barber and others found that analyst buy recommendations rose to a peak of 74 percent of all recommendations in 2000, while sell recommendations declined to 2 percent.<sup>96</sup> Although studies have found a decline in optimism following the stock market crash, the Global Research Settlement, and increased analyst regulation, the numbers remain skewed toward buy recommendations.<sup>97</sup> Analyst optimism extends beyond recommendations and also affects earnings forecasts and price targets. Mark Bradshaw, Scott Richardson, and Richard Sloan, for example, have demonstrated optimism in both earnings forecasts and target prices.<sup>98</sup> Anup Agrawal and Mark Chen found bias in analysts' long-term earnings forecasts (but not in short-term forecasts).<sup>99</sup>

Despite its optimism, analyst information clearly has information value. The release of analyst information is surprisingly effective in moving prices.<sup>100</sup> A recent study by Paul Ryan and Richard Taffler, for example,

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94. See Fisch, *supra* note 76, at 64–65 (describing studies finding excessive analyst optimism). Importantly, the studies do not incorporate noncoverage as a mechanism for conveying negative information.

95. Lynn E. Turner, Chief Accountant, SEC, Speech at the Third Annual SEC Disclosure & Accounting Conference: The State of Financial Reporting Today: An Unfinished Chapter III (June 21, 2001) (transcript available at <http://sec.gov/news/speech/spch508.htm>) (reporting that only 0.8 percent of 26,000 analyst recommendations surveyed as of March 1, 2000, were sell or strong sell).

96. Brad M. Barber et al., *Buys, Holds, and Sells: The Distribution of Investment Banks' Stock Ratings and the Implications for the Profitability of Analysts' Recommendations* 3 (Working Paper, Sept. 2005), available at <http://ssrn.com/abstract=495882>.

97. See, e.g., *id.* (reporting that buy recommendations numbered 42 percent at the end of June 2003, while sell recommendations had increased to 17 percent); see also Ohad Kadan et al., *Conflicts of Interest and Stock Recommendations—The Effects of the Global Settlement and Recent Regulations* 15–16 (AFA 2006 Boston Meetings Paper, May 2007), available at <http://ssrn.com/abstract=568884> (finding that analyst optimism decreased following the adoption of various regulatory reforms).

98. Mark T. Bradshaw et al., *Pump and Dump: An Empirical Analysis of the Relation Between Corporate Financing Activities and Sell-Side Analyst Research* (Working Paper, May 2003), available at <http://ssrn.com/abstract=410521>.

99. Anup Agrawal & Mark A. Chen, *Analyst Conflicts and Research Quality* 25 (Robert H. Smith Sch. Research Paper No. RHS 06-042, August 2005), available at <http://ssrn.com/abstract=559412>.

100. See, e.g., *id.* at 3 (citing studies demonstrating the investment value of analyst forecasts and recommendations); Scott E. Stickel, *The Anatomy of the Performance of Buy and Sell*

revealed that sell-side analyst recommendations and earnings forecast revisions explain “17.4% of major market-adjusted price changes and 16.1% of high trading volumes that are triggered by reported news events.”<sup>101</sup> Analyst releases of reports or revisions commonly trigger significant stock price reactions.<sup>102</sup> Jeffrey Busse and T. Clifton Green demonstrated, for example, that the market responds in seconds to analyst information aired on CNBC and that the price response persists for weeks after the show.<sup>103</sup>

The price effect of analyst information is particularly significant in light of the substantial institutional ownership of the market. Institutions, to a large extent, move prices.<sup>104</sup> Moreover, analyst coverage focuses primarily on those issuers with substantial institutional ownership. Institutional investors, unlike individual retail investors, should be aware of analyst’s potential conflicts and not be fooled by tainted research or misled by overoptimism. Institutional investors can and do use their own buy-side analysts, who are free of the potential taint of the above-described business relationships. Institutions also have the resources to purchase research directly from analysts in market transactions that do not pose the risk of a conflict. Yet, institutions use and rely on information from supposedly conflicted analysts rather than relying exclusively on unaffiliated analysts.<sup>105</sup> The only plausible reason for their continued use of sell-side research is that, despite the potential conflicts, analysts provide useful information.<sup>106</sup>

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*Recommendations*, FIN. ANALYSTS J., Sept.–Oct. 1995, at 25, 25 (concluding that buy and sell recommendations influence stock prices); Kent L. Womack, *Do Brokerage Analysts’ Recommendations Have Investment Value?*, 51 J. FIN. 137, 164 (1996) (finding “strong evidence that stock prices are significantly influenced by analysts’ recommendation changes”).

101. Paul Ryan & Richard J. Taffler, *Are Economically Significant Stock Returns and Trading Volumes Driven by Firm-Specific News Releases?*, 31 J. BUS. FIN. & ACCT. 49, 51 (2004).

102. See, e.g., Peter Cohen, *Apple Stock Jumps Following Analyst Report*, MACWORLD, Nov. 22, 2004, available at <http://www.macworld.com/news/2004/11/22/applestock/index.php> (reporting that Apple Computer stock reached a four-year high after the release of an analyst report).

103. Jeffrey A. Busse & T. Clifton Green, *Market Efficiency in Real Time*, 65 J. FIN. ECON. 415 (2002).

104. See Scott Gibson & Assem Safieddine, *Does Smart Money Move Markets?*, 29 J. PORTFOLIO MGMT. 66 (2003) (finding that the magnitude of the price response to earnings announcements is related to the extent and nature of institutional ownership).

105. See, e.g., Green, *supra* note 37, at 1 (“Institutional investors pay significant amounts to obtain real-time access to brokerage firm research through providers such as First Call . . .”); *id.* at 3 (“Trading activity more than doubles following recommendation changes . . .”); Paul J. Irvine, *Analysts’ Forecasts and Brokerage-Firm Trading*, 79 ACCT. REV. 125, 126, 147–48 (2004) (finding that clients of brokerage firms, including institutional investors, increase trading in response to recommendations and forecast revisions of brokerage firm analysts).

106. See Yingmei Cheng et al., *Buy-Side Analysts, Sell-Side Analysts, and Investment Decisions of Money Managers* (Working Paper, Mar. 2004), available at <http://ssrn.com/abstract=383060> (modeling the manner in which fund managers use sell-side research and empirically testing the factors that influence reliance on sell-side analysts).

Regulators have attributed analyst optimism to investment banking conflicts of interest. A substantial number of recent studies have attempted to test this conclusion, and the results remain mixed. In part, the conflicting results may be due to differences between analyst recommendations and other information such as earnings forecasts. A number of studies have found that analysts who are affiliated with investment banking firms issue more optimistic recommendations than nonaffiliated analysts,<sup>107</sup> and that analysts make more optimistic recommendations with respect to issuers that have underwriting relationships with their firms.<sup>108</sup> A recent paper by Barber and others found a concentration of excessive optimism by affiliated analysts during the bear market immediately following the NASDAQ market peak. The authors posited that this optimism was due to a reluctance to downgrade stocks whose prospects dimmed during the bear market.<sup>109</sup> Similarly, Adam Kolasinski and S.P. Kothari found “evidence that M&A related conflicts significantly influence[d] analyst recommendations” during the 1993–2001 time period.<sup>110</sup>

Other studies have failed to find a strong tie between investment banking relationships and forecast accuracy.<sup>111</sup> Agrawal and Chen found

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107. See, e.g., Amitabh Dugar & Siva Nathan, *The Effect of Investment Banking Relationships on Financial Analysts' Earnings Forecasts and Investment Recommendations*, 12 CONTEMP. ACCT. RES. 131 (1995) (finding the earnings forecasts and stock recommendations issued by analysts affiliated with investment banks are more optimistic than those by unaffiliated analysts); Hsiou-wei Lin & Maureen F. McNichols, *Underwriting Relationships, Analysts' Earnings Forecasts and Investment Recommendations*, 25 J. ACCT. & ECON. 101 (1998) (showing that affiliated analysts issued significantly more favorable growth forecasts and recommendations); Anup Agrawal & Mark A. Chen, *Do Analyst Conflicts Matter? Evidence From Stock Recommendations* 33 (Working Paper No. RHS-06-038, July 2006), available at <http://ssrn.com/abstract=654281> (finding that “analysts respond to investment banking and brokerage conflicts by inflating their stock recommendations”).

108. See, e.g., Roni Michaely & Kent L. Womack, *Conflict of Interest and the Credibility of Underwriter Analyst Recommendations*, 12 REV. FIN. STUD. 653, 657 (1999) (finding that lead underwriter analysts make 50 percent more buy recommendations than unaffiliated analysts).

109. Brad M. Barber et al., *Comparing the Stock Recommendation Performance of Investment Banks and Independent Research Firms* 3–4 (Working Paper, Sept. 2005), available at <http://ssrn.com/abstract=572301>. Significantly, however, the study found no significant bias by affiliated analysts in the pre-2000 bull market. *Id.* at 3.

110. Kolasinski & Kothari, *supra* note 64, at 2. But see Jonathan Clarke et al., *Are Analyst Recommendations Biased? Evidence From Corporate Bankruptcies*, 41 J. FIN. & QUANTITATIVE ANALYSIS 169 (2006) (finding that analyst recommendations for firms filing for bankruptcy during the 1995–2001 time period were not overly optimistic and that affiliated analysts were not influenced by conflicts of interest).

111. At least one study has found that brokerage-affiliated analysts were even more optimistic than analysts affiliated with investment banks. See Jeffery Abarbanell & Reuven Lehavy, *Biased Forecasts or Biased Earnings? The Role of Reported Earnings in Explaining Apparent Bias and Over/Underreaction in Analysts' Earnings Forecasts* 7–8 (Working Paper, Jan. 2003),



that neither brokerage nor investment banking conflicts affected the quality of short-term earnings forecasts, after controlling for forecast age, firm resources, and analyst workloads.<sup>112</sup> They did find that long-term forecasts produced by brokerage-affiliated analysts were optimistically biased.<sup>113</sup> Amitabh Dugar and Siva Nathan found earnings forecasts by investment-banking analysts and non-investment-banking analysts to be equally accurate.<sup>114</sup> Amanda Cowen and others found that price and earnings forecasts by underwriter analysts were less biased than those made by analysts at brokerage-only firms.<sup>115</sup> Jonathan Clarke and others found “large investment banks issue less optimistic and more accurate earnings forecasts, while making more favorable stock recommendations [than independent analysts].”<sup>116</sup> As this study demonstrates, although optimism is related to forecast accuracy, it is not the same thing.<sup>117</sup> John Jacob, Steve Rock, and David Weber also found that “forecasts from analysts employed by [investment banks] are generally more accurate than forecasts from analysts employed by independent research firms.”<sup>118</sup>

On the whole, analyst-recommended stocks outperform the market,<sup>119</sup> and this performance persists<sup>120</sup> and is not a short-term reaction to the

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available at <http://ssrn.com/abstract=232453> (finding that the distribution of negative forecast errors by analysts is inconsistent with hypotheses of analyst optimism based on investment-banking conflicts and other incentives).

112. Agrawal & Chen, *supra* note 107, at 5.

113. *Id.*

114. Dugar & Nathan, *supra* note 107, at 152.

115. Cowen et al., *supra* note 92.

116. Jonathan Clarke et al., *The Good, the Bad and the Ugly? Differences in Analyst Behavior at Investment Banks, Brokerages and Independent Research Firms* 4 (Working Paper, Sept. 2004), available at <http://ssrn.com/abstract=562181>.

117. *But see* Roger K. Loh & G. Mujtaba Mian, *Do Accurate Earnings Forecasts Facilitate Superior Investment Recommendations?*, 80 J. FIN. ECON. 455 (2006) (demonstrating a correlation between forecast accuracy and the investment value of an analyst’s recommendations).

118. John Jacob et al., *Do Analysts at Independent Research Firms Make Better Earnings Forecasts?* 5 (Working Paper, July 2003), available at <http://ssrn.com/abstract=434702>.

119. *See, e.g.*, Brad Barber et al., *Can Investors Profit From the Prophets? Security Analyst Recommendations and Stock Returns*, 56 J. FIN. 531, 561 (2001) (finding that purchasing stocks with the most favorable consensus recommendations produces higher returns absent transaction costs).

