

January 2003

## Investor Skepticism v. Investor Confidence: Why the New Research Analyst Reforms Will Harm Investors

John L. Orcutt

Follow this and additional works at: <https://digitalcommons.du.edu/dlr>

---

### Recommended Citation

John L. Orcutt, Investor Skepticism v. Investor Confidence: Why the New Research Analyst Reforms Will Harm Investors, 81 Denv. U. L. Rev. 1 (2003).

This Article is brought to you for free and open access by the Denver Law Review at Digital Commons @ DU. It has been accepted for inclusion in Denver Law Review by an authorized editor of Digital Commons @ DU. For more information, please contact [jennifer.cox@du.edu](mailto:jennifer.cox@du.edu), [dig-commons@du.edu](mailto:dig-commons@du.edu).

---

**Investor Skepticism v. Investor Confidence: Why the New Research Analyst Reforms Will Harm Investors**

# INVESTOR SKEPTICISM V. INVESTOR CONFIDENCE: WHY THE NEW RESEARCH ANALYST REFORMS WILL HARM INVESTORS

JOHN L. ORCUTT<sup>†</sup>

## TABLE OF CONTENTS

INTRODUCTION.....	2
I. OVERVIEW OF RESEARCH ANALYSTS.....	6
A. <i>Sell-Side Analysts</i> .....	7
B. <i>Buy-Side Analysts</i> .....	8
C. <i>Independent Analysts</i> .....	9
D. <i>Sell-Side Analysts' Role in the Boom-Bust</i> .....	10
II. CONFLICTS OF INTEREST THAT PLAGUE SELL-SIDE RESEARCH .....	13
A. <i>Brokerage Activities</i> .....	14
B. <i>Investment Banking Fees</i> .....	16
1. Winning IPO Business .....	16
2. Winning Follow-on Offering and Financial Advisory Business.....	19
3. Investment Banking Clients v. Brokerage Clients .....	20
C. <i>Analyst Compensation</i> .....	21
D. <i>Equity Stakes</i> .....	22
E. <i>Pressure from Covered Companies</i> .....	25
III. THE NEW REGULATORY ENVIRONMENT.....	26
A. <i>Overview of the Regulatory Actions</i> .....	28
1. Section 501 of the Sarbanes-Oxley Act.....	29
2. New NASD and NYSE Analyst Independence Rules.....	29
3. Regulation Analyst Certification.....	30
4. The Regulatory Settlement with Wall Street.....	30
B. <i>Fundamental Changes Sought by the Regulatory Actions</i> .....	35
1. Clearly Separate Sell-Side Research from Investment Banking .....	35
a. Reinforce the Chinese Wall that separates research from investment banking.....	35
b. Prevent promises of favorable research coverage .....	39

---

<sup>†</sup> Professor of Law at the Franklin Pierce Law Center. Prior to joining Pierce Law, Professor Orcutt worked for Robertson Stephens Inc. (the former investment bank subsidiary of FleetBoston Financial Group) from 1997-2001 in various roles, including serving as head of the firm's West Coast Telecom Services Investment Banking Practice. He does not own any of the stocks discussed in this Article.

- 2. Restrict Personal Trading of Analysts in the Companies They Cover.....40
- 3. Require Analysts to Certify Their Research.....41
- 4. Increase Disclosure Requirements .....43
- 5. Require Certain Firms to Provide Independent Research ..46
- 6. Additional Measures.....47
- IV. THE CASE FOR INVESTOR SKEPTICISM .....48
  - A. Predictive Abilities of Sell-Side Analysts—Uncertainty Reigns ....48
  - B. Regulatory Actions Do Not Address Fundamental Conflicts .....54
  - C. Value of Rendering Sell-Side Research More Independent is Unclear .....63
- V. A SIMPLER SOLUTION TO THE SELL-SIDE RESEARCH ISSUE—ELIMINATE THE INFORMATION GAP .....69
  - A. Retail Investors Are in the Dark .....69
  - B. Mandatory Warning Label .....73
- CONCLUSION .....77

INTRODUCTION

Should investors trust the advice they receive from Wall Street’s “sell-side”<sup>1</sup> research analysts? In late March 2000, the stock market bubble burst and the U.S. stock market began a historic collapse that has since shed trillions of dollars in market capitalization.<sup>2</sup> One of the more prominent villains that has arisen from the crash has been Wall Street’s sell-side analysts, who are nominally responsible for making stock rec-

---

1. Sell-side analysts work for brokerage firms and produce research reports that are used by the brokerage firm to “sell” investment ideas to its clients. For a more detailed description of sell-side analysts, as well as descriptions of buy-side analysts (who work for entities that invest for their own account in securities on a regular basis, such as mutual funds, hedge funds, insurance companies, or retirement funds) and independent analysts (who, like sell-side analysts, provide research to motivate a third-party investor to make an investment decision, but are not linked with a particular broker or investment bank), see Securities and Exchange Commission, *Investor Alert: Analyzing Analyst Recommendations*, at <http://www.sec.gov/investor/pubs/analysts.htm> (last visited Nov. 16, 2003) [hereinafter *Analyzing Analyst Recommendations*].

2. It is difficult to compare one market crash to another—and that is not the focus of this Article. However, it is clear that the recent stock market collapse has been very serious (due to its severity and its longevity). Below is a chart that helps to illustrate the severity of the 2000 stock market meltdown:

	Peak	Trough (Oct. 10, 2002)	Percentage Change
Dow Jones	11908 (1/14/00)	7181	-39.7%
S&P 500	1553 (3/24/00)	769	-50.5%
NASDAQ	5132 (3/10/00)	1108	-78.4%

Source: Yahoo! Finance, at <http://finance.yahoo.com> (selecting specific index under “Market Summary,” then “Historical Prices”).

To illustrate the longevity of the 2000 stock market meltdown: 2002 marked the third straight year that the Dow Jones Industrial Average declined; a phenomenon we have not seen since 1939-1941. Jeff D. Opydke, *Year-End Review of Markets & Finance 2002—Essay: History Says Gray Days Will End, but Maybe Not Right Away—Market Endures 1st 3-Year Slump Since Pearl Harbor, and Recovery Will Take Time, Too, and Patience*, WALL ST. J., Jan. 2, 2003, at R7.

ommendations to investors.<sup>3</sup> In the late 1990s, these sell-side analysts rose to prominence as the U.S. stock market climbed to record heights. Historically an anonymous group on Wall Street,<sup>4</sup> sell-side analysts became media darlings and achieved near “rock-star” status<sup>5</sup> as their predictions of rising stock prices were largely validated with the U.S. experiencing the longest bull market in its history.<sup>6</sup>

Unfortunately, these same analysts failed to warn investors of the impending crash and have since drawn considerable attention from regulators, politicians, investors, and the media.<sup>7</sup> The primary focus of the recent attention has been on conflicts of interest that plague sell-side research, with particular attention paid to the influence of investment banking fees on research. Did these conflicts of interest impact sell-side analysts in both their role in inflating the stock market’s bubble and their failure to warn of its burst? Regulators have clearly indicated their belief that conflicts of interest were a primary culprit and have moved to dramatically revamp the environment for sell-side research, with four major regulatory actions: (1) the inclusion of Section 501 (governing analyst conflicts of interest) in the Sarbanes-Oxley Act of 2002;<sup>8</sup> (2) the enactment by the National Association of Securities Dealers (“NASD”) and the New York Stock Exchange (“NYSE”) of very detailed regulations governing research analysts and their firms; (3) the enactment of Regulation Analyst Certification; and (4) a \$1.4 billion global settlement with ten of the leading U.S. investment banks (collectively the “Regulatory Actions”). The foundation for the Regulatory Actions is the hypothesis that sell-side research analysts provided investors with poor investment

---

3. See *Shoot All the Analysts*, FIN. TIMES, Mar. 20, 2001, at 22; see also Charles Gasparino, *Deals & Deal Makers: Outlook for Analysts: Skepticism and Blame*, WALL ST. J., June 13, 2001, at C1.

4. BENJAMIN MARK COLE, *THE PIED PIPERS OF WALL STREET: HOW ANALYSTS SELL YOU DOWN THE RIVER*, at xi (2001).

5. Raymond L. Moss, Michael P. Gilmore & Gerald B. Kline, *The Wall Street Analyst: Rise and Fall of a Rock Star*, in SECURITIES ARBITRATION 2002: TAKING CONTROL OF THE PROCESS 101 (PLI Corp. Law & Practice Course Handbook Series No. B0-01A6, 2002); see also Ken Brown & Jeff D. Opdyke, *Analysts Were Once the Rock Stars of the Street, but Tunes Changed*, WALL ST. J., Nov. 16, 2001, at C1; Charles Gasparino, *NASD Prepares Action Against a Star Analyst: Salomon’s Grubman Faces Allegations He Touted Winstar Despite Red Flags*, WALL ST. J., July 22, 2002, at A1 [hereinafter Gasparino, *Red Flags*].

6. A bull market is:

A prolonged period in which investment prices rise faster than their historical average.

Bull markets can happen as a result of an economic recovery, an economic boom, or investor psychology. The longest and most famous bull market is the one that began in the early 1990s in which the U.S. equity markets grew at their fastest pace ever.

Webfinance, Inc., *Investorwords*, at <http://www.investorwords.com> (last visited Oct. 31, 2003). Some trace the recently ended bull market back to 1982. See ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* 5-7 (2000).

7. See *infra* Part I.D for a discussion of analysts’ failure to warn investors of the impending crash.

8. Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.) [hereinafter Sarbanes-Oxley Act].

guidance due to the severe conflicts of interest they faced.<sup>9</sup> Consequently, the primary focus of the Regulatory Actions has been to render sell-side research more independent, in order to promote the integrity of, and restore confidence in, sell-side research analysts.<sup>10</sup>

While certain aspects of the Regulatory Actions are not objectionable, taken as a whole, the Regulatory Actions are not likely to improve the performance of sell-side analysts. However, by restoring confidence in these analysts, the Regulatory Actions expose the most vulnerable class of investors—retail investors—to inappropriate financial risk. To understand this problem, one must first ask the most fundamental question: Is sell-side research valuable?<sup>11</sup> The answer to this question turns out to be both “yes” and “maybe not.” Yes, sell-side analysts provide valuable information and analysis that assists the market to efficiently determine the appropriate price for a given stock.<sup>12</sup> Maybe not, in that sell-side analysts have historically had difficulties with both forecasting the future performance of companies and making stock recommendations.<sup>13</sup> More specifically, numerous studies have demonstrated that: (1) it is unclear whether investing strategies based on sell-side analysts’ recommendations will consistently outperform the market; and (2) sell-side analysts have consistently proven to be overly optimistic about the future performance of the companies they cover.

---

9. See Securities and Exchange Commission, Self-Regulatory Organizations, Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc. Relating to Exchange 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 Analysts Conflicts of Interest, and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3 to the Proposed Rule Changes 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, Release No. 34-48252; File No. SR-NASD-2002-154; SR-NYSE-2002-49 (July 29, 2003), available at <http://www.sec.gov/rules/sro/34-48252.htm> (last visited Jan. 21, 2004) [hereinafter SEC Release No. 34-48252]; see also Sarbanes-Oxley Act, *supra* note 8, at § 501 (codified as new § 15D of the Securities Exchange Act of 1934 at 15 U.S.C. § 78o-6 (2002)); Regulation AC—Analyst Certification, 17 C.F.R. §§ 242.500 to 242.505; Final Rule Release: Regulation Analyst Certification, Securities Act Release No. 33-8193; Exchange Act Release No. 34-47384, 17 C.F.R. § 242 (2003), available at <http://www.sec.gov/rules/final/33-8193.htm> (last visited Sept. 17, 2003) [hereinafter Regulation AC Press Release]; Joint Press Release, Securities and Exchange Commission, New York Attorney General’s Office, North American Securities Administrators Association, National Association of Securities Dealers and New York Stock Exchange, *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> (last visited Sept. 17, 2003) [hereinafter Press Release on Global Settlement]; William H. Donaldson, Testimony Concerning Global Research Analyst Settlement, Before the Senate Committee on Banking, Housing and Urban Affairs (May 7, 2003), available at <http://www.sec.gov/news/testimony/ts050703whd.htm> (last visited Sept. 17, 2003) [hereinafter Donaldson Testimony].

10. See *supra* note 9.

11. Donald Luskin asked this same question in a recent article, and concluded that the answer is both “yes and no.” Donald Luskin, *Enough Analyst Bashing*, CAPITALISM MAGAZINE (Nov. 27, 2002), available at <http://www.capmag.com/article.asp?ID=2204> (last visited Oct. 25, 2003).

12. See *infra* notes 279-80 and accompanying text.

13. See discussion *infra* Part IV.A.

Can this “maybe not” problem be fixed? Can sell-side analysts’ forecasting and recommendation abilities be improved? The Regulatory Actions seek to improve sell-side research primarily by separating it from the influences of investment banking.<sup>14</sup> While substantial verbiage is given to “clearly separating” research from investment banking, this Article will argue that the separation required by the Regulatory Actions is not substantial and is not likely to change the fundamental pressures at the root of the conflict.<sup>15</sup> The only way to truly separate research from investment banking’s influence would be to require a complete divestiture of research from brokerage firms that conduct investment banking activities. However, the ramifications of such a forced separation are likely to be substantially worse than the status quo arrangement, as the separation would likely cause a reduction in both the quality and volume of available investment research.<sup>16</sup> Moreover, based on a substantial body of work that has been conducted on this subject, it is unclear whether rendering sell-side analysts more independent will substantially improve their forecasting and recommendation skills.<sup>17</sup> There appears to be a number of significant biases and factors that impact the quality of sell-side research in addition to conflicts of interest. As a result, it is both misleading and harmful to investors for regulators to attempt to restore credibility in what is likely to continue to be a very faulty system.