120. Some studies have found underperformance for discrete time periods. For example, Roni Michaely and Kent Womack’s widely cited study finds that affiliated analyst recommendations led to lower returns than those of unaffiliated analysts for the 1990–1991 time period. Michaely & Womack, *supra* note 108; *see* Maureen F. McNichols et al., *The Performance of Underwriter Analyst Recommendations* 19 (Working Paper, Aug. 2004), available at <http://home.business.utah.edu/actmp/wconf05/micnicholsobrienpanalysts.doc> (suggesting that Michaely and Womack’s findings may be specific to the time period of their sample). Similarly, Brad Barber and others found that analyst-recommended stocks underperformed less-favored stocks during the 2000–2001 time period. Brad Barber et al., *Reassessing the Returns to Analysts’ Stock Recommendations*, FIN. ANALYSTS’ J., Mar.–Apr. 2003, at 18.

recommendation itself.<sup>121</sup> Maureen McNichols and others studied buy recommendations following an IPO and found that buy recommendations from affiliated analysts “generally earned significantly higher returns” than those from unaffiliated analysts.<sup>122</sup> Significantly, the study was conducted during the 1994–2001 time period, a period in which affiliated analysts were alleged to have engaged in the most egregious misconduct.<sup>123</sup> Leslie Boni and Kent Womack found that analysts are particularly effective at picking and ranking stocks within their industry of expertise, suggesting that industry-specific knowledge is a component of the value provided by analyst research.<sup>124</sup>

There are several reasons why analysts affiliated with investment banks might produce more accurate information. One possible explanation is the presence of natural synergies between investment banking and research.<sup>125</sup> For example, investment-banking analysts may have access to superior information or a better understanding of the industry by virtue of their firm’s investment banking operations.<sup>126</sup> A currently pending securities fraud case against Credit Suisse, for example, is premised on the claim that Credit Suisse analysts, by virtue of their involvement in the firm’s investment banking operations, obtained negative information about America Online (AOL) that they failed to disclose in

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121. See Womack, *supra* note 100.

122. McNichols et al., *supra* note 120, at 18.

123. *Id.* at 19.

124. Leslie Boni & Kent L. Womack, *Analysts, Industries, and Price Momentum*, 41 J. FIN. & QUANTITATIVE ANALYSIS 85, 106 (2006); see also Chul W. Park & Morton Pincus, *Market Reactions to Changes in Analyst Consensus Recommendations Following Quarterly Earnings Announcements 1* (Working Paper, Oct. 2000), available at <http://www.biz.uiowa.edu/accounting/papers/workingpapers/00-10.pdf> (finding that analyst consensus revisions have information content and concluding that this “finding is consistent with the capital market viewing consensus analyst recommendation revisions as reflecting valuable expertise to process and interpret public signals”).

125. Cf. Steven Drucker & Manju Puri, *On the Benefits of Concurrent Lending and Underwriting*, 60 J. FIN. 2763 (2005) (identifying synergies when a financial institution provides both loans and underwriting services to an issuer and concluding that such synergies benefit the issuer through lower underwriter fees and loan costs).

126. See Murali Jagannathan & Srinivasan Krishnamurthy, *Investment Banker Directors and Affiliated Analysts’ Forecasts*, 3 J. INV. MGMT. 4, 19 (2005) (finding that firms with investment banker directors issue more accurate forecasts and attributing that accuracy to better access to firm-specific information); Erik Sirri, *Investment Banks, Scope, and Unavoidable Conflicts of Interest*, (Working Paper, 2004), available at <http://www.frbatlanta.org/news/CONFEREN/fm2004/sirri.pdf> (describing potential synergies and economies of scale that can result from integrating investment banking, securities sales, and proprietary trading within a single financial firm); see also Dugar & Nathan, *supra* note 107, at 152.

their research reports.<sup>127</sup> But for the firm's investment banking operations, the analysts would not have had access to this information.

Alternatively, differences in pay structures and resources may enable investment banks to attract better analysts.<sup>128</sup> The high compensation paid to analysts because of their role in investment banking during the late 1990s, the time period that is the subject of many of these studies, may have allowed investment banks to attract highly skilled analysts.<sup>129</sup> A third possibility is that, although the conflicts have the potential to distort analyst reports, analysts do not respond to this incentive. Perhaps the incentive is outweighed by the analyst's need to maintain a sufficient reputation for accuracy to be able to convey information credibly to the market. Mark Chen and Robert Marquez, for example, model the relationship between investment banking conflicts and research quality. As they have demonstrated, the desire to attract future underwriting business may create an incentive for optimism, but unbiased research may lead to more accurate pricing or a better stock of underwriting customers.<sup>130</sup> The benefits to the firm of accurate research may act as a check on an analyst's natural tendency toward optimism because too much optimism will result in the analyst losing his or her credibility and thus the ability to help sell securities.<sup>131</sup>

Studies have found that analyst reputation matters, suggesting that the market disciplines analysts for tainted research. Lily Fang and Ayako Yasuda found that recommendations by analysts with strong reputations have the greatest market effect.<sup>132</sup> Similarly, Sorin Sorescu and Avanidhar Subrahmanyam observed that "there is reliable evidence that both experience and reputation count in the analyst industry."<sup>133</sup>

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127. *In re Credit Suisse-AOL Sec. Litig.*, 465 F. Supp. 2d 34 (D. Mass. 2006).

128. See Jacob et al., *supra* note 118, at 5 (suggesting that their findings are consistent with higher skill levels and resources at investment banks).

129. See Nina Mehta, *Sellside Research Must Try Harder: Rocked by Scandals, Institutional Sellside Research Will Never Be the Same*, TRADERS MAG., Dec. 1, 2003, at 32, 38 (describing analyst compensation as dropping by 30 percent during 2003, as firms began to implement regulatory reforms).

130. Mark A. Chen & Robert Marquez, *Regulating Securities Analysts* (Working Paper, Mar. 2004) (copy on file with the UCLA Law Review).

131. This perhaps explains Alexander Ljungqvist and other's finding that analyst optimism does not enable investment banks to attract underwriting business. See Ljungqvist et al., *supra* note 80 (finding no evidence that aggressive analyst recommendations or upgrades increased their employer's ability to win an underwriting contract).

132. Lily H. Fang & Ayako Yasuda, *Are Stars' Opinions Worth More? The Relation Between Analyst Reputation and Recommendation Values* (AFA 2006 Boston Meetings Paper, Dec. 2005), available at <http://ssrn.com/abstract=687491>.

133. Sorin Sorescu & Avanidhar Subrahmanyam, *The Cross-Section of Analyst Recommendations*, 41 J. FIN. & QUANTITATIVE ANALYSIS 139, 141 (2006).

Additionally, the market appears to respond to investment banking and other conflicts by discounting information that carries the greatest risk of bias. For example, studies have shown a limited market response to buy recommendations issued by investment bank–affiliated analysts, a more significant response to recommendation revisions, and a greater response to downgrades than to upgrades.<sup>134</sup>

The empirical results are troubling, because they highlight a key concern about mandated analyst independence. If analyst research provides useful information to the market and if affiliated analysts produce more accurate research, either because of synergistic effects or higher pay scales, then the forced separation of investment banking from research may reduce not just research quantity, but also research quality. Moreover, if the top sell-side analysts cannot receive multimillion dollar compensation packages based on their firm’s investment banking revenues, they are likely to seek alternative positions in which they can receive comparable compensation positions that may reduce public and market access to the information they produce.<sup>135</sup>

### III. REGULATORY RESPONSE TO ANALYST CONFLICTS

U.S. regulators responded to the analyst scandals<sup>136</sup> with a variety of new rules.<sup>137</sup> The new regulations include disclosure requirements,

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134. See Carl R. Chen et al., *Are All Security Analysts Equal?*, 25 J. FIN. RES. 415, 426 (2002) (finding that national brokerage firm analysts have the greatest ability to affect stock prices, but that buy recommendations from such analysts do not have a significant effect on firm valuation); Dugar & Nathan, *supra* note 107, at 150 (showing that market participants seem to discount optimism in investment banker analysts’ research more heavily, but the difference is not statistically significant); Michael J. Ho & Robert S. Harris, *Market Reactions to Messages From Brokerage Rating Systems*, FIN. ANALYSTS J., Jan.–Feb. 1998, at 49 (finding that stock prices react more significantly to ratings downgrades than to upgrades).

135. Hedge funds, for example, are reportedly bringing some former sell-side analysts in-house. Identifying short-selling opportunities for hedge funds can be lucrative; top analysts are reportedly commanding compensation packages of \$1 to \$4 million. Ann Davis, *Negative Analysts Score Points*, WALL ST. J., Nov. 23, 2004, at C5.

136. For a further description of the analyst scandals, see Jill E. Fisch, *Fiduciary Duties and the Analyst Scandals*, 58 ALA. L. REV. 1083, 1083–84 (2007).

137. Evaluating the rationale for and effect of the U.S. regulatory reforms is important from a global perspective because a number of countries are examining potential analyst conflicts of interest and considering the extent to which they should follow the U.S. regulatory approach. See, e.g., AUSTL. SEC. & INV. COMM’N, MANAGING CONFLICTS OF INTEREST: AN ASIC GUIDE FOR RESEARCH REPORT PROVIDERS 4 (2004), [http://www.asic.gov.au/asic/asic.nsf/lkuppdf/ASIC+PDFW?opendocument&key=managing\\_conflicts\\_interest\\_guide\\_pdf](http://www.asic.gov.au/asic/asic.nsf/lkuppdf/ASIC+PDFW?opendocument&key=managing_conflicts_interest_guide_pdf); AUSTL. SEC. & INV. COMM’N, RESEARCH ANALYST INDEPENDENCE 8 (2003), [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Analyst\\_Independence\\_Report.pdf/\\$file/Analyst\\_Independence\\_Report.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Analyst_Independence_Report.pdf/$file/Analyst_Independence_Report.pdf); FOREIGN GROUP TO THE EUROPEAN COMM’N, FINANCIAL ANALYSTS: BEST

limitations on personal trading by analysts, and a variety of structural reforms. The reforms characterize analyst business relationships as conflicts of interest<sup>138</sup> and attempt to reduce or eliminate these conflicts through mandated independence. The primary focus is on investment banking conflicts of interest.<sup>139</sup> The regulations require that firms formally separate research from investment banking and attempt to eliminate the potential influence of a firm's investment banking operations on analyst behavior. Significantly, the reforms do not address the relationship between research and brokerage, nor do they require that analyst compensation be independent of a firm's trading commissions.

Of the reforms, the Global Research Settlement between the New York attorney general, the SEC, and ten large Wall Street banks received the most public attention and imposes the most extensive restrictions.<sup>140</sup> The terms of the settlement mandated a formal separation of investment banking and research for firms subject to the settlement.<sup>141</sup> The settlement

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PRACTICES IN AN INTEGRATED EUROPEAN FINANCIAL MARKET (2003), [http://europa.eu.int/comm/internal\\_market/securities/docs/analysts/bestpractices/report\\_en.pdf](http://europa.eu.int/comm/internal_market/securities/docs/analysts/bestpractices/report_en.pdf); IOSCO TECHNICAL COMM., REPORT ON ANALYST CONFLICTS OF INTEREST 2 (2003), <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD152.pdf>; IOSCO TECHNICAL COMM., STATEMENT OF PRINCIPLES FOR ADDRESSING SELL-SIDE SECURITIES ANALYST CONFLICTS OF INTEREST (2003), <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD150.pdf>; Fin. Serv. Auth., *Conflicts of Interest: Investment Research and Issues of Securities* (Consultation Paper 171, Feb. 2003), available at <http://www.fsa.gov.uk/pubs/cp/cp171.pdf>.

138. It is not clear that this characterization is warranted. Cf. Jerome P. Kassirer, *Financial Conflict of Interest: An Unresolved Ethical Frontier*, 27 AM. J.L. & MED. 149, 152 (2001) (defining a conflict of interest as "a condition in which an individual's professional judgment is unduly influenced by some personal gain").

139. See SEC, Statement Regarding Global Settlement Related to Analyst Conflicts of Interest (Apr. 28, 2003), available at <http://www.sec.gov/news/speech/spch042803com.htm> (describing limitations on investing banking contacts as "designed to maintain the analyst's role as gatekeeper in the offering process but to prevent the analyst from serving as marketer or cheerleader for investment banking transactions").

140. See SEC, *supra* note 12 (describing settlement terms); Global Research Analyst Settlement Final Judgment Addendum A, *supra* note 12 (describing settlement requirements in more detail).