Consequently, there does not appear to be a solution to the “maybe not” problem, and sell-side research will continue to operate under the “yes/maybe not” dichotomy. Institutional investors have long understood this dichotomy.<sup>18</sup> A New York Times editorial described the relationship between sell-side analysts and institutional investors as follows: “Fund managers are not schoolchildren looking for instructions on what to buy. They look to [sell-side] analysts for specific information and general insight.”<sup>19</sup> Unfortunately, the dichotomy does not appear to be widely understood by retail investors,<sup>20</sup> who increasingly have become owners of publicly traded stocks. Rather than encourage retail investors to see sell-side research for what it truly is, the Regulatory Actions mask the weaknesses of sell-side research, and lend renewed credibility to these analysts. By early 2000, sell-side analysts, in many ways, had become

---

14. See *supra* note 9.

15. See discussion *infra* Part IV.B.

16. *Id.*

17. See discussion *infra* Part IV.C.

18. Institutional investors are entities with large amounts of money to invest, such as mutual funds, insurance companies, pension funds, and investment banks. For a more detailed discussion of institutional investors see discussion *infra* Part V.A. For a discussion of institutional investors’ understanding of the dichotomy, see Leslie Boni & Kent L. Womack, *Wall Street’s Credibility Problem: Misaligned Incentives and Dubious Fixes?*, in BROOKINGS-WHARTON PAPERS ON FINANCIAL SERVICES 2002, at 94, 116 (2002).

19. Gary Sernovitz, Editorial, *Don’t Shoot the Analyst*, N.Y. TIMES, Nov. 15, 2002, at A31.

20. See Boni & Womack, *supra* note 18, at 94, 116.

“informal advisers and stock-picking gurus to the masses.”<sup>21</sup> Retail investors have paid a very expensive price to learn the weaknesses of sell-side analysts. Rather than enforce this lesson, the regulators are working to erase it from investors’ memories, which increases the likelihood that we will once again be discussing the damaging impact of sell-side analysts when the next major bear market<sup>22</sup> hits.

Part I of this Article provides an overview of research analysts and their basic functions, including a discussion of sell-side analysts’ role in the market’s recent boom and bust. Part II examines the conflicts of interest that have plagued sell-side research, and Part III reviews the Regulatory Actions that are meant to address these conflicts. In Part IV, the author will make the case for encouraging, rather than lessening, investor skepticism in sell-side research and will explain why the Regulatory Actions are not likely to improve the performance of sell-side analysts. Finally, Part V will offer a simpler proposal to address the sell-side analyst issue. While there may not be a solution to the “maybe not” problem, the information gap between institutional investors and retail investors regarding the weaknesses of sell-side research can be eliminated, which would allow retail investors to benefit from the value of sell-side research while also granting them the opportunity to properly protect themselves from its weaknesses. Akin to the Surgeon General’s warning for cigarette manufacturers, this Article proposes that sell-side analysts and their firms be required to prominently include, with all research, a short and clear warning from the United States Securities and Exchange Commission (“SEC”), regarding the historical weaknesses of sell-side research.<sup>23</sup>

## I. OVERVIEW OF RESEARCH ANALYSTS

Analysts have historically played an important role in the U.S. capital markets by “promoting the efficiency of our markets by ferreting out facts and offering valuable insights on companies and industry trends.”<sup>24</sup> The concept is that securities markets are very efficient at pricing and allocating capital based on all of the publicly available information at the

---

21. Keith Regan, *Are Tech Stock Analysts Too Powerful?*, E-COMMERCE TIMES (Apr. 10, 2001), at <http://www.ecommercetimes.com/perl/story/8841.html> (last visited Sept. 17, 2003).

22. A bear market is:

A prolonged period in which investment prices fall, accompanied by widespread pessimism. If the period of falling stock prices is short and immediately follows a period of rising stock prices, it is instead called a correction. Bear markets usually occur when the economy is in a recession and unemployment is high, or when inflation is rising quickly. The most famous bear market in U.S. history was the Great Depression of the 1930s.

Webfinance, Inc., *Investorwords*, at <http://www.investorwords.com> (last visited Oct. 31, 2003).

23. A “Surgeon General’s warning” approach has also been proposed by Gary Sernovitz. See Sernovitz, *supra* note 19.

24. *Analyzing Analyst Recommendations*, *supra* note 1.



time.<sup>25</sup> The more information that is available about a given stock, and the more reliable that information is, the more efficient the capital markets will be at generating the appropriate price for that stock. Analysts are a principal source of this information. There are three main categories of analysts: sell-side analysts, buy-side analysts, and independent analysts.<sup>26</sup>

### A. Sell-Side Analysts

Sell-side analysts have recently dominated the media's attention. Sell-side analysts work for brokerage firms,<sup>27</sup> which serve as intermediaries between buyers and sellers in securities transactions. Sell-side analysts produce research reports that are used by brokerage firms to "sell" investment ideas to their clients (e.g., whether to buy, hold, or sell a particular stock). Many of the most high-profile sell-side analysts (e.g., Henry Blodgett (formerly of Merrill Lynch), Jack Grubman (formerly of Solomon Smith Barney), Paul Johnson (formerly of Robertson Stephens), and Mary Meeker (of Morgan Stanley)) work for brokerage firms that also provide investment-banking services for their corporate clients. Both the brokerage and investment banking relationships can lead to substantial conflicts of interest that will be discussed in detail in Part II of this Article.

Typical characteristics shared by most sell-side analysts include:<sup>28</sup>

- Specializing in one specific industry sector (e.g., automotive, media, pharmaceuticals, or telecommunications).<sup>29</sup>
- Generating detailed research reports on the companies they cover. Such reports will usually contain a rating (e.g., buy, hold, or sell), a price-target for the stock, an earnings model, detailed analysis regarding the company (including both strengths and weaknesses of the company), comparisons of the company to its peer group, and an investment thesis.
- Gathering information for research reports by reading the company's SEC filings, meeting with its management, talking with

---

25. This is a rudimentary description of the semi-strong form of the efficient market theory. For a more detailed discussion of the efficient market theory, see *infra* notes 287-89 and accompanying text.

26. *Analyzing Analyst Recommendations*, *supra* note 1.

27. There are a number of different types of brokerage firms, including insurance brokerage firms and real estate brokerage firms. All references to brokerage firms in this Article, however, are to securities brokerage firms.

28. See Frank Fernandez, *The Roles and Responsibilities of Securities Analysts*, 7 RES. REP. 3, 3-4 (2001), available at <http://www.sia.com/research/pdf/RsrchRprtVol2-7.PDF> (last visited Nov. 16, 2003); see also Roni Michaely & Kent L. Womack, *Conflict of Interest and the Credibility of Underwriter Analyst Recommendations*, 12 THE REV. OF FIN. STUD. 653, 657-59 (1999); *Analyzing Analyst Recommendations*, *supra* note 1.

29. Brokerage firms may also employ generalist analysts, who cover the movements of the market as a whole or general economic conditions, rather than specific companies.

personally cultivated sources in the industry (including suppliers and customers), and following the news generally.

- Focusing on a very limited number of stocks (usually ten to fifteen), because generating and maintaining such research reports is a very time-consuming effort.

Research reports are typically made available only to clients of the brokerage firm, although in the last few years, many brokerage firms have begun to distribute their reports to non-clients as well, through research resale services<sup>30</sup> or through discount brokerage firms.<sup>31</sup> Part II of this Article will address the economics of sell-side research. While the reports themselves are only distributed to clients, the information in sell-side research reports typically gets into the market very quickly, and is generally viewed to be publicly available information.<sup>32</sup> Moreover, with the emergence of all-business-news cable networks and Internet sites, and the increased focus given by the media to business and financial news, sell-side analysts have taken to providing investment advice through general media outlets in addition to their traditional research reports.<sup>33</sup>

### B. Buy-Side Analysts

Buy-side analysts work for entities that invest on a regular basis for their own accounts in securities such as mutual funds, hedge funds, insurance companies, or retirement funds. A buy-side analyst conducts proprietary investment analysis for the fund manager (i.e., the individual who has the ultimate responsibility for investing the entity's funds), although in some cases the fund manager will serve as her own buy-side analyst.

---

30. An example of a research resale service is Multex, which among other services, allows parties to purchase historical sell-side and independent research reports. Multex.com, Inc., Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Fiscal Year Ending December 31, 2002 (Form 10-K), File No. 0-24559, at 2, available at <http://www.sec.gov/edgar/searchedgar/webusers.htm> (last visited Feb. 11, 2004).

31. A discount brokerage firm is a brokerage firm that executes securities orders at a "discount" commission to full-service brokerage firms, but does not provide all of the services of a full-service brokerage firm, such as research. It is not uncommon for discount brokerage firms to provide to their clients the research of full-service brokerage firms for a fee.

32. See Boni & Womack, *supra* note 18, at 100.

Many analysts' earnings forecasts and recommendations are now readily available to the general public. For example, the Nasdaq web site ([www.nasdaq.com](http://www.nasdaq.com)) currently provides the analyst recommendations (including upgrades, downgrades, and coverage initiation) from 90 firms for stocks listed on Nasdaq and the New York Stock Exchange (NYSE), updated three times a day. It also provides the consensus of analysts' recommendations and earnings forecasts as well as lists of stocks with the largest percentage change in analyst consensus of earnings forecasts and with the highest number of analysts' earnings revisions for the week.

*Id.*

33. Joseph McLaughlin, *Maybe They Should Be on a Leash, but We Shouldn't Muzzle Analysts*, 167 AM. BANKER 8 (2002).

Typical characteristics of buy-side analysts include:<sup>34</sup>

- Drawing their own conclusions on what investment decisions should be made, which they report to their fund managers.
- Using sell-side research as an important source of information for the stocks they research (which allows buy-side analysts to cover more stocks than sell-side analysts) and for future investment ideas and trends. To a lesser extent, buy-side analysts may also consult independent analysts.<sup>35</sup>
- Conducting independent and proprietary research, which may include, among other things, talking with their own industry contacts, meeting personally with company management, conducting their own due diligence on the company, and attending investor conferences (which are typically sponsored by sell-side firms) where the management teams of various companies give presentations and hold individual meetings with investors.
- Specializing in one or a few specific industry sectors (e.g., automotive, media, pharmaceuticals, or telecommunications).
- Covering a limited number of stocks (typically in the range of thirty to forty) and making investment recommendations on those stocks only.

Research generated by buy-side analysts is solely for the benefit of their employers and is not made available to the general public. Because the objectives of buy-side analysts and their employers (i.e., the investing entity) are basically aligned, buy-side analysts do not face the same conflicts of interest that plague sell-side analysts.

### *C. Independent Analysts*

Like sell-side analysts, independent analysts issue research to motivate third-party investors to make investment decisions. However, an independent analyst is not linked with a particular broker or investment bank.<sup>36</sup> As a result, independent analysts are free from many, but not all,

---

34. See Fernandez, *supra* note 28, at 3-4; see also Michaely & Womack, *supra* note 28, at 657-59; *Analyzing Analyst Recommendations*, *supra* note 1.

35. For a description of independent analysts, see *infra* Part I.C.

36. There is a good deal of debate over what constitutes "independent" research. See Larry Diggan, *Is Independence All That? Creating Independent Research Isn't as Simple as It May Sound. And It's Not Necessarily Better Anyway*, WALL ST. WEEK WITH FORTUNE, Nov. 21, 2002, at [http://www.pbs.org/wsw/news/featurestory\\_20021121.html](http://www.pbs.org/wsw/news/featurestory_20021121.html) (last visited Sept. 17, 2003). It is widely agreed that for an analyst to be deemed independent, the analyst cannot be employed by a firm with an investment banking relationship with the covered company. See *Analyzing Analyst Recommendations*, *supra* note 1. But, is an analyst that works for a brokerage firm that does not conduct any investment banking services an independent analyst? What if the firm does not conduct investment-banking services, but does make a market in the stock of the covered company? For purposes of this Article, and for simplicity's sake, the author has drawn a bright-line distinction between sell-side analysts (who work for a brokerage firm, regardless of whether the firm has an investment banking

of the conflicts of interest that plague sell-side analysts. Much of the purpose of the Regulatory Actions is to make sell-side research more “independent.” Independent analysts typically work for investment newsletters or large industry research groups (such as the Gartner Group or Forrester Research), who sell the proprietary research to institutional clients and/or individual investors.

#### *D. Sell-Side Analysts’ Role in the Boom-Bust*

Much of the recent criticism of sell-side analysts focuses on their role in inflating the stock market’s bubble and their failure to warn of the impending burst. The United States enjoyed the longest bull market in its history during the 1990s and through the first quarter of 2000.<sup>37</sup> Much of the growth in the stock market during this period is now attributed to the stock market experiencing a “bubble” effect.<sup>38</sup> A bubble occurs when the price for a class of items (e.g., stock) is high today because of a collective belief that the price will be even higher tomorrow, even though “fundamental” factors do not seem to justify the price (i.e., the price has become irrational).<sup>39</sup>

Sell-side analysts are accused of adding pressure to the bubble in a number of different ways, including their use of questionable valuation

department or not) and independent analysts (who have no relationship with a brokerage firm or investment bank).