141. Importantly, the reforms described in this Part apply only to the investment banks that participated in the settlement. Initially, the settlement applied to ten banks, but two additional banks subsequently agreed to be bound by the settlement. See Press Release, SEC, Deutsche Bank Securities Inc. and Thomas Weisel Partners LLC Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Aug. 26, 2004), available at <http://www.sec.gov/news/press/2004-120.htm>. Some states are imposing the provisions of the settlement more broadly. Former California treasurer Phil Angelides, for example, imposed the requirements, including the physical separation of investment banking and research, on all investment banks that do business with the State of California. Press Release, Phil Angelides, Cal. Treasurer, Treasurer Angelides Announces Tough New Requirements for Investment Banks That Do Business With State of California (May 8, 2003), available at <http://www.treasurer.ca.gov/news/releases/2003/20030508ips.pdf>; Press Release, Off. of the N.J. Att'y Gen., New Jersey to Receive \$561,458 in Wachovia Settlement

requires firms both to maintain Chinese Walls (information barriers) and a physical separation between investment banking and research.<sup>142</sup> All communications between analysts and investment bankers are strictly limited—communications are prohibited except on specifically designated topics, and those communications must be made in the presence of a chaperone.<sup>143</sup> Analysts are prohibited from assisting the underwriting process in various ways, and an analyst's compensation may not be based on underwriting performance. Firms are also required to provide investors with a variety of disclosures—including a “warning notice” that the firm's investment banking business may affect the objectivity of its research, and quarterly disclosure of the firm's earnings forecasts, ratings, and price targets—in order to enable investors to evaluate analyst performance.<sup>144</sup> The settlement also required the banks to provide independent research to their customers for a period of five years under the supervision of an independent consultant.<sup>145</sup> According to SEC Chairman William Donaldson, the settlement was designed “to help restore investor's faith in the objectivity of research.”<sup>146</sup>

In section 501 of the Sarbanes-Oxley Act of 2002,<sup>147</sup> Congress directed the SEC or the SROs to promulgate rules to address analyst conflicts of interest more broadly. The statute explicitly stated that its objective was “to protect the objectivity and independence of securities analysts.”<sup>148</sup> Congress's instructions with respect to the required rulemaking were fairly detailed: Congress specified that the rules were to restrict prepublication

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(Sept. 7, 2006), available at <http://www.nj.gov/oag/newsreleases06/pr20060907a.html> (describing efforts by North American Securities Administrators Association (NASAA) Analyst Research Task Force Steering Committee in organizing and coordinating efforts of state regulators to address research analyst conflicts of interest).

142. See SEC, *supra* note 12. The physical separation requirement has resulted in firms constructing separate offices and even bathrooms. As one banker only “half-jokingly” stated, “he was not even allowed to go into the bathroom with a research analyst without a compliance officer tagging along, although that is not quite how he phrased it.” Landon Thomas, Jr. & Gretchen Morgenson, *2 Analysts Likely to Pay \$20 Million in Fraud Case*, N.Y. TIMES, April 28, 2003, at C1.

143. Indeed, the SEC only subsequently conceded that a chaperone was not required to supervise a phone call in which an analyst and an investment banker merely scheduled a future chaperoned conversation. Letter from James A. Brigagliano, Assistant Dir. of SEC Div. of Mkt. Regulation, to Dana G. Fleischman, SEC Answer to Question 12 (Nov. 2, 2004), available at <http://www.sec.gov/divisions/marketreg/mr-noaction/grs110204.htm>.

144. William Donaldson, Chairman, SEC, Address Prepared for Delivery at SEC Press Conference Regarding Global Settlement (Apr. 28, 2003) (transcript available at <http://www.sec.gov/news/speech/spch042803whd.htm>).

145. *Id.*

146. *Id.*

147. Pub. L. No. 107-204, § 501, 116 Stat. 745 (2002).

148. *Id.* § 501(a)(1).

clearance of research reports by investment bankers, to prevent investment banking personnel from supervising analysts or evaluating them for purposes of compensation decisions, and to prohibit retaliation for research that adversely affected a firm's investment banking relationships.<sup>149</sup> The statute also required rules that establish "structural and institutional safeguards" to separate research from investment banking within firms.<sup>150</sup> In addition, Congress instructed the regulators to require a variety of disclosures, including information about an analyst's personal ownership positions in covered securities and investment banking relationships.<sup>151</sup> Again, the focus on the statute was investment banking conflicts, not brokerage or other business relationships. Importantly, because the statute was structured as a component of the SEC's regulatory authority over registered brokers and dealers, it does not extend to analysts that are not associated with a registered broker or dealer. In particular, the statute does not give the SEC the authority to regulate pure research firms or their analysts.

The SEC delegated responsibility for compliance with section 501 to two SROs: the NYSE and the NASD.<sup>152</sup> The NYSE and the NASD adopted two sets of rule changes to address analyst conflicts, one while Congress was in the process of considering the Sarbanes-Oxley Act and the second subsequent to the adoption of the statute.<sup>153</sup> Briefly, the

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149. *Id.*

150. *Id.* § 501(a)(3).

151. *Id.* § 501(b).

152. See *Implementation of the Sarbanes-Oxley Act of 2002: Hearings Before the S. Comm. on Banking, Hous. and Urban Affairs*, 108th Cong. 43 (2003) (statement of William H. Donaldson, Chairman, SEC), available at <http://www.sec.gov/news/testimony/090903tswhd.htm> (describing the SEC's approval of the self-regulatory organizations (SRO) rules and explaining that "[t]he Commission worked closely with the SROs to conform their rules to meet the directives of the Act").

153. See *Self-Regulating Organizations; Order Approving Proposed Rule Changes by the National Association of Securities Dealers, Inc. and the New York Stock Exchange, Inc. and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. and Amendment No. 1 to the Proposed Rule Change by the New York Stock Exchange, Inc. Relating to Research Analyst Conflicts of Interest*, Exchange Act Release No. 34-45908, 67 Fed. Reg. 34,968 (May 10, 2002), available at <http://www.sec.gov/rules/sro/34-45908.htm> [hereinafter *First SRO Analyst Release*]; *Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the New York Stock Exchange to Rules 344 ("Supervisory Analysts"), 345A ("Continuing Education for Registered Persons), 351 ("Reporting Requirements") and 472 ("Communications with the Public") and by the National Association of Securities Dealers, Inc. Relating to Research Analyst Conflicts of Interest and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3 to the Proposed Rule Change by the New York Stock Exchange, Inc. and Amendment No. 3 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Research Analyst Conflicts of Interest*, Exchange Act Release No. 34-48252, 68 Fed. Reg. 45,875 (July 29, 2003), available at <http://www.sec.gov/rules/sro/34-48252.htm> [hereinafter *Second SRO Analyst Release*].

reforms, which are concentrated in NASD Rule 2711<sup>154</sup> and NYSE Rules 472<sup>155</sup> and 351,<sup>156</sup> incorporate three approaches: structural safeguards, prohibitions on problematic practices, and increased disclosure requirements. With respect to structural safeguards, the reforms parallel the guidance reflected in the statute. They include a prohibition on investment banking personnel supervising analysts or approving their reports, a ban on retaliation for research reports that adversely affect the firm's investment banking business, and the establishment of quiet periods during which investment banks participating in an offering are prohibiting from releasing research reports.<sup>157</sup> The rules also detail formal procedures to insulate analyst compensation from investment banking influence, including the requirement that banks use compensation committees to determine analyst compensation, which must be based on performance and research quality, not on investment banking business.<sup>158</sup> Prohibited practices include the issuance of booster shots and the participation by analysts in solicitations of investment banking business, as well as the receipt by analysts of pre-IPO securities and personal trading during blackout periods surrounding the release of a research report.<sup>159</sup>

The rules also increase disclosure requirements. Analysts are required to disclose any actual or potential conflicts of interest, including whether the subject company is a client of the analyst's firm and any firm compensation based on investment banking revenues. In addition, the rules require information about the firm's rating systems, including an explanation of "the meanings of all ratings used by the member or member organization in its ratings system,"<sup>160</sup> "the percentage of all securities that the member or member organization recommends an investor 'buy,' 'hold,' or 'sell,'"<sup>161</sup> and "a chart that depicts the price of the subject company's stock over time and indicates points at which a member or member organization assigned or changed a rating or price target."<sup>162</sup>

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154. NASD Rule 2711, NASD Manual (CCH) 4516-25 (Dec. 2006).

155. NYSE Rule 472, 2 N.Y.S.E. Guide (CCH) ¶ 2472 (Oct. 2006).

156. NYSE Rule 351, 2 N.Y.S.E. Guide (CCH) ¶ 2351 (Mar. 11, 2004).

157. See First SRO Analyst Release, *supra* note 153 (summarizing rule changes); Second SRO Analyst Release, *supra* note 153 (same).

158. See sources cited *supra* note 157.

159. See sources cited *supra* note 157.

160. NYSE Rule 472(k)(1)(i)(f), 2 N.Y.S.E. Guide (CCH) ¶ 2472 (Oct. 2006).

161. *Id.* at 472(k)(1)(i)(g).

162. *Id.* at 472(k)(1)(i)(h); see also Brad Barber et al., *supra* note 96 (describing the distribution disclosure required by NASD Rule 2711 and empirically analyzing its effect).



The SRO rules expand the limitations on personal trading by analysts. NYSE Rule 472 and NASD Rule 2210 had previously required that analysts disclose if they had a financial interest in a covered security, although there are indications that enforcement of the requirement was extremely limited.<sup>163</sup> The new rules expand on the disclosure requirement and explicitly require that analysts disclose personal positions in covered company securities, including options and derivatives positions, both in their reports and in public appearances.<sup>164</sup> In addition, the rules prohibit analysts from personal trading in covered securities “for the period beginning 30 days prior to the issuance of the research report and ending five days after the date of the report. The analyst also may not engage in trading contrary to the analyst’s most recent recommendations.”<sup>165</sup>

The SEC enacted two rules addressed to analyst conflicts of interest. SEC Regulation FD,<sup>166</sup> which was adopted in 2000 prior to the passage of the Sarbanes-Oxley Act, attempts to reduce the analyst’s incentive to provide favorable coverage of an issuer in order to gain access to information by barring issuers from providing selective disclosure.<sup>167</sup> The SEC characterized the rule as an effort to reduce analyst conflicts, explaining: “Selective disclosure also may create conflicts of interests for securities analysts, who may have an incentive to avoid making negative statements about an issuer for fear of losing their access to selectively disclosed information.”<sup>168</sup> Regulation AC,<sup>169</sup> which was adopted in 2003, was intended by the SEC to complement the new regulations adopted by the SROs.<sup>170</sup> Regulation AC requires analysts to certify that the views expressed in their

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163. See Fisch & Sale, *supra* note 16, at 1043–44 (describing the prior disclosure requirements).

164. First SRO Analyst Release, *supra* note 153. It is unclear exactly what this disclosure requirement means. As the SEC noted in its release, previously the New York Stock Exchange (NYSE) had allowed the use of conditional language, such as the firm or its analysts “may own” covered securities. *Id.* The Release does not explicitly reject the use of such language, and it appears that some firms are continuing to structure their disclosures in this way. In addition, firms are only required to disclose ownership positions of 1 percent of the issuer’s equity securities. *Id.*

165. *Id.*

166. Selective Disclosure and Insider Trading, Exchange Act Release No. 34-43154, 65 Fed. Reg. 51,716 (Aug. 24, 2000), available at <http://www.sec.gov/rules/final/33-7881.htm>.

167. *Id.* For a detailed discussion of Regulation FD and the history of its adoption, see Fisch & Sale, *supra* note 16.

168. SEC, Fact Sheet: Regulation Fair Disclosure and New Insider Trading Rules (Aug. 10, 2000), available at <http://www.sec.gov/news/extra/seldsfct.htm>.

169. Regulation Analyst Certification, Securities Act Release No. 33,8193, 68 Fed. Reg. 9482 (Feb. 20, 2003), available at <http://www.sec.gov/rules/final/33-8193.htm>.

170. Harvey L. Pitt, Chairman, SEC, Statement at SEC Open Meeting: Proposal of Regulation AC (July 24, 2002) (transcript available at <http://www.sec.gov/news/speech/spch578.htm>).

reports reflect their personal views and to disclose any relationship between their compensation and their recommendation.<sup>171</sup>

#### IV. EFFECTS OF THE REGULATORY REFORMS

##### A. Effect on Analyst Recommendations and Performance

Although it is far too soon to measure the effect of the new regulations, early reports are mixed. The evidence indicates that analyst recommendations, although still optimistic, have become more balanced. For example, research by Ohad Kadan and others found that affiliated analysts' recommendations are now no more optimistic than those of unaffiliated analysts.<sup>172</sup> Troublingly, however, they found that recommendations are now less informative.<sup>173</sup> Barber and others found a substantial decline in the percentage of buy recommendations issued by investment bank-affiliated analysts after 2000 and an overall increase in analyst use of negative or neutral recommendations.<sup>174</sup> In part, however, the change appears to reflect a shift in rating systems—in particular, the move by a number of firms from a five-category to a three-category rating scale.<sup>175</sup> In addition, the percentage of negative or sell recommendations has remained low<sup>176</sup> and is again shrinking. StarMine Investors reported that only 7.1 percent of analyst recommendations were sells in 2006, down from a peak of 10.4 percent in 2003.<sup>177</sup>

With respect to performance, the large-scale studies still primarily consider data from the period prior to the implementation of the

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171. Regulation Analyst Certification, Securities Act Release No. 33,8193, 68 Fed. Reg. 9482 (Feb. 20, 2003), available at <http://www.sec.gov/rules/final/33-8193.htm>.