37. See SHILLER, *supra* note 6, at 5-7.

38. Substantial bubbles (also known as speculative crazes) such as the recent stock market crash occur periodically. Classic examples of bubbles include the Tulip-Bulb Craze of the 1600s, the South Sea Bubble of the early 1700s, the Railroad Bubble of the late 1800s, and the Great Stock Market Crash of 1928. The following description of bubbles is an excerpt from an essay by Art Cashin that was reprinted by John Mauldin in his weekly newsletter, *Thoughts from the Frontline E-Letter—Conflicting Opinions*, INVESTORS INSIGHT, AUG. 8, 2003, at <http://www.2000wave.com> (subscription required) (on file with author).

Bubbles are booms on steroids. Instead of just being frenzied bouts of over enthusiasm, they morph into the delusional. All caution is lost. All financial rules have been repealed. A key ingredient in most bubbles is the concept of novelty. Usually it’s a new invention or technology. The automobile, the radio, the telephone and the like were all accompanied by bubbles. One of the biggest bubbles in American history was the one involving the beginning of the railroads. It is the novelty that promotes—“this time it’s different.” The novel new technology will “change the way we live” so all the old rules have been repealed. This “opportunity” will be a great leveler. If you and I are bright enough to seize this opportunity, we believe we may become rich as Henry Ford, Carnegie or Vanderbilt. (Well, maybe as rich as one of their junior partners.) To pass up such an opportunity surely proves you are a fool.

*Id.*

39. A commonly cited measure that stock prices had lost touch with fundamentals is that P/E (price-to-earnings) ratios reached all time highs that were far outside the historical range of P/E ratios. See SHILLER, *supra* note 6, at 3-14. Shiller found that the P/E ratio for the S&P Composite Stock Index (calculated as the real (inflation corrected) S&P Composite Index divided by the ten-year moving average real earnings on the index) had reached approximately 44-to-1 in January 2000 (the highest ratio ever), compared to the historical range of P/E ratios which largely fell between 5-to-1 and 25-to-1 (although the P/E ratio did reach 33-to-1 in 1929). *Id.* at 7-10.

techniques to try to justify inflated company valuations,<sup>40</sup> overly optimistic earnings forecasts,<sup>41</sup> and their overly bullish stock recommendations.<sup>42</sup> In short, it is argued that sell-side analysts contributed to the bubble through their general over-optimism about the value of stocks, in particular in the technology, telecommunications, and Internet sectors.<sup>43</sup> The most easily documented (and also a frequently cited) indication of this over-optimism is the incredibly disproportionate ratio of “buy” to “sell” ratings that were issued by sell-side analysts during the bubble and the analysts’ failure to promptly correct those ratings once the bubble burst.<sup>44</sup> The following table sets forth the distribution of ratings by sell-side analysts for the period from 1996 to 2001:<sup>45</sup>

<u>Year</u>	<u>Strong Buy/Buy</u>		<u>Hold</u>		<u>Sell/Strong Sell</u>	
	<u>Number</u>	<u>% of Total</u>	<u>Number</u>	<u>% of Total</u>	<u>Number</u>	<u>% of Total</u>
1996	14,607	65.2%	7,007	31.3%	795	3.5%
1997	19,684	66.4%	8,929	30.1%	1,034	3.5%
1998	28,100	66.4%	12,754	30.1%	1,467	3.5%
1999	30,322	70.1%	11,728	27.1%	1,198	2.8%
2000	30,239	72.1%	11,037	26.3%	689	1.6%
2001	30,080	62.1%	16,615	34.3%	1,754	3.6%
Overall	153,032	67.1%	68,070	29.9%	6,937	3.0%

In order to understand these statistics, it is necessary to review how sell-side analysts applied ratings at the time. Broken down to the most basic level, an investor has three primary choices with respect to a given security: (1) should she “buy” the security at the current price (e.g., the security is currently under priced, and therefore, it will rise in value over

40. Such techniques included valuing companies on price-to-revenue ratios or on number of hits to a web site. On many occasions the analysts simply abandoned the use of traditional valuation techniques.

41. See *infra* notes 283-85 and accompanying text.

42. One author analogized the analysts’ role in the euphoric rise of the stock market to that of pied pipers, entrancing “the market with their flute work, to provide the captivating music that helps stock rise, and rise again.” COLE, *supra* note 4, at xi.

43. See generally COLE, *supra* note 4.

44. Examples of commentaries citing the disproportionate “buy” to “sell” ratings as an indication of the over-optimism of sell-side analysts include: COLE, *supra* note 4, at 97; Laura S. Unger, How Can Analysts Maintain Their Independence? Speech at the Ray Garrett Jr. Corporate and Securities Law Institute, Northwestern University School of Law (Apr. 19, 2001), available at <http://www.sec.gov/news/speech/spch477.htm> (last visited Dec. 17, 2003) [hereinafter Unger Speech at Northwestern]; John C. Bogle, *Remaking the Market: Reality Bites*, WALL ST. J., Nov. 21, 2002, at A16.

45. Brad Barber et al., *Reassessing the Returns to Analysts’ Stock Recommendations*, FIN. ANALYSTS J., Mar./Apr. 2003, at 88, 90 [hereinafter Barber et al., *Analysts’ Recommendations*]. Barber et al., employed data from First Call. *Id.* at 89.

time at a rate greater than the stock market as a whole); (2) should she “hold” the security at the current price (e.g., the security is fairly priced, and therefore, there is no urgency to either buy or sell the security); or (3) should she “sell” or “short”<sup>46</sup> the security (e.g., the security is currently overpriced, and therefore, it will decrease in value over time)? Given the three primary choices, it would be logical to expect ratings to be based on these choices. Historically, that has not been the case. A wide variety of terms are used to describe investment recommendations, including: “buy,” “sell,” “strong buy,” “hold,” “neutral,” “accumulate,” “near-term accumulate,” “long-term buy,” “outperform,” “market perform,” and “market under-perform.”<sup>47</sup> Because there were generally no set definitions for what any rating meant, a fair amount of confusion resulted.<sup>48</sup> For example, a stock could be downgraded from a “buy” to an “accumulate.” What did this mean? Should an investor still buy the stock, since accumulate appears to mean buy? Depending on the firm, the reduction could have meant that an investor should still buy the stock, but expect a lower return than from a “buy” rated stock, or (and this is where things really get confusing) accumulate could be a polite way of saying that the stock should be rated “neutral” or “hold” (e.g., the stock is fully priced and there is no need to purchase). Of course, if the rating had been reduced to “neutral” or “hold,” that would likely have been an indication that the stock should be sold.<sup>49</sup> Since actual “sell” ratings were very seldom given (many firms used “hold” to mean “sell”),<sup>50</sup> the “buy/sell” ratios in the above chart are substantially skewed.

Moreover, it is not unexpected for analysts to issue a preponderance of “buy” ratings for reasons that are wholly unrelated to over-optimism. First, there are over 14,000 stocks that are publicly traded in the United States, and sell-side analysts cover less than 6,000 of those stocks.<sup>51</sup> Of those stocks that are covered, “less than half are *actively* covered (mean-

---

46. “Selling short” is selling a security that is not currently owned by the seller. This technique is typically used when the seller believes the security price will decline. Mechanically, the seller borrows the securities from a brokerage firm and then sells them. At some point, the seller must purchase securities to return those she borrowed. If the securities have decreased in price, the seller realizes a profit on this price decrease, but if the price of the securities increases, the seller will realize a loss. A short selling strategy is also commonly used as a hedging strategy to protect a profit in a long position.

47. Laura S. Unger, Written Testimony Concerning Conflicts of Interest Faced by Brokerage Firms and Their Research Analysts, Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives (July 31, 2001), available at <http://www.sec.gov/news/testimony/073101tslu.htm> (last visited Sept. 21, 2003) [hereinafter Unger Written Testimony]. At the time of the testimony, Ms. Unger was the Acting Chair of the U.S. Securities and Exchange Commission. See *id.*

48. *Id.*

49. This “ratings game” is another indication of the information imbalance that exists between institutional investors (who understand the ratings game very well) and retail investors (who generally do not).

50. Jeff D. Opdyke, *Deals & Deal Makers: New Rules for Analysts—Are They Enough?*, WALL ST. J., Feb. 8, 2002, at C14.

51. Fernandez, *supra* note 28, at 7.

ing covered by more than two analysts so that a basis for comparison of analysts' opinions exists).<sup>52</sup> So, even with an overall recommendation frequency of 67.1 percent strong buy/buy, only a fraction of publicly traded stocks are receiving a "buy" rating.<sup>53</sup> In addition, in choosing which companies to cover, it has been shown that sell-side analysts tend to add firms they view favorably and drop firms they view unfavorably, rather than rate them a "sell."<sup>54</sup> Such a tendency coincides with the analysts' role to generate investment ideas for the firm's brokerage clients. It is generally believed that sell-side analysts have a stronger impact on trading volume with "buy" ratings because each of the firm's clients can act on a "buy" rating and purchase stock.<sup>55</sup> However, only clients that already own the particular stock (or who are interested in shorting the stock) can react to a "sell" recommendation.<sup>56</sup>

None of this is to suggest that sell-side analysts did not fail to warn investors of the bubble burst. Even taking into account the artful nature of ratings and the other reasons for disproportionate "buy" recommendations, it is clear that analysts failed to warn investors and were slow to adjust to the dramatically changed environment of the stock market.<sup>57</sup> However, the analysis of the sell-side analyst issue should be based on actualities, not hyperbole.<sup>58</sup>

The question then arises, what was the cause of the sell-side analysts' failures? The regulators, as well as many commentators, have focused on the conflicts of interest that plague sell-side research.

## II. CONFLICTS OF INTEREST THAT PLAGUE SELL-SIDE RESEARCH

There is no doubt that conflicts of interest played a role in some of the recent misguidance investors received from research analysts and investment banks, although the extent of that role is not so clear. While this Article argues that removing conflicts of interest is not the great cure that the Regulatory Actions envision, it is important to properly understand the scope of the conflicts. The following discussion is meant to provide a detailed look at these conflicts of interest, which can be divided into five basic categories: (1) brokerage activities; (2) investment

---

52. *Id.*

53. *Id.*

54. Maureen McNichols & Patricia C. O'Brien, *Self-Selection and Analyst Coverage*, 35 J. ACCT. RES. 167 (Supp. 1997).

55. Bogle, *supra* note 44.

56. *Id.* But see *infra* note 67, discussing a study conducted by Professor Kent L. Womack which found that "sell" ratings may actually generate greater trading volume than "buy" ratings.

57. See generally Barber et al., *Analysts' Recommendations*, *supra* note 45.

58. An example of this hyperbole is the oft-cited statistic that in 1999, less than one percent of stock ratings were "sells." COLE, *supra* note 4, at 97; see also Unger Speech at Northwestern, *supra* note 44; Bogle, *supra* note 44.

banking fees; (3) analyst compensation; (4) equity stakes; and (5) pressure from covered companies.<sup>59</sup>

### A. Brokerage Activities

To properly understand the conflicts faced by sell-side analysts, the most important concept to remember is that sell-side research typically generates no direct revenue for its firm. As a general rule, sell-side research is not sold to investors, but rather is provided for free to the firm's clients.<sup>60</sup> Since brokerage firms are for-profit entities, they came up with different strategies to make providing free research economically sensible.

Until the mid-1970s, brokerage services were amongst the most profitable services offered by securities firms.<sup>61</sup> This was the era of "fixed trading commissions." Securities trades had to go through licensed broker-dealers and the commission charged for these transactions was set at a fixed rate.<sup>62</sup> Not surprisingly, the rates were set to ensure the broker-dealers a comfortable profit margin. In that environment, with practically guaranteed profits for brokerage services, securities firms' greatest motivation was to attract and maintain active trading customers. One way that customers were attracted and maintained, as well as encouraged to trade, was by providing them with the firm's free proprietary research, which was subsidized by the brokerage commissions. In 1975, the SEC put an end to fixed-commission trading,<sup>63</sup> which resulted in a dramatic decline in the profitability of brokerage commissions (as broker-dealers had to compete on commission price) and their ability to subsidize research departments.

---

59. Laura S. Unger divides the conflicts slightly differently:

- (1) **Attracting and Retaining Clients:** The analyst's firm may have underwritten an offering for a company or seek to underwrite a future offering. The analyst may have been a part of the investment banking team that took the company public.
- (2) **Firm Profits:** Positive reports by brokerage firm analysts can also trigger higher trading volumes, resulting in greater commissions for the firms.
- (3) **Compensation:** An analyst's salary and bonus may be linked to the profitability of the firm's investment banking business.
- (4) **Equity Stakes:** The analyst, other employees, and the firm itself may own significant positions in the companies the analyst covers. Analysts may participate in employee stock purchase pools that invest in companies they cover or they may own stock directly. And, in a recent trend called "venture investing," firms and analysts may acquire a stake in a start-up company by obtaining discounted, pre-IPO shares.

Unger Written Testimony, *supra* note 47.

60. In the last few years many brokerage firms have begun to sell their reports to non-clients as well through research resale services (such as Multex) and through discount brokerage firms. *See supra* notes 30-31 and accompanying text. Based on the author's experience at Robertson Stephens, however, the fees generated from selling such reports are minimal.

61. COLE, *supra* note 4, at 45-50.

62. *Id.*

63. *See generally* Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975) (codified as amended in scattered sections of 15 U.S.C.).