172. Kadan et al., *supra* note 97, at 26.

173. *Id.* at 15.

174. Barber et al., *supra* note 109, at 14. On the other hand, Leslie Boni found that the ten investment bank signatories to the Global Research Settlement both reduced coverage and increased the optimism of their recommendations. See Janet S. Kidd, *With Analyst 'Sell' Signals Rare, Investors Need to Be Alert*, ASSOCIATED PRESS, Sept. 10, 2006, available at <http://www.baltimoresun.com/business/yourmoney/sns-yourmoney-0910analysts,0,1718220.story?coll=bal-business-headlines> (reporting Boni's findings).

175. Kadan et al., *supra* note 97, at 1. As the authors explained, "eight out of the original ten participants in the Global Settlement adopted a new rating system in 2002, and ten of the next twenty biggest brokerage houses adopted a new rating system starting in 2002." *Id.* at 9. In every case, the new system reflected a change from a five-point scale to a three-point scale. *Id.* Interestingly, the authors found that the market failed to respond to these massive reclassifications. *Id.* at 10–11.

176. *Id.* at 32 (reporting that, even postregulation, analysts are reluctant to issue pessimistic recommendations).

177. Kidd, *supra* note 174.

regulatory reforms. A few studies have looked at the performance of the specific firms that were signatories to the Global Research Settlement, and those studies have reported mixed results. A 2005 study by Investars.com reported improvement by many of the firms that were part of the settlement and found that the stock picks by nine of the twelve firms had outperformed Standard and Poor's (S&P) 500 over a one-year period.<sup>178</sup> Another report, looking at comparable data from Investars.com, found that the performance of five of ten settling banks improved during the 2003–2005 time period, but the performance of the other five declined.<sup>179</sup> Leslie Boni found that after the settlement, analyst-recommended stocks outperformed the market, but more often than not, stocks receiving the analysts' worst ratings outperformed those receiving the strongest recommendations.<sup>180</sup>

The effect of mandated independence cannot be evaluated solely by studying the effect of the new rules on analyst optimism or bias. Regulators state that the goal of recent reforms is “to improve the objectivity of research [and to] provide investors with more useful and reliable information.”<sup>181</sup> Yet, for investors, forced separation of investment banking and other conflicts from research may increase the cost or reduce research quality, particularly if the prior performance of investment banking affiliated analysts was due in part to synergies between investment banking and research.

#### B. Increased Market Segmentation

The market is responding to the increased cost of funding research with increased segmentation. Many firms are focusing primarily or exclusively on providing research to institutional investors because institutions are willing to pay for research, directly or indirectly, and an institutional clientele reduces the analyst's liability exposure.<sup>182</sup> This has led to an increased number of research firms who limit the dissemination of their research to a few exclusive clients<sup>183</sup> and charge a correspondingly

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178. See Jane J. Kim, *Stock Research Gets More Reliable: Third-Party Reviews Suggest Improvement in Performance of Buy-Sell Recommendations*, WALL ST. J., June 7, 2005, at D1 (describing results of Investars.com study).

179. Barr, *supra* note 92.

180. Leslie Boni, *Analyzing the Analysts After the Global Settlement* (Sept. 28, 2005), available at [http://www.tcf.or.jp/data/20050928\\_Leslie\\_Boni.ppt#9](http://www.tcf.or.jp/data/20050928_Leslie_Boni.ppt#9).

181. Second SRO Analyst Release, *supra* note 153.

182. See Schulz, *supra* note 8 (describing customized research created for hedge funds).

183. See, e.g., Chesler, *supra* note 32 (identifying hedge funds' interest in research but describing the traditional research model as unviable because research is distributed too broadly).

high fee.<sup>184</sup> Indeed, institutions are willing to pay a substantial premium for the assurance that the research that they receive is not being distributed broadly.<sup>185</sup>

Research firms are also developing specialized services tailored to the needs of institutional investors. Lehman Brothers, for example, has created “desk analysts” to sit on clients’ trading desks and provide extra research attention for institutional investors.<sup>186</sup> Firms are offering institutions customized research, sometimes termed “bespoke research” that responds to the institutional clients’ needs and instructions.<sup>187</sup> Research firms, such as Vista Research and Gerson Lehrman, provide contacts and access to sources of company and industry information, including retired executives and consultants.<sup>188</sup> Institutions reportedly pay as much as \$500,000 a year for these contacts.<sup>189</sup>

This segmentation is a predictable result of mandated independence. If cross-subsidization is no longer viable, firms will only provide research to those customers who are willing to pay for it. The resulting segmentation has the effect of aggravating the differential between retail and institutional investor access to information. If, prior to the regulatory reforms, the smart money got the information first, now, in many cases, retail investors do not get the information at all. Moreover, market segmentation reduces the ability of retail investors to benefit from reputational and other forms of market discipline imposed by sophisticated investors.<sup>190</sup> In many cases,

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184. See, e.g., Davis, *supra* note 32 (explaining that “the most pioneering, market-moving research is going exclusively to big mutual funds and the private investment pools known as hedge funds, not to the small investor”).

185. See, e.g., Schulz, *supra* note 8 (stating that approximately twenty research firms operate under this model, directing their research primarily to hedge fund clients, and charging quarterly subscription fees of \$250,000 to \$350,000).

186. See *US Analysts*, FIN. TIMES, May 5, 2006, at 18 (describing “desk analysts”).

187. See Davis, *supra* note 32 (describing custom research projects with six-figure annual fees).

188. Chesler, *supra* note 32.

189. *Id.* Some critics have questioned whether the information provided through these firms extends beyond legal bounds. See, e.g., Laurie Cohen, *Private Money: The New Financial Order; In the Know: Seeking an Edge, Big Investors Turn to Network of Informants, Mark Gerson Assembles Web of Moonlighting Managers; Applebee’s Bars Practice; Drawing a Line at ‘Nonpublic,’* WALL ST. J., Nov. 27, 2006, at A1 (detailing Gerson Lehrman’s practices in obtaining and compensating consultants). The SEC and the New York attorney general recently began investigating the consulting arrangements of Vista Research and Gerson Lehrman. Gregory Zuckerman & Peter Lattman, *Research Firms’ Consultant Ties Draw Scrutiny; New York, SEC Examine Information Disclosures to Hedge Funds, Others*, WALL ST. J., Jan. 16, 2007, at C1.

190. The problem is analogous to the problem observed in the mutual fund area, where segmentation limits the market’s ability to discipline fees charged by funds to less sophisticated investors. Donald Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1034 (2005).

institutions are using research that is not provided to databases and services such as Thomson First Call.<sup>191</sup>

Retail investors are also losing access to top analysts. The regulatory reforms led many financial firms to reduce greatly the compensation paid to analysts—a natural response to the inability of analysts to participate in investment banking.<sup>192</sup> At the same time, many firms cut their research budgets. The combination of these responses led many top analysts to leave sell-side firms.<sup>193</sup> Some struck out on their own, offering their research on an exclusive basis to institutional clients.<sup>194</sup> Others moved to investment banking,<sup>195</sup> to the buy side, or to hedge funds.<sup>196</sup> To the extent that buy-side research is substituting for sell-side research, there are additional reasons for concern. First, the substitution is likely to result in duplicative research, as multiple institutions substitute their own internal research for reliance on a single sell-side analyst. Second, empirical evidence suggests that buy-side research may be both less accurate and more optimistic than sell-side research.<sup>197</sup> Accordingly, to the extent that institutions are reducing their reliance on sell-side analysts, that reduction may come at a cost.

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191. See, e.g., Pam Abramowitz, *Sink or Swim: Demand for Independent Research Is Up, but Supply Is Up Even More*, 40 EUROMONEY INSTITUTIONAL INVESTOR 77 (Dec. 1, 2006) (describing Telsey Advisory Group's clients as having "exclusive access" to the firm's research because it is not disseminated to First Call or other public sources).

192. See, e.g., Mylene Mangalindan, *Oracle Hires Software Analyst*, WALL ST. J., May 16, 2003, at B2 (explaining that "many veterans in equity research are facing lower salaries and an image tarnished by conflict-of-interest scandals").

193. See, e.g., Beth Piskora, *Age of Analysts Comes to Close*, N.Y. POST, Feb. 8, 2003, at 20 (describing how established analysts are leaving investment banks as a result of the regulatory reforms).

194. See, e.g., Abramowitz, *supra* note 191 (describing how many veteran analysts have left investment banks to "strike out on their own").

195. See Emily Thornton, *Wall Street's Research Conundrum*, BUS. WK., Oct. 21, 2002, at 120 (describing why investment banks need to keep top analysts as part of their investment banking teams, and predicting that "most talented and experienced analysts are likely to metamorphose into bankers, who earn roughly twice what they do").

196. See, e.g., Hulus Alpay & Gene Marbach, *Sell-Side Coverage Remains as Elusive as Ever*, O'DWYER'S PR SERVICES REP., Jan. 2007, at 14 (stating that "analysts have been leaving the sell-side to join the buy-side and hedge funds"); Chris Hughes, *Rubinstein Jumps Ship for Hedge Fund*, FIN. TIMES, June 22, 2006, at 22 (describing the departure of several sell-side analysts to hedge funds).

197. Boris Groysberg et al., *Do Buy-Side Analysts Out-Perform the Sell-Side?* 45 (Working Paper, Mar. 2007), available at <http://ssrn.com/abstract=806264> (finding that the buy-side firm analysts made markedly more optimistic and less accurate earnings forecasts than their sell-side counterparts, even after controlling for analyst- and firm-specific factors). The authors found that sell-side recommendations were more optimistic, but that the lesser optimism of buy-side analysts did not translate into improved return performance. *Id.* They concluded that the shift toward greater use of buy-side research may not be desirable. *Id.* at 34.

### C. Effect on Quantity of Information

Retail investors are simply receiving less information. The number of sell-side analysts employed by investment banks has declined drastically in response to the regulatory reforms.<sup>198</sup> Those analysts who remain are focusing on large-cap companies, leaving many small-cap companies without any research coverage.<sup>199</sup> In its 2006 report to the SEC, the Advisory Committee on Smaller Public Companies reported that “approximately 1,200 of 3,200 of NASDAQ-listed companies, and 35% of all public companies, receive no analyst coverage at all.”<sup>200</sup> For companies with market capitalizations of less than \$125 million, the number with no analyst coverage increases to 83 percent.<sup>201</sup> Reuters found that since 2002 alone, 691 companies lost coverage altogether.<sup>202</sup> In addition, the combination of the independence mandate plus the quiet period means that a substantial number of new IPOs, particularly of small-cap companies, are not receiving any research coverage.<sup>203</sup>

The Global Research Settlement provided a substantial, albeit temporary, research subsidy designed in part to mitigate these effects by filling the gap in coverage with more independent research. As a result of the settlement, the defendant banks are collectively required to spend \$432.5 million over a five-year period to purchase independent research for their customers.<sup>204</sup> The effect of this subsidy on independent research

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198. See, e.g., Ken Brown, *Stock Research Goes From Frothy to Frugal*, WALL ST. J., May 27, 2003, at C1 (describing research cuts by Wall Street firms); Andrew Capon, *Research Less Besmirched*, EUROMONEY, June 1, 2006, at 70 (citing National Research Exchange statistics indicating that the number of analysts at Wall Street firms fell by 30 percent from 2001 to 2005); Marie Leone, *The Flight of the Sell-Side Analyst*, CFO.COM, July 8, 2004, <http://www.cfo.com/printable/article.cfm/3015019?if=options> (estimating a drop in the number of sell-side analysts at 15 to 20 percent).

199. Thor Valdmanis, *Few Believe \$1.4 Billion Deal Will Change Wall Street*, USA TODAY, Apr. 29, 2003, at 1B, available at [http://www.usatoday.com/money/industries/brokerage/2003-04-29-settle-cover\\_x.htm](http://www.usatoday.com/money/industries/brokerage/2003-04-29-settle-cover_x.htm) (quoting Zacks Investment Research as reporting a 23 percent increase since 2000 in the number of issuers with no coverage); Spelman Research, Independent Investment Research, <http://www.spelmanresearch.com/learn-about-investment-research.html> (last visited Aug. 8, 2007) (claiming that four out of five companies with market caps of \$100 million have no analyst coverage).

200. FINAL REPORT, *supra* note 5, at 65 n.126.

201. *Id.* (citing 2004 statistics provided by SEC Office of Economic Analysis).

202. Susanne Craig, *Moving the Market: Firm to Research Stock “Orphans,”* WALL ST. J., June 7, 2005, at C3.

203. IPOHome, *Renaissance Capital Study Shows IPOs Are Losing Research Coverage*, <http://www.ipohome.com/press/iporesearch.asp> (last visited Aug. 8, 2007) (describing the absence of coverage for new IPOs).

204. See Joint Press Release, NASAA, NASD, NYAG, NYSE, & SEC, *Ten of Nation’s Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking* (Apr. 28, 2003), available at <http://www.sec.gov/news/press/2003-54.htm>.

remains unclear, as the market continues to adjust to effects of the new regulatory structure. Media reports indicate that, although the prospect of obtaining money from the settlement spawned the growth of a number of small or boutique research firms, many new firms have been struggling since the Wall Street banks chose mostly the larger, independent firms to provide their independent research.<sup>205</sup> As the *Wall Street Journal* reported, now that the “initial burst of interest” in independent research is over, “some independents are getting out, and others are seeing their business decline.”<sup>206</sup> On the other hand, the most recent report from Institutional Investor indicated that the number of firms offering independent research has quadrupled since 2003, and that although some of the best firms have been driven from the business, others have emerged to take their place.<sup>207</sup>

The value of the subsidized research is also unclear. Even with this substantial budget, the banks cannot duplicate the research available to institutions because many independent analysts are unwilling to disseminate their research broadly, fearing that participation in the settlement will affect the ability to keep their institutional clients.<sup>208</sup> Critics also argue that the quality of the free research is low because banks are unwilling to pay more for research aimed at sophisticated investors.<sup>209</sup> Reports on investor use of the subsidized research are mixed; some media reports indicate that investors are making limited use of the independent research.<sup>210</sup>

Industry insiders indicate that “when the five years [of the subsidy] are up, the climate may not be so favorable for the independents.”<sup>211</sup>

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205. See Judith Burns, *Independent Research Hits Snags: Business Isn't Bustling as SEC May Move to Curb Soft Dollar Arrangements*, WALL ST. J., Sept. 20, 2004, at C15 (citing a 20 to 30 percent reduction in the industry).

206. Jesse Eisinger, *Long & Short: Why Independent Research Is Drying Up*, WALL ST. J., Mar. 8, 2006, at C1.

207. See Abramowitz, *supra* note 191, at 77.

208. See Valdmanis, *supra* note 199, at 1B (quoting several independent firms as stating that their research was inappropriate for retail investors or that participation in the settlement would detract from the value of their research and cost them institutional clients).

209. See Eisinger, *supra* note 206, at C1.

210. See Burns, *supra* note 10, at B3.

211. Chris Kentouris, *Seeking Soft Dollar Clarity*, SEC. INDUSTRY NEWS, Nov. 6, 2006, at 4, 4. The SEC removed one substantial risk when it decided not to require that institutions pay cash for third-party research rather than bundling those payments with their brokerage commissions through the use of soft dollars. See Guidance Regarding Client Commission Practices, Exchange Act Release No. 54,165, 71 Fed. Reg. 41,978, 41,993 (July 24, 2006). Commentators had warned that the proposal “would cripple the independent research industry.” Christopher Oster, *Small Researchers Face a Threat; Mutual-Fund Industry Proposal on “Soft-Dollars” Could End Revenue Source*, WALL ST. J., Dec. 18, 2003, at D9 (quoting The Alliance in Support of Independent Research, a trade group).

Independent analysts may simply lack the capacity to provide sufficient information to the market.<sup>212</sup> Most independent firms cover a small number of companies, and their financial structures do not allow them to pay Wall Street levels of analyst compensation.<sup>213</sup> Typically, they cannot compete with investment banks on features such as offering access to management.<sup>214</sup> Tellingly, despite the reputational fallout from the analyst scandals, the settlement subsidy, and the ongoing changes in the industry, Wall Street firms still provide more than 95 percent of all research coverage.<sup>215</sup>

The extent to which analysts who are not affiliated with investment banks can properly be characterized as independent also remains uncertain.<sup>216</sup> As this Article has demonstrated, so-called independent analysts may have a variety of business relationships that compromise their objectivity.<sup>217</sup> Many so-called independent analysts are affiliated with mutual funds, and these alliances may lead them to be overly optimistic with respect to securities within the funds' portfolios.<sup>218</sup> Analysts who serve institutional clients face continued pressure to maintain ratings that are favorable to the client's investment position.<sup>219</sup> Several independent analysts who sell research to hedge funds have recently been accused of

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212. See, e.g., Cheryl Winokur Munk & Lynn Cowan, *The Stock-Research Pact: Independent Firms Aim to Divide Spoils*, WALL ST. J., May 1, 2003, at C9 (describing how only the largest independent firms offer coverage anywhere close to that offered by the Wall Street investment banks); Randall Smith, *Quality of Morningstar's Research May Suffer*, WALL ST. J., May 26, 2004, at C1 (describing the claim that Morningstar would not be able to maintain research quality as it stretched coverage to meet the demands of the settlement).

213. Smith, *supra* note 212, at C1 (quoting a letter sent to the federal judge overseeing the settlement as stating that Morningstar analysts were receiving only \$22,000 extra to double their coverage, an amount "far below typical compensation standards for investment research").

214. See, e.g., Kentouris, *supra* note 211 (identifying differences in research approach and financial structure between Wall Street firms and independent analysts).

215. Valdmanis, *supra* note 199, at 1B.

216. Some independent firms have attempted to provide greater assurance of their independence. For example, Investorside Research Association has come up with a certified provider seal. The seal certifies that member firms are "free of investment banking, consulting, and research-for-hire conflicts." See Investorside Research Association, [http://www.investorside.org/about\\_us/index.htm](http://www.investorside.org/about_us/index.htm) (last visited Aug. 8, 2007) (describing Investorside certification).

217. See generally Choi & Fisch, *supra* note 13, at 284–86 (describing various business relationships that can compromise the objectivity of so-called independent analysts).

218. See, e.g., Davis & Craig, *supra* note 21, at C1 (describing how mutual fund Alliance Capital's ownership of research firm Sanford C. Bernstein could compromise independence of Sanford C. Bernstein's research); Randall Smith & Ann Davis, *Dark Horse Leads Stock-Research Sweepstakes*, WALL ST. J., Dec. 16, 2003, at C1 (reporting that the size of Alliance's trading operation has disqualified Sanford C. Bernstein from qualifying as independent for purposes of the Global Research Settlement).

219. Davis & Craig, *supra* note 21, at C1 (reporting statements by analysts that pressure from institutional clients has grown as trading business becomes a bigger factor in analyst compensation).



disseminating overly pessimistic information in an effort to make the funds' short selling more profitable.<sup>220</sup> Other independent firms trade covered securities on a proprietary basis.<sup>221</sup> Even the independence of Morningstar, one of the prime beneficiaries of the Global Research Settlement and a major source of research for the participating investment banks, has come under scrutiny for conflicts of interest between its research and the financial and consulting services that it provides to issuers.<sup>222</sup>

The regulatory reforms have a limited impact on potential conflicts that do not involve investment banking. The Street.com Ratings reported, for example, that proprietary trading represented the single largest source of revenue for the defendant banks that participated in the Global Research Settlement, yet the settlement does not address the incentive for analysts to release favorable information on securities owned by the banks in order to enhance the profitability of that trading.<sup>223</sup> The SRO rules require only limited disclosure of noninvestment banking conflicts, and that disclosure focuses primarily on proprietary trading by individual analysts.<sup>224</sup> More importantly, because the regulatory reforms have been implemented through SRO rules (and the Global Research Settlement), they do not apply to all research analysts. In particular, the SRO rules apply only to NYSE and NASD member firms and their employees. Research-only firms that do not function as brokers or dealers are not subject to the regulations.

One might reasonably question whether any of these effects matter. Of what importance is a reduction in the amount of sell-side coverage, particularly if it was of little value to retail investors? Institutional investors

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220. See, e.g., *Hedge Funds and Independent Analysts: How Independent Are Their Relationships?* Hearing Before the S. Judiciary Comm., 109th Cong. 19 (2006) (testimony of Marc Kasowitz, Senior Partner, Kasowitz, Benson, Torres & Friedman, LLP, Alliance for Investment Transparency) (describing a "a pattern of egregious collusion between certain influential hedge funds and certain supposedly independent analysts" in which research is "bought and paid for by the hedge funds"); Jenny Anderson, *True or False: A Hedge Fund Plotted to Hurt a Drug Maker?*, N.Y. TIMES, Mar. 26, 2006, § 3, at 1 (describing allegations that hedge fund clients are influencing the content of research disseminated by independent analysts).

221. Matthew Goldstein, *Second Curve: Hedge Fund on the Edge*, BUS. WK. ONLINE, Apr. 18, 2007, available at <http://www.businessweek.com> (describing writing by analyst Thomas Brown on his bankstocks.com website about stocks owned by his hedge fund).

222. John Spence, *Morningstar Focus of Spitzer Inquiry*, CBS MARKETWATCH.COM, Dec. 16, 2004.

223. MARTIN D. WEISS, *RESEARCH ANALYST REFORMS AND THE SETTLEMENT: WHY REFORMS DON'T ADEQUATELY PROTECT INVESTORS* (2003), available at <http://www.weissratings.com/settlement.asp>.

224. See *supra* notes 152–165 and accompanying text (describing SRO rules).

can continue to purchase research and trade on it. From a consumer-protection standpoint, investors may be better off with no information than with information that is false or misleading.

A partial answer to this question is that the explicit purpose of the regulatory reforms was to provide investors with reliable information and to enhance the role of research analysts as gatekeepers.<sup>225</sup> Congress, the SEC, and even the U.S. Supreme Court have identified a valuable role for research analysts in disseminating information to the market and increasing market efficiency.<sup>226</sup> If the reforms cannot achieve this objective, it is difficult to justify them. Furthermore, to the extent that regulatory reforms further segment the market for investment information, small investors will likely be forced to rely on inferior information sources. I have questioned elsewhere the competence of regulators to identify and control investor use of information, but the proven willingness of investors to rely on sources such as anonymous chat room postings and emails should caution the SEC about shutting down traditional research.<sup>227</sup>

Moreover, the changes in the research market have not reduced what might have been characterized as excessive coverage; rather, they have eliminated coverage for a distinct set of issuers—new and smaller companies. The absence of research coverage increases the cost of capital for these firms.<sup>228</sup> The higher cost of capital in turn reduces the ability of small firms to finance business opportunities. Large institutional investors are less interested in investing in smaller companies because of their concerns over information asymmetries and liquidity constraints. Although analyst coverage mediates these concerns, the smaller trading

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225. See, e.g., SEC, Statement Regarding Global Settlement Related to Analyst Conflicts of Interest (Apr. 28, 2003), available at <http://www.sec.gov/news/speech/spch042803com.htm> (describing the analyst's role as a "gatekeeper").

226. See, e.g., *Dirks v. SEC*, 463 U.S. 646, 659 n.17 (1983) ("The SEC expressly recognized that '[t]he value to the entire market of [analysts'] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors.'" (quoting *In re Dirks*, Exchange Act Release No. 17,480, 21 SEC Docket 1401, 1406 (Jan. 22, 1981))).

227. See Fisch, *supra* note 76, at 70–71 (describing investor reliance on websites, chat rooms, and phony telephone messages).

228. See, e.g., Robert M. Bowen et al., *Analyst Coverage and the Cost of Raising Equity Capital: Evidence From Underpricing of Seasoned Equity Offerings* 5 (Sauder Sch. of Bus. Working Paper, Jan. 2006), available at <http://ssrn.com/abstract=417860> (finding that "greater analyst coverage is associated with a significantly lower cost of raising equity capital"); see also Stephen Taub, *Analyst (Un)coverage Hurting Small Firms*, CFO.COM, July 16, 2004, <http://www.cfo.com/article.cfm/3015231> (reporting a National Bureau of Economic Research finding that "[t]he decline in analyst coverage of small companies has cost those businesses roughly 138 basis points per year").

volume of these issuers makes it uneconomic for brokerage-affiliated or pure research analysts to sell research on these companies. Significantly, subsidizing research through investment banking revenues had offered a realistic solution by creating an economic rationale for Wall Street firms to cover smaller issuers.