While firms no longer generate the profit margins from brokerage activities that they generated in the fixed commission days, brokerage activities can still be a very important part of the economics of a securities firm, and sell-side research can still help to generate substantial fees for brokerage activities, primarily by issuing positive research reports. As noted earlier, analysts are used to “selling” investment ideas to the brokerage firm’s investor clients. Since each of the firm’s clients can act on a “buy” rating and purchase stock, but only clients that already own the particular stock (or who are interested in shorting the stock) can react to a “sell” recommendation, analysts will typically initiate coverage on stocks with a “buy” rating, since it is generally believed that “buy” ratings are more likely to encourage trading volumes.<sup>64</sup> Research has shown that sell-side analyst recommendations can have a substantial impact on both stock prices and trading volumes.<sup>65</sup> One study found that within a three-day period following a recommendation change, a new “buy” recommendation (either initiation or an upgrade from a lower category) resulted in a three percent price increase for the stock, while a new “sell” recommendation resulted in a 4.7 percent decrease.<sup>66</sup> In each case, a substantial increase in trading volume resulted for the stock.<sup>67</sup>

Once an analyst has issued a favorable rating, the firm’s sales force will then sell the idea to the firm’s clients. After accounts have purchased the stock, it can be very difficult for an analyst to reduce her rating on the stock, since to do so would likely reduce the price of the stock, harming the firm’s clients who purchased it.<sup>68</sup> To do so risks the ire of both the firm’s clients (who can take their business elsewhere) and its sales force. Other less obvious brokerage conflicts can also pressure sell-side analysts to issue positive research. For example, firms that have favorable ratings for a company are more likely to be awarded lucrative assignments by the company to administer its stock option plan or company buyback plan, or to conduct block sales. Finally, where a subject company is an active trader of securities, less than glowing research about the company can lead the company to pull its trading from the offending firm.<sup>69</sup>

---

64. See Bogle, *supra* note 44. *But see infra* note 67.

65. Kent L. Womack, *Do Brokerage Analysts’ Recommendations Have Investment Value?*, 51 J. FIN. 137 (1996).

66. *Id.* at 137.

67. *Id.* at 138. For additional information on the Womack study, see *infra* notes 293-97 and accompanying text. Interestingly, the Womack Study’s finding of substantially increased trading volumes for “sell” recommendations could be an indication that brokerage firms’ contention that “buy” ratings generate greater trading volumes than “sell” ratings may be flawed and that firms could generate meaningful brokerage revenue by encouraging sell-side analysts to find and label “bad” companies as well as “good” companies.

68. See *supra* note 66 and accompanying text.

69. COLE, *supra* note 4, at 81. Cole cites an example of NationsBank instructing its trust officer to stop trading stocks and bonds through Kidder Peabody after an analyst at Kidder Peabody issued a “sell” rating on NationsBank. *Id.*

The conflicts between sell-side research and brokerage activities have received substantially less press than the investment banking conflict and were largely ignored by the Regulatory Actions.

### *B. Investment Banking Fees*

The conflict that has received the most attention from the press and the regulators is the conflict that sell-side analysts face from their investment banking departments. As brokerage commissions decreased, the costs of running “a respectable research department at a top tier bank” did not.<sup>70</sup> One industry commentator has estimated that cost to be between \$500 million and \$1 billion per year.<sup>71</sup> One replacement for the inflated revenues generated by fixed commission trading has been investment-banking revenues.<sup>72</sup>

Investment banking departments generate revenue primarily by raising capital for companies (e.g., underwriting initial public offerings (“IPOs”) and follow-on offerings) and by providing financial advisory services (e.g., assisting companies with mergers and acquisitions (“M & A”) work).<sup>73</sup> In each case, the investment banking department’s ability to generate the fees can be greatly enhanced by a cooperative research department.

#### 1. Winning IPO Business

One of the more profitable businesses on Wall Street, until the March 2000 stock market crash, was underwriting IPOs.<sup>74</sup> Winning IPO business is very important to the revenues of an investment bank because of both the size of the possible underwriting fees for the IPO, and be-

---

70. Jason Draho, *Analysts' Conflict of Interest: How Are IPOs Affected?*, VC EXPERTS (Jan. 14, 2003), at <http://vcexperts.com> (subscription required) (article on file with author).

71. *Id.*; see also Womack, *supra* note 65, at 138. Womack states that “[b]rokerage firms spend hundreds of millions of dollars annually analyzing stocks and trying to persuade investors that certain stocks are more or less attractive than others.” *Id.*

72. The term “investment bank” can be confusing because it encompasses both the securities firm as a whole (e.g., Goldman Sachs is an investment bank) and one specific department within the firm. A brokerage firm that also conducts investment-banking activity will typically be referred to as an “investment bank.”

73. More specifically, the capital raising function consists of assisting corporate and municipal clients to raise money through offerings of securities (either public or private). A typical investment-banking department can perform a wide array of securities offerings, including equity securities, corporate debt securities (investment grade and non-investment grade), government debt securities (e.g., municipal bonds) and convertible securities. Underwriting IPOs is a classic example of the capital raising function. The financial advisory function may entail both advising clients on various financial matters (e.g., assisting a company to implement anti-takeover measures) and assisting the client in finding and executing various business combinations (typically referred to as M&A work).

74. In an underwritten IPO, a company sells shares of its common stock to the underwriters (a group of typically three to five investment banks) who in turn sell the shares to the public. The investment banks generate their revenues from the deal by purchasing the shares from the issuer at a discount (the “underwriting discount”) to the price at which the shares are sold to the public.

cause being part of the IPO can be critical to having an opportunity to access later follow-on offering and financial advisory fees.<sup>75</sup>

In the 1990s, research analysts became critical to an investment bank's ability to win IPO business. Investment banks almost never compete with each other based on price for underwriting business.<sup>76</sup> Therefore, investment banks must compete based on brand name and the quality of the services they offer.<sup>77</sup> Since these services are often relatively comparable in both scope and quality between the different investment banks vying for a deal, investment banks would look for other ways to distinguish themselves. One such way was to market the abilities of their sell-side research analysts as an instrumental part of their pitches to win IPO mandates. The pitch from the investment bankers would go something like this:

Our analyst is [one of] the leading analyst[s] in your sector. He is very well respected in the industry and carries a lot of clout with institutional investors. There have been an unprecedented number of new companies going public over the last few years, and it is critical to the future success of your company that you have the voice of our analyst to help to distinguish your company from all of these other companies. You do not want your company to get lost in this mass of new companies.

Implicit in this pitch are two very important concepts: (1) if their investment bank is not chosen as an underwriter, their analyst will not cover that company—irrespective of the investment merits of the company; and (2) if their investment bank is chosen as an underwriter, their analyst will initiate coverage on the company with a “buy” rating once the quiet period has expired.<sup>78</sup> If awarded the underwriting assignment,

75. See discussion *infra* Part II.B.2.

76. The typical underwriting discount for an IPO is seven percent. While the underwriting discount may vary somewhat based on the size of the deal (e.g., extremely large deals will typically be conducted at a lesser discount), investment banks will almost never vary that percentage in order to win business.

77. These services include: (1) distribution (e.g., finding investors to buy the company's stock); (2) aftermarket services (e.g., stabilizing the price of the stock for a period of time after the IPO and generally making a market in the stock); (3) positioning the company (e.g., assisting the company to develop an investment thesis that will be used to help convince investors to purchase the stock); (4) coordinating the process (conducting an IPO can be a daunting task and the investment banks will help guide the company through the process); and (5) other services, such as managing the finances of the founders and senior management, or running an employee shareholder program.

78. A basic principle of U.S. securities law is that shares distributed in IPOs are to be sold based on the prospectus that is published in connection with the offering (which carries with it substantial liability to the issuer, the issuer's board and some of its management, the underwriters, and the auditors, for material misstatements or omissions in the prospectus), and not on other marketing materials—in particular research reports from the firms underwriting the IPO. The quiet period is meant to establish a period during which the primary information impacting sales of the IPO shares is the prospectus. Research reports by analysts whose firms were involved in the IPO as either an underwriter or dealer are prohibited from issuing research reports on the IPOed company until the expiration of the quiet period. See *infra* notes 209-12 and accompanying text for a discussion of the Regulatory Actions' impact on quiet periods.

some sell-side analysts would also assist to “sell” the deal to investors by speaking with potential investors during the “road show” and the “book building” process.<sup>79</sup>

This process generated a number of possible conflicts for the sell-side analysts. In particular: (1) analysts began to spend more of their time looking for IPO candidates and less of their time conducting research; (2) an analyst could ignore (or worse, disparage) a company that the analyst felt had promising investment potential because the analyst’s firm was not named as an underwriter; and (3) an analyst could be motivated to issue a “buy” rating on a company that the analyst believed had questionable investment potential in order to garner the investment banking fee. This last conflict is particularly tricky since it has multiple opportunities to present itself to the analyst. For example, let us assume the following set of facts:

- Company X is seeking to conduct an IPO and Investment Bank Y is pitching to be one of the underwriters.
- Company X’s IPO is priced at \$15 per share.
- Forty days after the IPO takes place, Company X’s stock is trading at \$30 per share.
- Three months after the IPO takes place, Company X’s stock has risen to \$50 per share.

First, a sell-side analyst may feel pressured to support a company that the analyst does not feel should be taken public, or should not be taken public at the valuation proposed by the analyst’s investment bank. Based on the above facts, the analyst for Investment Bank Y may be uncomfortable with a \$15 per share price for Company X, but may feel pressured to support the deal nonetheless. Another possibility is that the analyst may think the company is a solid IPO candidate and likes the company at \$15 per share. However, sell-side analysts are not allowed to initiate research coverage on IPO companies that their firms underwrote (or acted as a dealer for) until the “quiet period” has ended. Prior to the

---

79. The road show is the company’s marketing trip to investors that takes place prior to setting the actual price for the offering. It typically involves a few of the company’s executive officers who try to explain to investors why their company will make a good investment. It was not uncommon for the research analysts from the underwriters to use the road show as a means to communicate to investors their forecasts about the company’s future performance. Since most investors base their investment choices on forecasts of a company’s future performance, such communications could be critical to the success of an IPO. The book building process consists of the underwriters on the deal collecting non-binding commitments from prospective investors. In a firm commitment underwritten offering (which is the typical method of conducting an IPO) the issuer sells an allotment of securities to the underwriters, who then sell the securities to investors. The underwriters bear the risk if investors choose not to purchase the securities. Due to this risk and the non-binding nature of the investor commitments, it is very important for the success of an IPO that it be considerably over-subscribed by investors. Analysts were used on occasion during the book building process to call particular investors for the purpose of encouraging them to commit to buying into the IPO.

Regulatory Actions, the quiet period for an IPO typically lasted twenty-five calendar days from the date of the offering, but now extends to forty days for sell-side analysts employed by the managing or co-managing underwriters.<sup>80</sup> Based on the above scenario, Company X's stock price has increased to \$30 per share, which the analyst may think is too high. The analyst may feel compelled, however, to initiate coverage with a "buy" rating regardless. Finally, the analyst may be okay with \$30 per share, but the price continues to climb within a few months after the analyst initiated coverage. Even if the analyst thinks that \$50 per share is too high a price, the analyst may feel pressured not to lower the rating so soon after the IPO.

## 2. Winning Follow-on Offering and Financial Advisory Business

Once a company has been taken public, investment banks compete to win additional fees for follow-on offerings (e.g., additional public offerings that take place after the IPO, such as additional common stock offerings, convertible stock offerings, and debt offerings) and for financial advisory work (e.g., M & A work).<sup>81</sup> Sell-side analysts can play an important role in their firms' ability to garner these fees.

In some cases, the fees from follow-on and financial advisory business can dwarf the fees from the original IPO. A classic example of this phenomenon was McLeodUSA, Inc. and Salomon Smith Barney. In the late 1990s, McLeod was considered to be a leader in the emerging competitive telecommunications arena.<sup>82</sup> While this Article is not the place to discuss the failings of this industry segment,<sup>83</sup> it is appropriate to point out that the competitive telecommunications sector was coveted by investment banks because competitive telecommunication companies, collectively, needed to raise hundreds of billions of dollars in order to build next generation communication networks. Investment banks were able to generate billions of dollars in fees from these massive capital raises in the late 1990s. Salomon Smith Barney was the lead underwriter on McLeod's \$240 million IPO in June of 1996,<sup>84</sup> for which Salomon Smith

80. NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC. ("NASD"), Rule 2711(f)(1)(A), available at <http://www.nasd.com> (last visited Nov. 1, 2003); NEW YORK STOCK EXCHANGE, INC. ("NYSE"), Rule 472(f)(1), available at <http://www.nyse.com/pdfs/rule472.pdf> (last visited Nov. 8, 2003).

81. The financial advisory function typically entails services such as assisting clients in finding and executing various business combinations (typically referred to as M&A work) and advising clients on various financial matters (e.g., assisting a company to implement anti-takeover measures).

82. Yahoo! Finance, *Telecommunications Services Industry Profile*, at <http://biz.yahoo.com/ic/prof/42.html> (last visited Nov. 1, 2003).

83. It is a common misconception that much of the current market troubles are a result of the burst of the Internet bubble (i.e., the "dot bomb" phenomena). In reality, the decline of the Internet sector pails in comparison to the trillions of dollars that investors lost in the collapse of the telecommunications sector. See Dennis K. Berman, *Dialing for Dollars: Before Telecom Industry Sank, Insiders Sold Billions in Stock—As They Cashed Out Shares, Many Executives Touted Sector's Growth Potential—Mr. Gallucio's New Winery*, WALL ST. J., Aug. 12, 2002, at A1.