#### D. Issuer-Financed Research

Some small issuers have responded to the lack of analyst coverage by paying analysts directly.<sup>229</sup> Issuer-paid research, or “pay to play,” seems to be a natural market-based response to the reduced coverage of small issuers. Several research firms are marketing their research services directly to issuers, claiming that their coverage will improve liquidity and stock price.<sup>230</sup> Dutton Associates, one of the largest issuer-paid firms, charges \$39,500, prepaid, for a year of coverage, which consists of four quarterly reports.<sup>231</sup> Spelman Research, charges \$26,500, also prepaid, for a research report, which it distributes to 50,000 industry professionals, as well as a year of coverage.<sup>232</sup> Investrend Research provides a similar type of fee-based research, and claims that its analysts are paid to deliver reports “to the benefit of the public.”<sup>233</sup>

Issuer-paid research has been highly controversial.<sup>234</sup> Defenders claim that fee-based providers are free of the highly criticized investment-banking, brokerage, and other business conflicts. Critics argue that commissioned research is inherently conflicted. The need to generate business from other issuers clearly gives commissioned research firms an incentive to provide optimistic reports rather than to be critical of covered

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229. See Susanne Craig, *Stock Analysis: Left Out of Shrinking Research Pool, Companies Resort to Buying Coverage*, WALL ST. J., Mar. 26, 2003, at C1 (describing the increasing use by issuers of purchased coverage).

230. See FIRST Research Consortium, <http://www.firstresearchconsortium.com/members.html> (last visited Aug. 8, 2007) (listing member firms who provide fee-based research to issuers). Significantly, the costs of issuer-paid research are far less than the \$165,000 to \$185,000 it costs a Wall Street firm annually to cover a stock. John Dutton, *Small Cap Strategy*, CALIFORNIA CEO, Winter 2006, at 13, 13, available at [http://www.jmdutton.com/PDF\\_Files/CaCEO-1206.pdf](http://www.jmdutton.com/PDF_Files/CaCEO-1206.pdf).

231. See *Headline Maker: Dutton Associates Announces Qiao Xing Universal Telephone Raised to Strong Buy Rating*, INVESTORS.COM, January 17, 2007, <http://www.investors.com/breakingnews.asp?journal=47899882> (describing the services offered by Dutton Associates).

232. Spelman Research, *supra* note 199.

233. Essary, *supra* note 61, at 2.

234. See, e.g., SEC Told ‘No Crisis in Disclosure,’ but Non-Disclosures Almost Daily Now, FINANCIAL WIRE, Sept. 10, 2004 [hereinafter *No Crisis*], available at <http://www.investors.com/breakingnews.asp?journalid=23034610&brk=1> (describing concerns about the adequacy of the disclosure that research is paid for by the issuer).

companies or their management, leading some to call such analysts indistinguishable from stock promoters. The *Wall Street Journal* recently observed that Dutton has buy-type ratings on 77.5 percent of the stocks it covers; Thomson Financial reports that, in the aggregate, 46.5 percent of analyst ratings are buys.<sup>235</sup> Some fee-based research has been distributed without full disclosure that it was paid for by the issuer,<sup>236</sup> and some firms own stock in covered companies.<sup>237</sup> Concerns about the reliability of issuer-paid research have led Thomson Financial to begin excluding paid-for research from its consensus earnings and recommendations,<sup>238</sup> although seven firms, including Dutton, were “grandfathered in” and continue to contribute research on 145 companies.<sup>239</sup>

A number of issuer-paid providers have attempted to address concerns about the reliability of issuer-paid research by banding together into the FIRST Research Consortium.<sup>240</sup> The Consortium issued standards for independent research providers that include various measures of independence, full disclosure of financial considerations, and the requirement that analysts not own or trade covered securities.<sup>241</sup> Similar guidelines were jointly released by the CFA Center for Financial Market Integrity and the National Investor Relations Institute.<sup>242</sup> The extent to which analysts will adhere to these standards—which are not binding—remains unclear.<sup>243</sup>

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235. Karen Richardson, *In Quiet Niche, Paid-for Stock Research Persists*, WALL ST. J., Dec. 13, 2006, at C1.

236. See, e.g., *No Crisis*, *supra* note 234. SEC Regulation 17(b) requires analysts who provide research for compensation to disclose that compensation, but it is unclear whether the regulation requires similar disclosure by the issuer itself when it distributes the analyst's report. See *id.* In addition, analyst compensation may not be disclosed when investors access the analyst's research through sites such as Yahoo! Finance or Thomson Financial. Richardson, *supra* note 235, at C1.

237. See, e.g., Richardson, *supra* note 235, at C1 (describing coverage of Qiao Xing Universal Telephone by two issuer-paid analysts, one of which owned \$20,000 worth of company stock).

238. See Veronica Belitski, *Thomson Financial Snubs Paid-for Researchers; First Domino?*, WALL STREET LETTER, Apr. 1, 2005, available at <http://www.westlaw.com> (search for citation 2005 WLNR 6883086) (reporting Thomson Financial's decision to exclude issuer-paid research providers from First Call and I/B/E/S databases).

239. Richardson, *supra* note 235, at C1.

240. FIRST Research Consortium, Standards of Practice for Research Providers, <http://www.firstresearchconsortium.com/standards.html> (last visited Aug. 8, 2007).

241. *Id.*

242. CFA CTR. FOR FIN. MKT. INTEGRITY & NAT'L INVESTOR RELATIONS INST., BEST PRACTICE GUIDELINES GOVERNING ANALYST/CORPORATE ISSUER RELATIONS (2004), [http://www.niri.org/irresource\\_pubs/pdfs/CFAI-NIRIGuidelines.pdf](http://www.niri.org/irresource_pubs/pdfs/CFAI-NIRIGuidelines.pdf).

243. See, e.g., CFAI-NIRI 'Analyst-Issuer Best Practices Guidelines' Violated Within 4 Hours of Release, FINANCIALWIRE, Dec. 9, 2004, available at <http://www.investtrend.com/articles/article.asp?analystId=0&id=12139&topicId=160&level=160> (describing the publication of

In 2005, Reuters and NASDAQ created a joint venture called the Independent Research Network (IRN).<sup>244</sup> The IRN was designed to act as an intermediary between independent research providers and issuers.<sup>245</sup> Under the IRN model, issuers pay the IRN for coverage and the IRN selects the research providers, who are not then in the awkward position of critically evaluating the firm and managers that have selected them.<sup>246</sup> The explicit objective of the IRN was to mitigate analyst conflicts of interest.<sup>247</sup> Regulators determined that under certain conditions, the IRN would be allowed to serve as an independent research provider under the terms of the Global Research Settlement.<sup>248</sup> The market did not appear, however, to accept the model.<sup>249</sup> Reuters recently announced that the IRN was being shut down “due to weak demand from investors.”<sup>250</sup>

## V. AN ALTERNATIVE REGULATORY APPROACH

The foregoing analysis suggests that efforts by regulators to improve information quality in the capital markets have had predictable and undesirable effects. Current regulations were premised upon a link between analyst conflicts and research quality that is not borne out by empirical research. More recent studies fail to demonstrate that mandatory independence has made research more reliable. The market for research has become increasingly segmented; institutional investors have access to highly sophisticated and costly information sources, while retail investors are receiving less information than ever. At the same time, the reforms have dramatically reduced coverage of small issuers, making it more difficult for them to access the public capital markets. As this Article explains, given

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Spelman’s research of issuer Consortium Service Management Group without disclosing that the issuer had paid for the research).

244. Finextra.com, Reuters and Nasdaq Form JV to Deliver Independent Analysis (June 7, 2005), <http://www.finextra.com/fullstory.asp?id=13786>.

245. *Id.*; see also *Paid Research You Can Trust?*, BUS. WK., Oct. 3, 2005, available at [http://www.businessweek.com/bwdaily/dnflash/sep2005/nf20050930\\_5622\\_db008.htm](http://www.businessweek.com/bwdaily/dnflash/sep2005/nf20050930_5622_db008.htm) (describing the Independent Research Network’s (IRN) role as an intermediary in an interview with IRN president, Daniel Blank).

246. *Paid Research You Can Trust?*, *supra* note 245.

247. *Id.*

248. Karen Richardson, *Research Providers Get Green Light—Some ‘Independent’ Firms Will Be Allowed to Work With Clients on Coverage*, WALL ST. J., Oct. 13, 2005, at C5.

249. See *Fixing Wall Street Research Years After Global Settlement, Critics Say Conflicts Remain*, WALL ST. J., Nov. 12, 2006 (quoting Jonathan Boersma as stating that “it is yet to be seen if these models will take hold”).

250. Finextra.com, Reuters and Nasdaq to Shut Down Independent Research Network (Sept. 12, 2007), <http://www.finextra.com/fullstory.asp?id=17423>.

the economic structure of equity research, there is little reason to believe that high-quality objective research can be provided to public investors on a cost-effective basis absent subsidization of that research through business relationships that potentially compromise analyst independence.

One possible solution is to provide alternative sources of research financing. In prior work with Stephen Choi, I argued for a system of issuer-based financing that would place control over resource allocation in the hands of shareholders.<sup>251</sup> The IRN reflected a similar approach, although it lacked our proposal's market discipline over research quality.

If the markets are to rely on third-party providers both to supply research and to finance that research, then a mandate of analyst independence is unrealistic. Based on existing evidence, it is also unnecessary. Instead, the solution is to manage rather than eliminate so-called conflicts of interest. This Part introduces a two-part mechanism for managing analyst conflicts. Subpart V.A proposes a requirement of analyst registration. Subpart V.B describes the creation of a new SEC Analyst Website, SECAW.

This Article advocates SECAW as an alternative regulatory approach that would substitute for the existing government-mandated independence. For institutional investors, neither the current regulatory restrictions nor SECAW are necessary; institutional investors can adequately address analyst conflicts by contract. For retail investors, the disclosure effected through SECAW addresses collective action problems and provides increased transparency. In addition, by increasing the reliability of analyst research, by allowing firms to subsidize that research through other, properly disclosed business operations, and by lowering the costs of disseminating that research broadly, the proposal is likely to increase coverage of small issuers. Finally, the markets as a whole will benefit from better information with which to judge the value of research.

#### A. Analyst Registration

Registration is a commonly used tool in securities regulation. The Securities Act of 1933<sup>252</sup> introduced the registration requirement—a cornerstone in the regulation of the securities markets—in connection with the public offering process. As Louis Brandeis explained in support of the disclosure-based approach to regulation: “Sunlight is said to be the

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251. Choi & Fisch, *supra* note 13.

252. 15 U.S.C. §§ 77a–77aa (2000).

best of disinfectants; electric light the most efficient policeman.”<sup>253</sup> Felix Frankfurter, who was largely responsible for overseeing the creation of the federal regulatory scheme, embraced this philosophy and used it as the basis of federal securities regulation.<sup>254</sup> Although the disclosure-based regime has been criticized,<sup>255</sup> it is widely credited with “improved selection of new investment projects, improved managerial performance, and reduced investor risk.”<sup>256</sup> As Merritt Fox observed, despite repeated debates over whether market forces will produce an optimal level of disclosure without regulation, “even most economics-oriented legal academics” conclude that mandatory disclosure is desirable.<sup>257</sup>

The registration requirement has been extended beyond issuers; the Investment Company Act of 1940<sup>258</sup> requires mutual funds to register with the SEC and to disclose their investment positions and financial condition.<sup>259</sup> Registration is also used to regulate securities professionals. Section 15(a) of the Securities Exchange Act of 1934<sup>260</sup> requires broker-dealers to register with the SEC.<sup>261</sup> The Investment Advisors Act of 1940<sup>262</sup> requires nonexempt investment advisors to register.<sup>263</sup>

Research analysts are not now and never have been subject to a registration requirement. Although many analysts are employed by registered broker-dealers, the broker-dealer disclosure requirements are not tailored to specific issues concerning analyst reliability and performance,

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253. LOUIS D. BRANDEIS, *OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT* 92 (1914).

254. Adam Winkler, *Corporate Law or the Law of Business?: Stakeholders and Corporate Governance at the End of History*, *LAW & CONTEMP. PROBS.*, Autumn 2004, at 109, 113–14.

255. See, e.g., Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 *WASH. U. L.Q.* 417, 420–30 (2003) (criticizing existing disclosure requirements as excessive).

256. Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 *VA. L. REV.* 1335, 1338 (1999).

257. *Id.* at 1339.

258. 15 U.S.C. §§ 80a-8, 80a-29 (2000).

259. *Id.*

260. 15 U.S.C. § 78o(a) (2000).

261. *Id.* Registration also subjects brokers to various requirements regarding recordkeeping, financial reporting, and net capital. See Alexander C. Dill, *Broker-Dealer Regulation Under the Securities Exchange Act of 1934: The Case of Independent Contracting*, 1994 *COLUM. BUS. L. REV.* 189, 208–22 (describing the importance of a broker-dealer registration requirement in enabling oversight of the financial services industry); see also David A. Lipton, *A Primer on Broker-Dealer Registration*, 36 *CATH. U. L. REV.* 899 (1987) (describing registration requirements).

262. 15 U.S.C. § 80b-3 (2000).

263. *Id.*; see *Goldstein v. SEC*, 451 F.3d 873, 876 (D.C. Cir. 2006) (“By keeping a census of advisers, the Commission can better respond to, initiate, and take remedial action on complaints against fraudulent advisers.”).

nor is broker-dealer disclosure made at the level of individual analysts.<sup>264</sup> Additionally, these requirements do not apply to analysts who are not employed by broker-dealers.

Registration is less intrusive than substantive regulation.<sup>265</sup> By establishing a registration requirement, the SEC can more easily monitor the accuracy and completeness of conflict disclosure.<sup>266</sup> Allowing analysts to disclose rather than eliminate conflicts would enable firms to cross-subsidize research through other business activities, including investment banking and brokerage. At the same time, disclosure would allow the market, rather than the regulators, to evaluate the extent to which these activities compromise the quality or integrity of the research.

Congress could impose a registration requirement by statute, but this Article advocates that the SEC exercise its rulemaking authority to require analyst registration. Section 501 of the Sarbanes-Oxley Act explicitly authorizes the SEC to promulgate rules addressed to analyst conflicts of interest.<sup>267</sup> Importantly, the statute is not, by its terms, limited to investment banking conflicts or to analysts affiliated with investment banks or broker dealers. Thus, by promulgating a registration requirement under the authority of section 501, the SEC could identify and address conflicts involving unaffiliated or “independent” analysts—analysts who fall outside the scope of the current regulations.

Because, as indicated above,<sup>268</sup> institutional investors do not require regulatory protection from analyst conflicts of interest, this Article proposes that the registration requirement apply only to analysts who provide their research to the investing public, directly or indirectly. Analysts who provide research directly to the public by releasing reports or recommendations to the media, appearing on talk shows, or posting

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264. See Fisch & Sale, *supra* note 16, at 1056–57 (describing regulation of analysts employed by broker-dealers).

265. See, e.g., Letter from Rebecca McEnally, Vice President, CFA Inst. Ctr. for Fin. Mkt. Integrity, to Jonathan G. Katz, Sec’y, SEC (Sept. 30, 2004), available at <http://www.sec.gov/rules/proposed/s73004/rmcenally093004.pdf> (commenting, in the context of a proposed hedge fund registration, that registration requirements have increasingly widespread acceptance in the securities industry, impose a relatively minimal burden on firms, and offer valuable increased transparency).

266. The SEC justified its hedge fund registration requirement (Hedge Fund Rule) on this basis, stating that registration would enable oversight and the identification of conflicts without impeding legitimate hedge fund investment activities. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275, 279). The D.C. Circuit recently invalidated the Hedge Fund Rule as inconsistent with the Investment Advisors Act. *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

267. Pub. L. No. 107-204, § 501, 116 Stat. 745 (2002).

268. See *supra* notes 104–106 and accompanying text.



information on a publicly accessible website, blog, or chat room, would be required to register. Analysts who provide research to an intermediary such as Thomson First Call or directly to an issuer, would be required to register if the intermediary will release the information to the public. The registration requirement would further apply to analysts who release information to a sufficiently large number of customers or subscribers that the information will foreseeably make its way into the public domain and affect the securities markets. A reasonable threshold would require registration by analysts who disseminate information to one thousand or more investors.<sup>269</sup> Analysts who provide research exclusively to their employers, such as those analysts employed by mutual funds or hedge funds, as well as analysts who provide research to a limited number of institutional clients, would not be required to register.

What would the registration requirement entail? The primary objective of the registration requirement would be to obtain disclosure of any business relationships by the analyst or the analyst's employer that could potentially influence the analyst's research. As detailed earlier in this Article,<sup>270</sup> those business relationships include investment banking, brokerage, asset management (directly or through affiliates), and proprietary trading. In addition to requiring that the analyst identify himself or herself and the analyst's employer, the registration requirement would require the analyst to identify all such business relationships in which the analyst or the analyst's employer is engaged. The analyst would also be required to provide a breakdown, by revenue, of how the firm's research and brokerage services are distributed between retail and institutional clients, to describe special services provided to institutional investors, and to identify whether the firm receives payment in the form of soft dollars. The analyst would be required to disclose pending and prior disputes concerning the accuracy of his or her research and any allegations of a failure to disclose conflicts of interest—this disclosure would include litigation and customer arbitration proceedings. Finally, the analyst would be required to identify any other material business relationships.

The information provided through the registration process would be made available to investors and the markets through the SECAW, as set forth in Subpart V.B below. It would also enable the SEC to gain a better understanding of the market structure by providing information on analysts

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269. A catchall provision could require registration by other analysts who disseminate information in a manner targeted to or calculated to reach the investing public.

270. See *supra* Subpart I.B.

outside the traditional investment banking and brokerage firms who disseminate research to public investors.

#### B. SECAW: The SEC Analyst Website

The second component of this Article's proposal for managing analyst conflicts of interest is the creation of a research analyst website. The Article proposes that the SEC create a website providing the public with access both to the information provided through the analyst registration process and to current and historical analyst research.<sup>271</sup> The website, known as SECAW, would provide investors and the market with a single public source for information about analysts, their recommendations, and potential conflicts of interest. The website would enable investors to track down and evaluate information disseminated through talk show appearances, chat rooms, and press reports. In addition, the website would serve as a source of historical information, enabling the market more readily to evaluate analyst performance.

SECAW would contain three types of information. First, SECAW would contain background information and business relationships relating to each individual analyst, which would be obtained from the analyst's registration filing. Second, analysts would be required to post real-time information concerning any recommendation, earnings estimate, or price target disseminated directly or indirectly to the public.<sup>272</sup> This posting would be required on the first date that the information is released to the public and would include the opening price of the covered security on the date of the posting. Analysts would not be required to post their full research reports, but would be required to disclose whether a report had been prepared and to identify those to whom the report is available, such as customers or subscribers.

Third, analysts would be required to list any relationships specific to the covered company, including prior employment, whether the company has been an investment banking client within the past year, and whether the firm has pitched for investment banking business within the past year. To address the differential treatment of institutional and individual

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271. Funding for SECAW could come from imposing a modest fee in connection with the registration requirement.

272. The definition of public dissemination would be consistent with that used in the registration requirement, *see supra* Subpart V.A, and would include dissemination of research to one thousand or more customers, as well as any dissemination reasonably calculated to reach the investing public.

investors, the analyst would be required to disclose whether the analyst or its firm provided the posted information to any clients prior to its public release and, if so, to identify the date that the posted information had first been provided to clients. The analyst would have to identify any personal ownership of or derivative positions in the covered securities, and any personal trading within a six-month period prior to the posting. The analyst's firm would also be required to disclose whether it has a proprietary position (long or short) in the covered securities and the approximate size of that position.

SECAW would be maintained in such a way as to provide both current and historical information about analyst research. Analyst postings would be retained on the site for a twelve-month period, enabling the market to evaluate performance of prior recommendations, consistency, and changes in coverage. Analysts and their firms would also be required to identify any changes to the posted information on a real-time basis. Thus, if a firm, subsequent to the analyst's posting, purchased covered securities or was retained to perform investment banking services, that information would be added to the website. Similarly, individual analysts would be able to sell covered securities, such as for liquidity reasons, without running afoul of the current prohibition on trading inconsistent with a recommendation.<sup>273</sup>

The mechanics of the website could be handled by establishing an account for each individual analyst in connection with the registration process. Once the SEC set up the account, analysts could be given the ability to post their research directly to the website. This mechanism would reduce the administrative costs of the website and facilitate prompt market access to the information. Incorporation of a standard search engine would allow users of the site to obtain information on individual analysts, compare analyst information on specific securities, and track analyst performance over time.

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273. This would address the problem apparently faced by Brad Hintz, who seemingly wanted to realize substantial gains and diversify his portfolio, but was unable to do so because of the firm's favorable rating on the subject securities. Press Release, NASD, Sanford C. Bernstein & Co., Research Analyst Brad Hintz Fined \$550,000 for Violations of Research Analyst Conflict of Interest Rules (Feb. 8, 2006), available at [http://www.nasd.com/PressRoom/NewsReleases/2006NewsReleases/NASDW\\_015940](http://www.nasd.com/PressRoom/NewsReleases/2006NewsReleases/NASDW_015940).

### C. The Advantages of SECAW

SECAW would greatly increase information flow to public investors. It would enable investors to verify research, identify potential conflicts of interest, and evaluate analyst performance. In particular, SECAW would respond to the fact that retail investors often obtain access to analyst research through secondary sources: television shows, press reports, or the Internet. Current disclosure requirements are largely tied to analyst's formal report—but an individual investor may learn of the analyst's recommendation or price target without ever seeing that report and thus without learning of potential conflicts of interest. SECAW would offer the investor a single reliable source to verify the reported information, identify potential conflicts, and review the analyst's track record with respect to other recommendations.

SECAW could also be used to increase investor information concerning bundled or consensus recommendations. A number of organizations, most prominently Thomson Financial's First Call, bundle analyst recommendations and forecasts together to produce a consensus figure that is then disseminated broadly to public investors without information on the individual analysts who have supplied the underlying information.<sup>274</sup> Investors using the consensus figures do not know the composition of the analysts whose forecasts were combined, the conflicts or business relationships that those analysts might have, or the performance history of the analysts.<sup>275</sup> One solution might involve requiring Thomson and similar services to identify, by name, the analysts whose recommendations are included in its consensus figures. Investors could then obtain detailed information about those analysts from SECAW. This approach would relieve Thomson of any obligation to collect and disclose analyst-specific information to investors.

SECAW would facilitate the market's ability to evaluate research quality and analyst performance. It would enable private service providers to compile information on analyst performance by giving those service

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274. See Green, *supra* note 37, at 4 (explaining the methodology used by Thomson to compile consensus figures).

275. Thomson, for example, accepts forecasts from any analyst who works for a major brokerage firm. PAUL GLASSERMAN & COSTIS MAGLARAS, ANALYZING THE ANALYSTS 2 (2001), available at <http://www2.gsb.columbia.edu/faculty/pglasserman/B6014/TheAnalysts.pdf>. Thomson does not, however, include research from issuer-paid analysts, except for a few firms that were grandfathered in. See Belitski, *supra* note 238 (describing Thomson's exclusion of issuer-paid research); Richardson, *supra* note 235, at C1 (describing Thomson's decision to continue including research provided by Dutton and several other firms).

provides a comprehensive source of analyst recommendations. Importantly, SECAW would offer a new and centralized source of data on the quality and value of publicly distributed research. With this data, investors could better determine the extent to which they should base their investment decisions on analyst recommendations, and regulators could better appraise the extent to which equity research enhances market efficiency.

SECAW would also allow the market and academic researchers to evaluate the effect of analyst conflicts and business relationships. The D.C. Circuit recently struck down the SEC's rules requiring greater independence of mutual fund directors, criticizing the factual predicate of the SEC's rulemaking.<sup>276</sup> In particular, the court found that the SEC had failed adequately to consider the costs of its new rules and to evaluate a disclosure-only alternative.<sup>277</sup> Mandated analyst independence has been imposed through a combination of SRO rules and the Global Research Settlement and is therefore not subject to the same type of procedural attack. Nonetheless, as discussed in Part II above, the empirical evidence to date has failed to establish a strong justification for mandated independence.<sup>278</sup> SECAW responds directly to this deficiency by offering researchers access to information on a broader set of analysts as well as detailed information on analysts' conflicts and performance. As a result, SECAW will enable researchers to focus specifically on the extent to which independence is a good proxy for reliability. Ultimately, regulators will be better able to justify the case, if any, for substantive regulation.

SECAW would also increase analyst accountability. The filing and public disclosure requirements would increase the visibility of analyst conflicts. This increased visibility would likely temper an analyst's willingness to release research to further investment banking or other business interests if that research lacked sufficient support or was inconsistent with internal information. In addition, the historical component of the website would counteract the market's focus on short-term performance. The relative permanence of historical data would also limit an analyst's ability to retreat from a losing position by terminating coverage.