84. MCLEODUSA, INC., 1996 PROSPECTUS 424(b)(4).

Barney generated an underwriting fee approaching \$10 million.<sup>85</sup> As one would expect, Salomon Smith Barney's competitive telecommunications research analyst, Jack Grubman, initiated coverage on McLeod after the IPO with a "buy" rating.<sup>86</sup> McLeod was not done raising money or generating investment-banking fees. During an approximately five-year period following the IPO, McLeod raised an additional \$3.5 billion over eight transactions.<sup>87</sup> Salomon Smith Barney was the lead underwriter on each of these transactions and collected almost \$100 million in fees.<sup>88</sup> McLeod also conducted a number of acquisitions during this time period, which also produced significant fees.<sup>89</sup> It was commonly understood in the industry that for an investment bank to have any chance at such follow-on or financial advisory work, it had to have a positive rating on the company. Not surprisingly, Grubman maintained a "buy" rating on McLeod throughout this entire fee generating process.<sup>90</sup> Grubman did not reduce his rating on McLeod from "buy" until November 2001 (it was reduced to "neutral"),<sup>91</sup> at which time McLeod's stock was trading for less than \$1.00 per share and was down approximately ninety-eight percent from its high in 2000.<sup>92</sup> McLeod filed for Chapter 11 bankruptcy protection in January 2002.<sup>93</sup>

Unfortunately, the McLeod example was by no means an isolated incident. Grubman alone has also been linked to similar practices relating to WorldCom, Global Crossing, XO Communications, and Winstar.<sup>94</sup>

### 3. Investment Banking Clients v. Brokerage Clients

Broken down into its simplest terms, the increased importance of sell-side analysts in generating investment banking fees has resulted in sell-side analysts serving two very different audiences: brokerage clients and investment banking clients. Each of these audiences exerts a different pressure on the sell-side analyst. Brokerage clients want "accurate" research that will assist them to invest profitably, while investment-banking clients want "optimistic" research that will boost their stock price.<sup>95</sup> With investment banking revenues far outstripping brokerage

---

85. Gretchen Morgenson, *Telecom's Pied Piper: Whose Side Was He On?*, N.Y. TIMES, Nov. 18, 2001, at 3-1 [hereinafter Morgenson, *Telecom's Pied Piper*].

86. *Id.*

87. *Id.*

88. *Id.*

89. *See id.*

90. *See id.*

91. Yahoo! Finance, *Analyst Opinion for McLeodUSA Inc.*, at <http://biz.yahoo.com/c/m/mcld.html> (last visited Oct. 25, 2003).

92. McLeod's shares reached a split-adjusted high of \$34.83 per share in March 2000. *See* Morgenson, *Telecom's Pied Piper*, *supra* note 85.

93. McLeodUSA, Inc., Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Fiscal Year Ended December 31, 2001 (Form 10-K), File No. 0-20763, at I-6, available at <http://www.sec.gov/edgar/searchedgar/webusers.htm> (last visited Nov. 2, 2003).

94. Gasparino, *Red Flags*, *supra* note 5.

95. Boni & Womack, *supra* note 18, at 94, 121.

revenues in recent years for the most prominent firms on Wall Street,<sup>96</sup> the fear is that their analysts, which are amongst the most high profile, are swayed more by their investment banking audience than their brokerage audience.

### C. Analyst Compensation

Critical to understanding the impact of the brokerage and investment banking conflicts on sell-side analysts is the compensation structure for most sell-side analysts. As with many Wall Street professionals, analysts earn a base salary plus a discretionary year-end bonus. On Wall Street, year-end bonuses make up a substantial percentage of an employee's annual compensation, including for sell-side analysts. During the late 1990s and the year 2000, it was not uncommon for bonuses to constitute fifty percent or more of an employee's annual compensation.<sup>97</sup> As a result, employees can be very motivated to satisfy whatever criteria will allow them to maximize their year-end bonuses.

For sell-side analysts, the most important criteria in determining their year-end bonuses have traditionally been: (1) the analyst's perceived reputation with investors; and (2) the analyst's ability to generate investment-banking fees for the firm.<sup>98</sup> An analyst's perceived reputation with investors is often measured, at least in part, by the analyst's ranking in the *Institutional Investor All-American Research Team Poll* ("II Ranking"). II Rankings measure how well analysts are regarded by institutional investors by polling investors about analysts' performance in a number of categories including: (1) industry knowledge; (2) company visits and conferences; (3) financial models; (4) written reports; (5) earnings estimates; (6) useful and timely calls and visits; and (7) stock picking.<sup>99</sup> The II Rankings are used as a proxy for determining whether an analyst's research has generated brokerage commissions by motivating investors to trade securities through the analyst's firm.<sup>100</sup> Of note in considering how analysts are incentivized, while the forecasting and stock picking capabilities of sell-side analysts are considered in the II Rank-

---

96. In 1999, major firms generated \$24.6 billion in investment banking fees compared to \$9.5 billion in brokerage commissions. Carolyn Sargent, *The 2000 All-American Research Team*, INSTITUTIONAL INVESTOR, Oct. 2000, at 72.

97. A typical compensation structure at a top-tier investment bank would be as follows: all Vice Presidents earn a base salary of \$125,000 per year, all Principals (i.e., Senior Vice Presidents) earn a base salary of \$150,000 per year, and all Managing Directors earn a base salary of \$200,000. The remainder of the employees' compensation comes from a year-end discretionary bonus. Therefore, a research analyst who is a Principal earning \$750,000 per year, generates eighty percent of annual compensation from the bonus. A Managing Director who earns \$1,500,000 per year generates 86.6 percent from the bonus.

98. See Fernandez, *supra* note 28, at 659-60.

99. Sargent, *supra* note 96, at 62.

100. Institutional investors who are pleased with the research they receive from a sell-side analyst are more likely to send trading volume to that analyst's firm. It is an informal way for the institutional investor to pay for the research.

ings, they do not weigh heavily in determining the final rankings.<sup>101</sup> It is not unusual for the top II Ranked sell-side analysts to receive very mediocre stock picking and earnings forecasts ratings.<sup>102</sup>

The other major factor in analysts compensation has been their ability to generate investment-banking fees.<sup>103</sup> During the late 1990s and 2000, it was well understood by sell-side analysts that the highest paid analysts would be those who could generate significant investment banking revenues.<sup>104</sup>

#### D. Equity Stakes

Over the last twenty years, it has become increasingly common for sell-side analysts, their firms, and other investment bank employees to own significant equity stakes in companies that are covered by the analyst.<sup>105</sup> The practice gained substantial notoriety in the late 1970s and 1980s, when Drexel Burnham Lambert employed it.<sup>106</sup> Specifically, Michael Milken (the now-infamous junk bond king) would establish investment partnerships for his key employees to purchase securities (often high yield bonds) of the firm's clients.<sup>107</sup> Many of these investment partnerships turned out to be extremely profitable, and their returns allowed Drexel to provide very lucrative employee compensation packages and thereby attract top-level personnel.<sup>108</sup>

The practice increased with the Internet boom of the late 1990s, when access to private equity deals became a significant source of profits for brokerage firms and their employees, including sell-side analysts.<sup>109</sup> A July 2000 *Wall Street Journal* report examined in detail Wall Street's practice of investing in pre-IPO companies in the late 1990s.<sup>110</sup> The report pointed out that venture investing had become an important part of

101. Sargent, *supra* note 96, at 62. A survey conducted in 2000 by Institutional Investor, which publishes the II Rankings, "asked voters for the All-America Research Team to rate ten attributes in order of importance in assessing the worth of an analyst or his firm . . ." *Id.* Stock picking and earnings estimates were ranked the seventh and fifth most important attributes, respectively. *Id.*

102. Thor Valdmanis, *Some Widely Touted Analysts Didn't Perform So Well*, USA TODAY, Nov. 27, 2002, available at <http://www.usatoday.com> (archival copy available for a fee) (on file with author).

103. See Fernandez, *supra* note 28, at 659-60. See generally Unger Written Testimony, *supra* note 47.

104. See Fernandez, *supra* note 28, at 659-60. See generally Unger Written Testimony, *supra* note 47.

105. See Gretchen Morgenson, *Buy, They Say. But What Do They Do?*, N.Y. TIMES, May 27, 2001, 3-1 [hereinafter Morgenson, *Buy, They Say*].

106. *Id.*

107. See CONNIE BRUCK, THE PREDATORS' BALL 80-83, 282 (1988); Morgenson, *Buy, They Say*, *supra* note 105.

108. See generally BRUCK, *supra* note 107.

109. Mark Maremont, *Raising the Stakes: As Wall Street Seeks Pre-IPO Investments, Conflicts May Arise*, WALL ST. J., July 24, 2000, at A1; see Morgenson, *Buy, They Say*, *supra* note 105.

110. Maremont, *supra* note 109.



the economics for the largest investment banks.<sup>111</sup> Profits from pre-IPO investments were by no means limited to the investment banks. The firms' senior management, investment bankers, and research analysts were also able to reap substantial profits from this practice.<sup>112</sup> It was not unheard of for employees to generate multiple hundred-thousand dollar gains on their pre-IPO investments.<sup>113</sup> In 2001, a study conducted by the SEC confirmed the practice of analysts investing in pre-IPO companies.<sup>114</sup> The study found that "16 of 57 analysts reviewed" made pre-IPO investments "in a company they later covered."<sup>115</sup>

With the ability of profits from pre-IPO investments to dwarf traditional investment banking fees on occasion,<sup>116</sup> and the personal stakes in these companies held by bank employees (including research analysts), many firms focused substantial resources on pre-IPO companies. The basic model was: (1) find a young, promising pre-IPO company; (2) in-

111. *Id.* Specifically, the report stated that:

Between 13% and 18% of Goldman's net income [in 1999] came from "private equity" gains, primarily venture-style technology investments, compared with 4% to 5% in 1998, according to Salomon Smith Barney analyst Guy Moszkowski. At Lehman Brothers Holdings Inc., he says, such gains jumped to between 17% and 22% in [the] first quarter [of 2000], from about 4% of net income for [1999]; much of the increase came from a huge windfall in VerticalNet Inc., a provider of online business-to-business trading sites that Lehman invested in and then took public.

*Id.* The report also included a number of specific examples of pre-IPO investments that generated astronomical returns, such as:

	<u>COMPANY BANK INVESTED IN</u>	<u>PRE-IPO STAKE</u>	<u>STOCK REGISTERED FOR SALE*</u>	<u>BANK'S RECOM- MENDATION AT THE TIME</u>
Morgan Stanley Dean Witter	Vignette Corp.	\$1.5 million	\$41 million**	Outperform
Chase H&Q	Infospace	\$2 million	\$69 million***	Buy
Lehman Brothers	VerticalNet	\$2 million	\$238 million	Buy
FleetBoston****	Internet Capital Group	\$4 million	\$137 million	Buy/Strong Buy

\*Approximate value of shares that bank registered to sell, or sold.

\*\*Represents half of stake sold; other half worth currently worth [sic] about \$26 million.

\*\*\*Includes shares registered by H&Q, an H&Q employee fund and an H&Q limited partnership.

\*\*\*\*Shares owned by BancBoston Investments unit; ratings by Robertson Stephens.

*Id.*

112. Employee investments were typically made through employee venture pools that were established by the investment banks, but were also made on occasion through individual investments. While these investments were often very lucrative, they could also result in substantial losses—in particular for employees who made pre-IPO investments in 2000.

113. See generally Morgenson, *Buy, They Say*, *supra* note 105.

114. Unger Written Testimony, *supra* note 47.

115. *Id.*; see also Laura S. Unger, Oral Testimony Concerning Conflicts of Interest Faced by Brokerage Firms and Their Research Analysts, Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives (July 31, 2001), available at <http://www.sec.gov/news/testimony/073101ortslu.htm> (last visited Sept. 21, 2003) [hereinafter Unger Oral Testimony].

116. Classic examples include Goldman Sachs' \$36 million pre-IPO investment in StorageNetworks Inc., which was valued at approximately \$1.6 billion in July 2000, Maremount, *supra* note 109, and CIBC Oppenheimer's \$30 million pre-IPO investment in Global Crossing Ltd., which was valued at approximately \$4.6 billion in March 1999, COLE, *supra* note 4, at 58.

vest in the company; (3) take the company public; and (4) shortly thereafter, sell the holdings in the newly public company for a substantial profit. Because investment banks can play an important role in determining whether or not a private company is ready to go public, there is concern that in the late 1990s the investment banks failed in this gate-keeping role because the banks and their employees (including research analysts) were more motivated to liquidate their investments in pre-IPO companies than they were in bringing quality companies to public investors.<sup>117</sup>

In addition, two interrelated problems regarding sell-side analysts' ratings and pre-IPO investments have recently come to light: (1) research analysts issuing "buy" or "strong buy" ratings on a stock while the analyst, the analyst's firm, and the firm's employees, were selling the stock; and (2) "booster shots."<sup>118</sup> After making pre-IPO investments, the analyst, the investment bank, and the other employees who invested, typically look for an opportunity to sell these shares for a profit. A common liquidity event in the late 1990s for such a pre-IPO investment was to sell the shares in the open market after an IPO. Once the IPO has taken place, there is a public market for the securities, which makes sales substantially easier, and often at a price substantially above the pre-IPO price. These sales could begin six months after the IPO takes place, following expiration of the customary lock-up agreements.<sup>119</sup> It was not uncommon for the analyst, the analyst's firm, and the employees of the firm, to sell most or all of their shares within days or weeks after the expiration of the lock-ups. While these sales were taking place, the analyst's rating on the stock would often be a "buy" or a "strong buy."<sup>120</sup> A number of non-manipulative reasons can be given for this practice, including: (1) a different investment discipline for private equity investing, where it is not uncommon to formulaically liquidate private equity investments once a company has gone public, irrespective of the possible upside; and (2) the need for individual employees to make personal financial decisions regardless of the current rating.<sup>121</sup> Nevertheless, the whole process lends to the perception of a severe conflict and has generated substantial criticism.