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276. U.S. Chamber of Commerce v. SEC, 412 F.3d 133, 143–45 (D.C. Cir. 2005).

277. *Id.*

278. See also Fisch, *supra* note 76, at 81 (criticizing regulators for attempting to determine appropriate information sources for investors).

#### D. Possible Criticisms

The combination of analyst registration and SECAW offers a disclosure-based alternative to mandated independence. The specific advantages of the approach advocated by this Article are increased transparency over the regulatory environment that existed in the prescandal period, and the ability for firms to continue to subsidize research through other business relationships. A disclosure-based system has disadvantages as well as advantages, however. This Subpart anticipates and responds to possible criticisms.

##### 1. Investor Hubris

One of the most powerful criticisms of the disclosure-based approaches to investor protection is that disclosure is ineffective. Critics argue that the securities laws mandate disclosure that is too extensive or complex and that investors are incapable of evaluating the information they receive. Behavioral economists have identified a variety of biases that interfere with rational investor decisionmaking. Retail investors are likely to be overconfident, causing them possibly to pay insufficient attention to the risk that analyst conflicts of interest will cause research to be overly optimistic. Disclosure may be a particularly ineffective response in that overconfident investors will simply disregard warnings of these risks, believing that they are meant for someone else.<sup>279</sup>

I have argued elsewhere that, despite the shortcomings of a disclosure-based regime, it is likely to be preferable to more paternalistic substantive regulation.<sup>280</sup> A more affirmative case can be made, however, in favor of disclosure. As this Article demonstrates, the purpose of analyst regulation is largely the protection of retail investors. As such, the regulatory scheme can be understood in terms of consumer protection. The government's approach to consumer protection has relied heavily on disclosure, in part because it operates as an adjunct to rather than as a substitute for market discipline over price and quality, and in part because one of the objectives of consumer protection is enhanced choice.<sup>281</sup> Thus, for example,

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279. Donald C. Langevoort, *Ego, Human Behavior, and Law*, 81 VA. L. REV. 853, 880 (1995); see also Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 187–88 (2006) (criticizing disclosure-based securities regulation for failing to address investor irrationality).

280. Fisch, *supra* note 76.

281. James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 WASH. U. L.Q. 907, 930–31 (2005).

regulation of the mutual fund industry, which is mainly designed to protect retail investors, has focused primarily on disclosure, with regulatory reforms addressed largely to enhancing investor use and understanding of that disclosure.<sup>282</sup>

The mutual fund analogy also demonstrates one of the risks associated with the increasing segmentation of the market for research. To the extent that relatively informed investors participate in a market, their knowledge and expertise enhances market discipline, which in turn allows uninformed participants to free ride and enjoy market efficiencies. If informed investors participate in a distinct market, however, by purchasing different products or services from those sold to retail investors, the uninformed market may operate inefficiently.<sup>283</sup> Thus, because SECAW enhances the availability of sell-side research for both institutional and retail investors, it increases the likelihood that the reputational and other disciplines of institutional clientele will increase the incentives for analysts to post accurate information.

## 2. Regulatory Intervention Is Unnecessary

A second and powerful concern is that, if the information described in this proposal is valuable, the market can be expected to supply that information without regulatory intervention. Analysts at Wall Street

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282. See *id.* (identifying problems with investor use of investment information); cf. Eric D. Roiter, *An Apology for Mutual Funds: Delivering Fiduciary Services to Middle and Working Class Investors*, 23 ANN. REV. BANKING & FIN. L. 851, 860 (2004) (“Some issues should more properly be seen as customer or consumer issues. The traditional approach in this respect is promoting effective disclosure and informed choices by consumers, rather than imposition of corporate governance rules or, for that matter, creation of new fiduciary duties.”). Concededly, the effectiveness of mutual fund disclosure has been mixed, but many of those failures can be attributed to flaws in the disclosure process. See, e.g., Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 834–35 (1995) (observing that it took the SEC twenty years to require disclosure of the identities of those persons making investment decisions for the fund); Douglas Litowitz, *The Corporation as God*, 30 J. CORP. L. 501, 526 (2005) (quoting former SEC Chair Arthur Levitt describing mutual fund disclosures as “impossible to understand”). Notably, studies suggest that the most problematic mutual fund investment patterns are in broker-directed investments, in which investors appear to rely on professional advice as an alternative to reviewing disclosure. See, e.g., Bergstresser et al., *supra* note 59, at 36 (finding that funds sold through brokers have higher fees and lower returns).

283. See, e.g., Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1034 (2005) (suggesting that segmentation of the mutual fund market may prevent institutional investors from disciplining fees and returns in funds marketed primarily to retail investors).

firms are already providing increased disclosure of their compensation and conflicts of interest. And several firms are already supplying retail investors with analyst ratings and other performance information.

Historically, information on analyst performance has been very limited. *Institutional Investor* magazine has ranked analysts for years, but its rankings were based on polls of institutional investors, not on actual analyst performance.<sup>284</sup> More recently, private organizations such as Investars and StarMine started to compile information on analyst performance and to create analyst rating systems.<sup>285</sup> Most of this information is only available to institutional investors, but some is available to individual retail investors.<sup>286</sup> Nonetheless, retail investor access to these ratings remains limited.<sup>287</sup> Some data providers have reportedly refused to provide information to analyst ranking services, citing analyst reluctance to be rated.<sup>288</sup> Many analysts are not included in the ranking services, particularly independent analysts.<sup>289</sup> One report stated that fewer than half of the independent analysts providing research as part of the Global Research Settlement are publicly ranked on their performance.<sup>290</sup> Finally, and

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284. See Fisch & Sale, *supra* note 16, at 1053 n.107 (describing the methodology of *Institutional Investor* magazine's analyst rating system); Xi Li, *Performance, Herding, and Career Concerns of Individual Financial Analysts* (EFA 2002 Berlin Meetings Discussion Paper, Jan. 15, 2002), available at <http://ssrn.com/abstract=300889> (explaining that analyst rankings are based primarily on reputation and recognition).

285. See Melissa Lee & John Metaxas, *Quality of Analysis Gradually Improving; Firms Publishing Accuracy of Research Predictions*, CNBC, Apr. 30, 2004, available at <http://www.investars.com/articles/article30042004.asp> (describing Investars as one of many firms now supplying performance-based analyst rankings).

286. For example, Investars offers some performance information to retail investors but its Internal Performance Measurement platform is sold to institutional clients. See Investars, <http://www.investars.com/synopsis.asp>. StarMine used to provide free limited information to retail investors, but discontinued that service in favor of selling a more complete service to portfolio managers and other professional investors. See StarMine, [http://www.starmine.com/index.phtml?page\\_set=investor](http://www.starmine.com/index.phtml?page_set=investor) (last visited Aug. 8, 2007) (explaining that StarMine's analyst rating service for individual investors has been discontinued because it was "currently focusing [its] resources on [its] institutional-grade StarMine Professional research service"). Some of StarMine's information is also available free through Yahoo! Finance, <http://finance.yahoo.com/q/sa?s=YHOO> (last visited Aug. 8, 2007).

287. A further existing limitation is that analyst ratings, when available, are not provided to investors together with the analyst's recommendation and report, creating search costs. SECAW would provide a readily identifiable and reliable source of this information.

288. See Alistair Barr, *Rating the Independent Researchers; Despite Restrictions, Some Researchers Are Tracked*, CBS MARKETWATCH, Aug. 6, 2004, available at <http://www.investars.com/articles/article08062004-2.asp> (stating that the independent firms restrict rating service access to the necessary information if the service is going to provide ratings to retail investors).

289. See Barr, *supra* note 92 (explaining that independent research providers are not required to disclose their recommendations or their performance).

290. Barr, *supra* note 288.



perhaps most importantly, the principles described above concerning the market for research apply equally to the market for evaluating research quality. Firms are able to sell their information on analyst performance to institutional investors, but only to the extent that the firms do not make the information available at little or no cost to the public. As a result, firms such as StarMine have discontinued their services for retail investors in favor of their institutional clientele.<sup>291</sup>

### 3. Political Viability

A third concern is that the registration and disclosure requirements of SECAW are not politically viable and that, in particular, the research industry will object to the requirements. Although the disclosure requirements are not cost free, there are reasons to believe that they are actually consistent with analysts' business interests as well as those of the markets. First, substituting disclosure requirements for substantive regulation restores flexibility for research firms in funding and subsidizing analyst research. Firms that are able to exploit synergies between their business operations, such as between research and investment banking, will be able to benefit from those synergies as long as they disclose the relationships. The market, in turn, will be in a better position to evaluate the effect of the relationship.

Second, SECAW will increase the distribution and visibility of analyst research. Widespread distribution of analyst research (at least after preferred and institutional clients have been given access) serves the needs of issuers and institutional investors by increasing sales, generating demand, and driving up stock prices. Indeed, one of the problems with the issuer-financed model is the risk that no one will read the resulting reports. Ironically, by enabling low-cost distribution and comparison of analyst information, SECAW may serve as a mechanism for allowing the market to test the issuer-financed model.

Third, SECAW may offer a justification for reevaluating the appropriate nature and scope of analyst liability exposure for securities fraud. Under current law, the liability exposure of research analysts remains unpredictable. Although courts have dismissed a number of lawsuits against analysts and their firms arising out of the collapse of the technology bubble,

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291. See *supra* note 286 (describing StarMine's decision to stop providing free analyst ratings to retail investors).

other cases remain.<sup>292</sup> Class actions premised on the fraud on the market theory—in which class members do not need to establish reliance on analyst misstatements—offer the potential for particularly large exposure. Although exploring the various arguments regarding litigation reform is beyond the scope of this Article, SECAW offers a vehicle for exploring alternative mechanisms to traditional class action litigation for increasing analyst accountability. One possibility, for example, that would increase analyst incentives for candor on SECAW would be to establish a safe harbor from fraud liability for information that is properly disclosed. Another possibility would be to exploit the reduced enforcement costs associated with SECAW's transparency by replacing private litigation against analysts with SEC enforcement.<sup>293</sup> These alternatives to traditional litigation would likely be welcomed by the research community, would be consistent with the goal of enhancing information flow in the securities markets, and would eliminate the difficult questions about loss causation and damages that have plagued private civil litigation against analysts.

### CONCLUSION

In a time when public confidence in the markets is low, it is tempting for regulators to seek to offer investors greater protection against losses. The analyst scandals enabled regulators and the investing public to scapegoat research analysts for failing to operate as reliable gatekeepers and led to reforms that attempted to establish a gatekeeping role by mandating analyst independence.

It is unclear whether the reforms have had the effect of making sell-side research more reliable. In particular, the existing reforms contain substantial gaps in coverage, leaving analysts with continued incentives to issue overly optimistic recommendations. Several effects of the reforms are undisputed, however—they have reduced the quantity of research

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292. One recent example is a pending class action against Credit Suisse and its analysts in connection with research about America Online (AOL). The district court recently rejected the defendant's motion to dismiss, finding that the plaintiffs had sufficiently alleged both transaction and loss causation. *In re Credit Suisse-AOL Sec. Litig.*, No. 02-12146-NG, 2006 U.S. Dist. LEXIS 86363 (D. Mass. Dec. 7, 2006).

293. The extent to which public enforcement or criminal litigation serves as a substitute for private civil liability is beyond the scope of this Article. For an analysis of the interplay and potentially complementary roles of government enforcement actions and private civil litigation, see Jill E. Fisch, *Class Action Reform, Qui Tam, and the Role of the Plaintiff*, LAW & CONTEMP. PROBS., Autumn 1997, at 167, 198–202.

available to the market in general and retail investors in particular, they have reduced coverage for smaller issuers, and they have increased the segmentation between institutional and retail investors.

This Article demonstrates that these effects were predictable; by reducing firms' ability to subsidize research through other business activities, the reforms have eliminated a key source of funding, particularly the funding of coverage for new and smaller issuers. By reducing firms' ability to exploit synergies between research and other business activities, the reforms may also be reducing information quality.

This Article advocates an alternative to mandated independence—managing analyst conflicts of interest. The Article has proposed that the SEC require registration by analysts who disseminate information to the investing public coupled with public disclosure of analyst recommendations, conflicts, and other information relevant to an assessment of the reliability of the analyst's research. By substituting analyst registration and SECAW for the mandatory independence required by existing law, the SEC would provide firms with the flexibility to finance quality research. At the same time, SECAW would enhance the transparency of that research, enabling investors and the market—rather than regulators—to evaluate research quality.