---

117. See generally COLE, *supra* note 4, at 58.

118. Unger Written Testimony, *supra* note 47; see also Unger Oral Testimony, *supra* note 115. For an explanation of "booster shots," see *infra* notes 123-25 and accompanying text.

119. Underwriters for an IPO will typically require all of the major shareholders, employees of the company, or any other "interested-party" shareholders, to enter into "lock-ups" that restrict such shareholders from selling any of their shares of the company for at least six months from the date of the IPO.

120. See Morgenson, *Buy, They Say*, *supra* note 105; see also Maremount, *supra* note 109. Investment banks cited as having conducted this practice included Chase H&Q (since merged into J.P. Morgan Securities), CS First Boston, Goldman Sachs, Lehman Brothers, Morgan Stanley, and Robertson Stephens. See Morgenson, *Buy, They Say*, *supra* note 105.

121. See Morgenson, *Buy, They Say*, *supra* note 105.

The question has also been raised whether some research analysts issued “booster-shot” research reports.<sup>122</sup> A booster-shot is a favorable research report that is issued shortly before the expiration of the lock-ups, with the purpose of running up the price of the stock, so that insiders can sell into a more favorable market once the lock-ups are lifted.<sup>123</sup> Insiders that can benefit from this practice include the analyst, the investment bank, and the investment bank’s employees (as noted above), as well as venture capital investors in the company. It should be noted that venture capital firms can play a very significant role in the appointment of an investment bank as the underwriter or financial advisor for a deal.<sup>124</sup> In 2001, a study conducted by the SEC found that “in 26 of 97 lock-ups reviewed, research analysts may have issued ‘booster shot’ reports.”<sup>125</sup>

### *E. Pressure from Covered Companies*

It may be the least publicized of the conflicts, but pressure on analysts by covered companies is by no means a minor matter. Research analysts depend upon access to the management of the companies they cover for a substantial portion of the information they use to generate their analysis.<sup>126</sup> If the company’s management is upset with an analyst over unfavorable research coverage, that analyst may be “shut out of mailings, meetings, conference calls and gatherings of the [company] . . . .”<sup>127</sup> A recent survey by Reuters Institutional Investor Survey Group found that analysts “express strong concern over punitive corporate reactions to any negative commentary.”<sup>128</sup> In response to this conflict, and separate from what this Article refers to as the Regulatory Actions, the SEC has requested the NASD and the NYSE to consider drafting new

---

122. Unger Written Testimony, *supra* note 47; Unger Oral Testimony, *supra* note 115.

123. See NASAA Comment Letter to the SEC Secretary Johnathan Katz Regarding SEC Release 34-45526 on Research Analysts Conflicts of Interest (April 18, 2002), available at [http://www.nasaa.org/nasaa/scripts/fu\\_display\\_list.asp?ptid=15](http://www.nasaa.org/nasaa/scripts/fu_display_list.asp?ptid=15) (last visited Nov. 3, 2003). Insiders also benefit if the research report is able to increase trading volume since the insiders will typically be owners of restricted stock, which can only be sold in limited volume increments, based on a percentage of the recent trading volume. The greater the recent trading volume, the more shares that can be sold. See generally 17 C.F.R. § 230.144(e) (2003).

124. Venture capital investors will often have representatives serving on the company’s board of directors, which is ultimately responsible for appointing the underwriters for the IPO. Since the venture capital directors are typically the most experienced directors regarding the IPO process, it is not unusual for them to have the dominant voice in choosing the underwriters.

125. Unger Oral Testimony, *supra* note 115; see also Unger Written Testimony, *supra* note 47.

126. See BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* 184 (2003).

127. Michael Siconolfi, *Incredible ‘Buys’: Many Companies Press Analysts to Steer Clear of Negative Ratings—Stock Research Is Tainted as Naysayers Are Banned, Undermined and Berated—Small Investors in the Dark*, WALL ST. J., July 19, 1995, at A1.

128. REUTERS INSTITUTIONAL INVESTOR RESEARCH GROUP, *THE U.S. EQUITIES INVESTMENT REPORT* (2002).

standards to prevent companies from retaliating against analysts who issue unfavorable research.<sup>129</sup>

### III. THE NEW REGULATORY ENVIRONMENT

Historically, sell-side analysts have been a relatively lightly regulated group on Wall Street.<sup>130</sup> They are regulated by a number of diverse bodies of law, including the federal securities laws,<sup>131</sup> NASD regulations, and NYSE regulations. In general, regulations of sell-side analysts have tended toward broad principles of propriety by the analysts, rather than detailed, technical requirements. Such regulations include a prohibition against insider trading, and general anti-fraud prohibitions.<sup>132</sup> Until 2001, the major reforms regarding sell-side analysts had focused on the ability of these analysts to garner material, non-public information from company insiders, which resulted in the adoption of Regulation Fair Disclosure (“Regulation FD”) in 2000.<sup>133</sup>

In 2001, however, a very negative spotlight began to show brightly on sell-side analysts, with particular focus on their conflicts of interest:

- In spring 2001, a former Merrill Lynch investor filed a NYSE arbitration claim against Merrill Lynch and Henry Blodget (the firm’s star Internet analyst),<sup>134</sup> over Mr. Blodget’s stock recom-

129. Deborah Solomon & Robert Frank, *Stock Analysis: ‘You Don’t Like Our Stock? You Are Off the List’—SEC Sets New Front on Conflicts By Taking Aim at Companies That Retaliate Against Analysts*, WALL ST. J., June 19, 2003, at C1.

130. Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1038 (2003). Professors Fisch and Sale note that “in some respects, analysts have enjoyed preferred status under the federal securities laws. Courts carved out an analyst exception to the prohibition on the use of nonpublic information in securities trading . . . .” *Id.*

131. In particular, the Securities Act of 1933, ch. 38, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§ 77a–77aa), and the Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a–78mm).

132. Most notably due to Rule 10b-5, 17 C.F.R. § 240.10b-5 (2003).

133. 17 C.F.R. §§ 243.100 to 243.103 (2003). Regulation FD, which took effect in October 2000, is aimed at eliminating the practice of selective disclosure. Subject to certain limited exceptions, Regulation FD prohibits the former practice of company officials selectively disclosing material nonpublic information to certain research analysts (or institutional investors) prior to, or rather than, disclosing the information to the market as a whole. 17 C.F.R. § 243.100. Under Regulation FD, all investors are to have access to the same information at the same time. *Id.*

134. Mr. Blodget came to fame in late 1998 when, as an analyst at CIBC Oppenheimer, he made the now infamous call that Amazon.com’s stock, then trading at \$243 per share, would trade at \$400 per share within twelve months. The stock exceeded the \$400 per share mark within three weeks and much of the credit was given to Mr. Blodget and his call. Mr. Blodget became one of the most celebrated analysts on Wall Street and was soon hired by Merrill Lynch to head its Internet research group. Background information is helpful in understanding the boldness of Mr. Blodget’s call. At the time of the call, Amazon was one of the early Internet darlings and was trading at a very high level. Amazon had never earned a profit at the time (and was not forecasted to earn a profit for another five years), and yet at \$240 per share, the company had a market capitalization of approximately \$27 billion. A \$400-per-share price translated into a market capitalization of approximately \$45 billion. It should also be noted that only two months earlier Mr. Blodget’s price target for Amazon was \$150. See generally COLE, *supra* note 4, at 70-73.

mendation of InfoSpace, Inc. (“InfoSpace”).<sup>135</sup> The investor asserted, among other things, that Mr. Blodget provided overly optimistic projections for InfoSpace, because they would boost Merrill Lynch’s investment banking business, and consequently Mr. Blodget’s compensation.<sup>136</sup> Merrill Lynch defended Mr. Blodget’s research, but ended up settling with the investor for a reported \$400,000.<sup>137</sup>

- During the spring and summer of 2001, the SEC “conducted on-site examinations of full-service” brokerage firms, focusing on the conflicts of interest of sell-side analysts.<sup>138</sup>
- In early summer 2001, largely in response to the Merrill Lynch/Henry Blodget NYSE arbitration, the Office of the Attorney General of the State of New York, led by Eliot Spitzer, commenced an investigation into stock recommendations issued by research analysts at Merrill Lynch.<sup>139</sup> The investigation focused on stocks covered by the Internet research analysts at Merrill Lynch, including most notably Mr. Blodget.<sup>140</sup>
- On July 13, 2001, the SEC issued an *Investor Alert* on research analysts, which warned investors of the substantial conflicts of interest under which analysts operate.<sup>141</sup>
- During the summer of 2001, the U.S. House of Representatives Financial Services Committee’s Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises held hearings on research analysts.<sup>142</sup> Most notably, on July 31, 2001, Laura S. Unger, Acting Chair of the U.S. Securities and Exchange Commission, testified before the subcommittee on the results of

---

135. Charles Gasparino, *Deals & Deal Makers: All-Star Analyst Faces Arbitration After Internet Picks Hit the Skids*, WALL ST. J., Mar. 2, 2001, at C18.

136. *Id.* Specifically, Merrill Lynch was acting as financial advisor to Go2Net, Inc., another Internet company, which was in the process of being acquired by InfoSpace. *Id.* Merrill Lynch’s fee for its financial advisor work was contingent upon the acquisition closing and a decrease in the stock price of InfoSpace would have jeopardized the acquisition. *Id.* As a result, Mr. Blodget may have been motivated to issue overly positive research on InfoSpace, or, in the alternative, refrain from issuing negative research.

137. Charles Gasparino, *Merrill Is Paying in Wake of Analyst’s Call on Tech Stock*, WALL ST. J., July 20, 2001, at C1.

138. Unger Written Testimony, *supra* note 47; *see also* Unger Oral Testimony, *supra* note 115.

139. Affidavit of Eric Dinallo, Assistant Attorney General of the State of New York, in Support of Application for an Order Pursuant to General Business Law § 354, at 2, *available at* <http://www.oag.state.ny.us/press/2002/apr/MerrillL.pdf> (last visited Nov. 3, 2003) [hereinafter Dinallo Affidavit]. The Dinallo Affidavit is often incorrectly referred to in the media as being the affidavit of Eliot Spitzer.

140. *Id.* at 2.

141. *Analyzing Analyst Recommendations*, *supra* note 1.

142. *See* Unger Oral Testimony, *supra* note 115.

the on-site SEC examinations, which found many of the conflicts cited in Part II of this Article.<sup>143</sup>

- Through the summer of 2001, the financial press began to focus substantial criticism on research analysts due to their perceived influence on the now collapsed stock market bubble, and numerous lawsuits were filed against Wall Street's research analysts and their investment banks.<sup>144</sup>

In response to this mounting pressure, a number of prominent investment banks unilaterally adopted new internal policies to curb the perceived impact of conflicts of interest, including Goldman Sachs requiring that its analysts disclose "their ownership in companies they cover," and Merrill Lynch and CS First Boston banning their "analysts from buying shares of companies they cover."<sup>145</sup> The Securities Industry Association ("SIA") and the Association for Investment Management and Research ("AIMR"), advocacy groups for the securities industries, also jumped into the fray by publishing a best practices piece<sup>146</sup> and an issues paper<sup>147</sup> on equity research, respectively. None of these self-regulatory measures proved to be sufficient, and the regulators continued to move forward.

#### A. Overview of the Regulatory Actions

An outgrowth of all this attention on research analysts has been four major regulatory actions aimed at changing the way sell-side analysts operate: (1) Section 501 of the Sarbanes-Oxley Act,<sup>148</sup> (2) new NASD and NYSE Analyst Independence Rules; (3) the SEC's Regulation Analyst Certification; and (4) the regulatory settlement with Wall Street.

143. Unger Written Testimony, *supra* note 47. Examples of the conflicts found in the SEC examinations included: (1) the line between research and investment banking was badly blurred; (2) analysts' relationships with the companies they followed was cozy; (3) use of "'booster shot' research reports close to the expiration of lock-up periods;" and (4) stock ownership in covered companies by sell-side analysts and other employees of the brokerage firm, and a practice of those individuals selling the stock while the analyst maintained a "buy" rating. *Id.* Ms. Unger also found that firms with internal policies against some of these problems were not followed. *Id.* Finally, Ms. Unger expressed concern that firms used a variety of undefined terms to describe their investment recommendations and that such practice may be confusing to investors. *Id.*

144. Randall Smith & Jerry Markon, *Heard on the Street: Note to Suers of Analysts: Rough Road Ahead*, WALL ST. J., Aug. 3, 2001, at C1. For a discussion of the potential liability of sell-side analysts, see Jill I. Gross, *Securities Analysts' Undisclosed Conflicts of Interest: Unfair Dealing or Securities Fraud?*, 2002 COLUM. BUS. L. REV. 631 (2002).

145. Jeff D. Opdyke, *Deals & Deal Makers: Goldman Analysts Must Disclose Ownership*, WALL ST. J., Aug. 9, 2001, at C17.

146. In June 2001, the SIA "formally adopted Best Practices For Research." Securities Industry Association, Inc. (SIA), *Analysts Integrity: Background*, available at [http://www.sia.com/analyst\\_integrity](http://www.sia.com/analyst_integrity) (last visited Nov. 3, 2003).

147. On July 11, 2001, the AIMR issued a report on analyst objectivity. Press Release, The Association for Investment Management and Research (AIMR), *Global Investment Association AIMR Issues Report on Analyst Objectivity* (July 11, 2001), available at [http://www.aimr.com/pressroom/01releases/01rpt\\_objectivity.html](http://www.aimr.com/pressroom/01releases/01rpt_objectivity.html) (last visited Nov. 3, 2003).

148. Sarbanes-Oxley Act, *supra* note 8, at § 501 (codified as new § 15D of the Securities Exchange Act of 1934 at 15 U.S.C. § 78o-6 (2002)).

## 1. Section 501 of the Sarbanes-Oxley Act

The recently adopted Sarbanes-Oxley Act<sup>149</sup> includes a Section 501 (which has been codified as a new Section 15D of the Securities Exchange Act of 1934) which requires that the SEC directly, or through a registered securities association or national securities exchange (e.g., the NASD and the NYSE), adopt “rules reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances . . . .”<sup>150</sup> The rule-making required by Section 15D of the Securities Exchange Act has been accomplished by the NASD and the NYSE through their enactment of the new analyst independence rules.<sup>151</sup>

## 2. New NASD and NYSE Analyst Independence Rules

The most fundamental of the Regulatory Actions taken in response to the research analyst issue is the enactment by the NASD and the NYSE of detailed regulations that address both the activities of research analysts and their firms. On May 10, 2002, the SEC approved new rules by the NASD and the NYSE “to address conflicts of interest that are raised when research analysts recommend securities in public communications.”<sup>152</sup> The primary regulatory changes involved the NASD adopting a new Rule 2711 and the NYSE substantially amending its Rules 351

149. The Sarbanes-Oxley Act is a very broad-reaching securities and auditing reform package that was adopted by Congress in response to the many accounting and corporate scandals that rocked the U.S. capital markets in 2001 and 2002. See William S. Duffey, Jr., *Corporate Fraud and Accountability: A Primer on Sarbanes-Oxley Act of 2002*, 54 S.C. L. REV. 405, 406 (2002). The Sarbanes-Oxley Act includes Section 501 which addresses research-analyst conflicts of interest. Sarbanes-Oxley Act, *supra* note 8, at § 501.

150. Sarbanes-Oxley Act, *supra* note 8, at § 501; Securities Exchange Act of 1934, § 15D (codified at 15 U.S.C. § 78o-6 (2002)). Specifically, § 15D(a) requires that rules be adopted that are designed, among other things:

- (1) to improve public confidence in securities research, and to protect the objectivity and independence of securities analysts, by (a) restricting the prepublication clearance of research by investment bankers, (b) prohibiting investment bankers from supervising or participating in the compensatory evaluation of analysts, and (c) preventing retaliation against an analyst for writing negative research reports that could harm present or prospective investment banking relationships;
- (2) to establish appropriate blackout periods during which firms who have acted as, or are to act as, underwriters or dealers in a public offering of securities for a company may not distribute research on that company; and
- (3) to establish structural and institutional safeguards to separate research analysts from the review, pressure, or oversight of investment banking.

*Id.* Section 15D(b) requires that rules be adopted that require more detailed disclosure from firms in research reports and research analysts in public appearances regarding conflicts of interest. *Id.*

151. Press Release, Securities and Exchange Commission, *SEC Announces Approval of SRO Rules Addressing Research Analyst Conflicts of Interest* (July 29, 2003), available at <http://www.sec.gov/news/press/2003-89.htm> (last visited Nov. 4, 2003).

152. NASD and NYSE Rulemaking, 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> (last visited Nov. 4, 2003) [hereinafter SEC Release No. 34-45908]. The NYSE and the NASD are each self-regulated organizations (“SROs”) that are subject to oversight by the SEC. See *id.* These SROs are charged with developing the rules for the functioning of their organizations. See *id.* However, the SEC retains certain oversight powers over the rulemaking of the SROs. See *id.*

and 472 (collectively, the “New NASD/NYSE Analyst Regulations”). A number of amendments were subsequently proposed by the NASD and the NYSE, and eventually approved by the SEC on July 29, 2003.<sup>153</sup>

### 3. Regulation Analyst Certification

The SEC adopted Regulation Analyst Certification<sup>154</sup> (“Regulation AC”), which took effect on April 14, 2003.<sup>155</sup> Regulation AC requires that specific certifications be made in connection with research reports and public appearances.<sup>156</sup> While not directly part of the rules required by Section 501 of the Sarbanes-Oxley Act, Regulation AC addresses some of the same issues (including, most notably, its goal to promote the integrity of, and restore investor confidence in, research reports) and is meant to complement the New NASD/NYSE Analyst Regulations.<sup>157</sup>

### 4. The Regulatory Settlement with Wall Street

The \$1.4 billion global settlement with ten of the leading firms on Wall Street has been, in many ways, the driver that spurred on the accomplishment of each of the other Regulatory Actions. In June 2001, largely in response to a NYSE arbitration claim filed against Merrill Lynch and its star Internet analyst Henry Blodget,<sup>158</sup> the Office of the Attorney General of the State of New York, led by Elliot Spitzer, commenced an investigation into stock recommendations issued by the Internet research analysts at Merrill Lynch.<sup>159</sup> Largely on the basis of a massive review of Merrill Lynch’s internal e-mails,<sup>160</sup> the New York Attorney General’s office filed an affidavit in New York state court that charged Merrill Lynch with violations of the Martin Act<sup>161</sup> for issuing misleading stock ratings because:

---

153. SEC Release No. 34-48252, *supra* note 9.

154. 17 C.F.R. §§ 242.500 to 242.505 (2003).

155. Regulation AC Press Release, *supra* note 9.

156. 17 C.F.R. §§ 242.501 to 242.502.

157. Regulation AC Press Release, *supra* note 9.

158. *See supra* notes 134-37 and accompanying text.

159. Dinallo Affidavit, *supra* note 139, at 2.

160. The e-mail records purport to demonstrate: (1) the analysts’ investment-banking motivations; and (2) that Merrill Lynch’s positive public support of certain stocks was contradicted by contemporaneous private e-mail messages that showed the analysts’ true, negative feelings about the stocks. *Id.* at 10-13. The Dinallo Affidavit charged that while analysts were publishing positive ratings on certain stocks, those same analysts were describing such stocks in private as “powder keg,” “piece of junk,” “piece of crap,” and “piece of shit.” *Id.* at 12-13.

161. N.Y. GEN. BUS. LAW § 352 (McKinney 2003). Spitzer’s authority to investigate and bring charges (both criminal and civil) against Merrill Lynch stemmed from the Martin Act. *Id.*

The Martin Act proscribes a wide array of practices in connection with the sale of securities. It prohibits and makes illegal any fraud, misrepresentation, deception, concealment, promise or representation that is beyond reasonable expectation while engaged in the issuance, distribution, investment advice, sale or purchase of securities within and from the State of New York. . . . Unlike the federal securities laws, no purchase or sale of stock is required, nor are intent, reliance, or damages required elements of a violation.

Dinallo Affidavit, *supra* note 139, at 7.



(1) the ratings in many cases did not reflect the analysts' true opinions of the companies; (2) as a matter of undisclosed, internal policy, no "reduce" or "sell" recommendations were issued, thereby converting a published five-point rating scale into a de facto three-point system; and (3) Merrill Lynch failed to disclose to the public that Merrill Lynch's ratings were tarnished by an undisclosed conflict of interest: the research analysts were acting as quasi-investment bankers for the companies at issue, often initiating, continuing, and/or manipulating research coverage for the purpose of attracting and keeping investment banking clients, thereby producing misleading ratings that were neither objective nor independent, as they purported to be.<sup>162</sup>

The affidavit also charged that Merrill Lynch's compensation system, under which analysts knew their compensation would be impacted by the investment banking business they generated, was a significant factor contributing to the misleading ratings.<sup>163</sup>

As a result of Spitzer's investigation, Merrill Lynch entered into a \$100 million settlement with the New York Attorney General's office in May 2002.<sup>164</sup> Under the settlement, Merrill Lynch agreed, among other things, to pay a \$100 million penalty<sup>165</sup> and to institute a number of reforms in the way it conducts research that have been largely subsumed by the subsequent global settlement.<sup>166</sup>

In spring 2002, Spitzer broadened the investigation to include the activities of several additional financial institutions and their research analysts.<sup>167</sup> The SEC, the NASD, the NYSE, the NASAA, and other state regulators joined in on these broadened investigations, which eventually led to the April 2003 global settlement among the SEC, the New York Attorney General's Office, NASAA, the NASD, the NYSE, and the following ten investment banks (collectively, the "Ten Investment Banks").<sup>168</sup>

---

162. *Id.* at 3.

163. *Id.* at 4.

164. Agreement Between the Attorney General of the State of New York and Merrill Lynch, Pierce, Fenner & Smith, Inc. (May 21, 2002), available at [http://www.oag.state.ny.us/investors/merrill\\_agreement.pdf](http://www.oag.state.ny.us/investors/merrill_agreement.pdf) (last visited Nov. 4, 2003). While Merrill Lynch neither admitted nor denied the specific charges brought against it by the New York Attorney General's Office, it did issue a statement of contrition, whereby Merrill Lynch publicly apologized to its "clients, shareholders and employees for the inappropriate communications brought to light by the New York State Attorney General's investigation." *Id.* at Exhibit B; see also *id.* at 2-3, 11. Merrill Lynch went on to express its sincere "regret that there were instances in which certain of our Internet sector research analysts expressed views which at certain points may have appeared inconsistent with Merrill Lynch's published recommendations." *Id.* at Exhibit B.

165. The \$100 million was divided as follows: \$48 million to New York State; \$50 million to the other forty-nine states, the District of Columbia, and Puerto Rico, and \$2 million to the NASAA. *Id.* at 12.

166. See *supra* note 164; see also Final Judgments, *infra* note 168.

167. Dinallo Affidavit, *supra* note 139, at 2.

168. SEC v. Bear, Stearns & Co., No. 03 Civ. 2937 (S.D.N.Y. Apr. 28, 2003), available at <http://www.sec.gov/litigation/litreleases/judg18109.htm> (last visited Oct. 31, 2003); SEC v. Citigroup Global Mkts. Inc. *f/k/a* Salomon Smith Barney Inc., No. 03 Civ. 2945 (S.D.N.Y. Apr. 28,

1. Bear, Stearns & Co. Inc. (“Bear Stearns”);
2. Citigroup Global Markets Inc. f/k/a Salomon Smith Barney Inc. (“SSB”);
3. Credit Suisse First Boston LLC (“CSFB”);
4. Goldman, Sachs & Co. (“Goldman”);
5. J.P. Morgan Securities Inc. (“J.P. Morgan”);
6. Lehman Brothers Inc. (“Lehman”);
7. Merrill Lynch, Pierce, Fenner & Smith, Incorporated (“Merrill Lynch”);
8. Morgan Stanley & Co. Incorporated (“Morgan Stanley”);
9. UBS Warburg LLC (“UBS”); and
10. U.S. Bancorp Piper Jaffray Inc. (“Piper Jaffray”).

The collective regulators alleged that each of the ten firms “engaged in acts and practices that created or maintained inappropriate influence by investment banking over research analysts, thereby imposing conflicts of interest on research analysts that the firms failed to manage in an adequate or appropriate manner. In addition, the regulators found supervisory deficiencies at every firm.”<sup>169</sup> These violations were neither admit-

---

2003), available at <http://www.sec.gov/litigation/litreleases/judg18111.htm> (last visited Oct. 31, 2003); SEC v. Credit Suisse First Boston LLC, No. 03 Civ. 2946 (S.D.N.Y. Apr. 28, 2003), available at <http://www.sec.gov/litigation/litreleases/judg18110.htm> (last visited Oct. 31, 2003); SEC v. Goldman, Sachs & Co., No. 03 Civ. 2944 (S.D.N.Y. Apr. 28, 2003), available at <http://www.sec.gov/litigation/litreleases/judg18113.htm> (last visited Oct. 31, 2003); SEC v. J.P. Morgan Sec. Inc., No. 03 Civ. 2939 (S.D.N.Y. Apr. 28, 2003), available at <http://www.sec.gov/litigation/litreleases/judg18114.htm> (last visited Oct. 31, 2003); SEC v. Lehman Brothers Inc., No. 03 Civ. 2940 (S.D.N.Y. Apr. 28, 2003), available at <http://www.sec.gov/litigation/litreleases/judg18116.htm> (last visited Oct. 31, 2003); SEC v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. 03 Civ. 2941 (S.D.N.Y. Apr. 28, 2003), available at <http://www.sec.gov/litigation/litreleases/judg18115.htm> (last visited Oct. 31, 2003); SEC v. Morgan Stanley & Co., No. 03 Civ. 2948 (S.D.N.Y. Apr. 28, 2003), available at <http://www.sec.gov/litigation/litreleases/judg18117.htm> (last visited Oct. 31, 2003); SEC v. UBS Warburg LLC, No. 03 Civ. 2946 (S.D.N.Y. Apr. 28, 2003), available at <http://www.sec.gov/litigation/litreleases/judg18112.htm> (last visited Oct. 31, 2003); SEC v. U.S. Bancorp Piper Jaffray Inc., No. 03 Civ. 2942 (S.D.N.Y. Apr. 28, 2003), available at <http://www.sec.gov/litigation/litreleases/judg18118.htm> (last visited Oct. 31, 2003) [hereinafter, collectively, Final Judgments]. Regulators also reached individual settlements with Henry Blodget and Jack Grubman for their roles in issuing fraudulent research. Joint Press Release, Securities and Exchange Commission, National Association of Securities Dealers and New York Stock Exchange, *The Securities and Exchange Commission, NASD and the New York Stock Exchange Permanently Bar Henry Blodget From the Securities Industry and Require \$4 Million Payment* (Apr. 28, 2003), at <http://www.sec.gov/news/press/2003-56.htm> (last visited Oct. 31, 2003); Joint Press Release, Securities and Exchange Commission, New York Attorney General's Office, National Association of Securities Dealers and New York Stock Exchange, *The Securities and Exchange Commission, New York Attorney General's Office, NASD and the New York Stock Exchange Permanently Bar Jack Grubman and Require \$15 Million Payment* (Apr. 28, 2003), at <http://www.sec.gov/news/press/2003-55.htm> (last visited Oct. 31, 2003). Neither admitting nor denying the charges against them, the former star analysts agreed to be censured and permanently barred from the securities industry, and Blodget agreed to pay a \$4 million penalty while Grubman agreed to pay a \$15 million penalty. *Id.*

169. Press Release on Global Settlement, *supra* note 9.

ted nor denied by the various firms.<sup>170</sup> The regulators also charged a number of additional specific violations against certain firms.<sup>171</sup>

Taking the Merrill Lynch settlement as a beginning template, the global settlement was negotiated between the regulators and the ten investment banks.<sup>172</sup> Under the global settlement, the Ten Investment Banks agreed to pay a collective \$1.3875 billion as follows: (1) \$487.5 million in penalties (including the \$100 million that Merrill Lynch paid in its May 2002 settlement); (2) \$387.5 million in disgorgement; (3) \$432.5 million to fund independent research; and (4) \$80 million to pro-

170. *Id.*

171. *Id.* Specifically, the regulators charged that:

CSFB, Merrill Lynch and SSB issued fraudulent research reports in violation of Section 15(c) of the Securities Exchange Act of 1934 as well as various state statutes; Bear Stearns, CSFB, Goldman, Lehman, Merrill Lynch, Piper Jaffray, SSB and UBS Warburg issued research reports that were not based on principles of fair dealing and good faith and did not provide a sound basis for evaluating facts, contained exaggerated or unwarranted claims about the covered companies, and/or contained opinions for which there were no reasonable bases in violation of NYSE Rules 401, 472 and 476(a)(6), and NASD Rules 2110 and 2210 as well as state ethics statutes; [and] UBS Warburg and Piper Jaffray received payments for research without disclosing such payments in violation of Section 17(b) of the Securities Act of 1933 as well as NYSE Rules 476(a)(6), 401 and 472 and NASD Rules 2210 and 2110. Those two firms, as well as Bear Stearns, J.P. Morgan and Morgan Stanley, made undisclosed payments for research in violation of NYSE Rules 476(a)(6), 401 and 472 and NASD Rules 2210 and 2110 and state statutes . . .

*Id.* The global settlement also charged two firms (CSFB and SSB) with “spinning” of “hot” IPO allocations. *Id.* “Spinning” was a practice by which an investment bank would grant shares in a particularly hot IPO to select senior executives in exchange for investment banking business from the executives’ companies. Press Release, National Association of Securities Dealers, *NASD Charges Frank Quattrone with Spinning, Undermining Research Analyst Objectivity, Failure to Cooperate in Investigation* (Mar. 6, 2003), at [http://www.nasdr.com/news/pr2003/release\\_03\\_010.html](http://www.nasdr.com/news/pr2003/release_03_010.html) (last visited Oct. 31, 2003). At a time when the share price of a hot IPO could double, triple, or increase by even more in a single day, obtaining access to hot IPOs could net an individual multiple millions of dollars. *See id.* This Article does not address the spinning portion of the global settlement.

172. Randall Smith & Deborah Solomon, *State-Level Stock Cops Retain Power*, WALL ST. J., July 25, 2003, at C1.

mote investor education.<sup>173</sup> In addition to the monetary payments, the global settlement imposes on the Ten Investment Banks a number of significant reforms that are in addition to the requirements of the New NASD/NYSE Analyst Regulations and Regulation AC.<sup>174</sup> These requirements are applicable only to the Ten Investment Banks.<sup>175</sup> Specifically, the global settlement requires the Ten Investment Banks: (1) to make additional structural reforms to separate research from investment banking; (2) to render additional disclosures; (3) to provide independent research to their clients for a period of five years; and (4) to pay for an investor education fund.<sup>176</sup>

It does not appear that the global settlement<sup>177</sup> has ended the regulatory investigation of the sell-side analyst issue.<sup>178</sup> There is still a possibility that regulatory actions will be taken against additional firms and analysts.<sup>179</sup> Moreover, the regulators have recently signaled an intent to ex-

173. Press Release on Global Settlement, *supra* note 9. The payments by individual firm are as follows:

Firm	Penalty (\$ Millions)	Disgorgement (\$ Millions)	Independent Research (\$ Millions)	Investors Education (\$ Mil- lions)	Total (\$Millions)
Bear Stearns	25	25	25	5	80
CSFB	75	75	50	0	200
Goldman	25	25	50	10	110
J.P. Morgan	25	25	25	5	80
Lehman	25	25	25	5	80
Merrill Lynch	100*	0	75	25	200
Morgan Stanley	25	25	75	0	125
Piper Jaffray	12.5	12.5	7.5	0	32.5
SSB	150	150	75	25	400
UBS	25	25	25	5	80
<b>Total (\$ Millions)</b>	<b>487.5</b>	<b>387.5</b>	<b>432.5</b>	<b>80</b>	<b>\$1,387.5</b>

\*Payment made in prior settlement of research analyst conflicts of interest with the states securities regulators.

*Id.* Of the \$875 million of penalties and disgorgement, \$100 million was previously paid by Merrill Lynch in its May 2002 settlement and was apportioned at that time. *See supra* note 165 and accompanying text. The remaining \$775 million is to be paid by the firms other than Merrill Lynch, and one-half of this amount will be placed into "Distribution Funds" to benefit customers of the firms. *See Securities and Exchange Commission, SEC Fact Sheet on Global Analyst Research Settlements*, at <http://www.sec.gov/news/speech/factsheet.htm> (last visited Oct. 31, 2003) [hereinafter *SEC Fact Sheet*]. The remaining \$387.5 million will be paid to the states. *Id.* A court-appointed and SEC-recommended Distribution Fund Administrator, will administer the Distribution funds. *Id.* "The Distribution Fund Administrator will formulate a plan to distribute the funds in an equitable, cost-effective manner to customers who purchased the equity securities of companies referenced in the complaint against the firm through which the customer bought the securities." *Id.*

174. *See* Press Release on Global Settlement, *supra* note 9.

175. *Id.*

176. *Id.*

177. Including the individual settlements with Blodget and Grubman. *See supra* note 168.

178. *See* Susanne Craig & Randall Smith, *Stock Analysis: A New Probe Targets Bosses On Wall Street—Regulators Are Facing Pressure to Pursue Executive Wrongdoing In Stock-Research Investigations*, WALL ST. J., June 3, 2003, at C1.

179. *Id.*

pand the scope of their research analyst inquiry to include “research executives, investment bankers and chief executive officers” of a number of major Wall Street firms.<sup>180</sup> This expanded inquiry has been reported as focusing on high ranking individuals and their role in influencing the production of tainted research.<sup>181</sup>

### *B. Fundamental Changes Sought by the Regulatory Actions*

Taken as a whole, the Regulatory Actions seek to make five fundamental changes to the way that sell-side research is conducted (in addition to the punishment function of the global settlement):<sup>182</sup> (1) clearly separate sell-side research from investment banking; (2) restrict personal trading of analysts in the companies they cover; (3) require analysts to certify their research; (4) increase disclosure requirements for research; and (5) require certain firms to provide independent research to their clients.

#### 1. Clearly Separate Sell-Side Research from Investment Banking

By far the most publicized function of the Regulatory Actions has been its goal to clearly separate sell-side research from the influences of investment banking. This separation is to be achieved primarily by reinforcing the Chinese Wall that separates research from investment banking and by implementing rules that prevent firms from promising favorable research in exchange for investment banking fees.

##### a. Reinforce the Chinese Wall that separates research from investment banking

Traditionally, the term “Chinese Wall” has been used to describe the internal procedures that an investment bank must establish to prevent its investment bankers from sharing material, non-public information about the firm’s publicly-traded investment banking clients with other departments within the firm (e.g., the firm’s sales and trading department and research department), in order to prevent insider trading.<sup>183</sup> The term

180. *Id.* According to the Wall Street Journal, the SEC, NASD, and NYSE sent out in late May 2003 information requests (including a request to review e-mails) to “more than 50 research executives, investment bankers and chief executive officers” of major Wall Street firms. *Id.* The Wall Street Journal reported that the following Wall Street CEOs received the request: Sanford Wiell (Citigroup), Philip Purcell (Morgan Stanley), Richard Fuld (Lehman Brothers), Henry Paulson Jr. (Goldman), Allen Wheat (former CEO of CSFB), and David Komansky (former CEO of Merrill Lynch). *Id.*

181. *Id.*

182. See Press Release on Global Settlement, *supra* note 9.

183. See Dinallo Affidavit, *supra* note 139, at 14.

The concept of Chinese Walls originated in the late 1960’s when Merrill Lynch misused material, nonpublic information that it obtained in its role of underwriter for McDonnell Douglas Corp. debentures. Learning that the company would report significantly lower earnings than Merrill Lynch had publicly predicted, Merrill Lynch personnel continued to promote the stock’s acquisition, while selectively disclosing the negative earnings information to certain institutional investors, who were able to sell their holdings prior to the

has since been used in a broader sense to refer to structural or procedural barriers that are used to “prevent investment bankers from influencing” the research of “existing or potential investment banking clients.”<sup>184</sup> The New NASD/NYSE Regulations aim to reinforce the Chinese Wall between research and investment banking by removing investment banking’s influence over the contents of research reports and analysts’ compensation. The new regulations attempt to limit structural influences that investment bankers may have over research analysts, including:

- Research analysts may not be subject to the supervision of, or control by, their firms’ investment banking department or its personnel. Additionally, investment banking personnel may not have any influence or control over the compensation of research analysts.<sup>185</sup>
- Investment banking personnel, and other non-research personnel,<sup>186</sup> may not review a pending research report (or even discuss the report with the analyst),<sup>187</sup> subject to limited exceptions.<sup>188</sup> On

public announcement [and thereby avoid a considerable loss]. The SEC took the position that the parties privy to material, adverse, and non-public corporate information known to emanate from a corporate source had gained an unfair, competitive advantage. It initiated administrative proceedings for violation of Rule 10b-5 [17 C.F.R. § 240.10b-5] promulgated under the Securities Exchange Act of 1934. Merrill Lynch settled the matter by consenting to a sanction and by adopting a policy prohibiting communication of material, nonpublic information attained by the investment banking department to other departments. This policy, which was sanctioned by the SEC, represents the original Chinese Wall.

Christine M. Bac & Carlton R. Asher, Jr., *Chinese Walls—Procedures and Remedies for Dealing With Conflicts of Interest and Other Abuses by Broker-Dealers in Connection With Conduct by Their Securities Analysts*, in *SECURITIES ARBITRATION 2002: TAKING CONTROL OF THE PROCESS* 128-29 (PLI Corp. Law & Practice Course Handbook Series No. B0-01A6, 2002).

184. See Dinallo Affidavit, *supra* note 139, at 14.

185. NASD Rule 2711(b)(1); NYSE Rule 472(b)(1). The provisions of NASD Rule 2711(b)(1) and NYSE Rule 472(b)(1) do not apply, however, to firms that over the previous three years, on average per year, have participated in ten or fewer investment banking services transactions as manager or co-manager and generated \$5 million or less in gross investment banking services revenues from those transactions. NASD Rule 2711(k); NYSE Rule 472(m). However, firms qualifying for this “Small Firm Exemption” must maintain records for three years of any communication that, but for the Small Firm Exemption, would have been subject to NASD Rule 2711(b)(1) or NYSE Rule 472(b)(1). *Id.*

186. Non-research personnel refers to any employee of the firm who is not directly responsible for investment research other than legal or compliance personnel. NASD Rule 2711(b)(2); NYSE Rule 472(b)(2).

187. NASD Rule 2711(b)(2); NYSE Rule 472(b)(2). For a discussion of the definition of what constitutes a research report for purposes of NASD and NYSE rules, see *infra* notes 271-72 and accompanying text.

188. NASD Rule 2711(b)(3); NYSE Rule 472(b)(3). Investment banking personnel may only review a pending research report to verify the accuracy of information, or to review the report for any potential conflict of interest, and only if the firm’s legal or compliance department serves as the intermediary. NASD Rule 2711(b)(3)(A); NYSE Rule 472(b)(3)(i). This intermediary role may be satisfied by passing all documents through the legal or compliance department or by copying them on the documents. *Id.* If the “fact checking” is done orally, it must be documented and it must be done either through the firm’s legal or compliance department or in their presence. NASD Rule 2711(b)(3)(B); NYSE Rule 472(b)(3)(ii). The provisions of NASD Rules 2711(b)(2), (3) and NYSE Rules 472(b)(2), (3) do not apply to firms that qualify for the Small Firm Exemption. NASD Rule 2711(k); NYSE Rule 472(m). However, firms that qualify for the Small Firm Exemption must

a similar note, a research analyst may not, subject to specific exceptions, provide a draft research report to the subject company prior to publication.<sup>189</sup>

- An analyst's compensation may not be tied to "specific" investment banking transactions.<sup>190</sup> More specifically, firms must establish committees (which must report to the firm's board of directors and may not include representatives from investment banking) to annually review and document research analyst compensation.<sup>191</sup> The compensation review committee must consider the following factors, if applicable, when reviewing an analyst's compensation: (1) the analyst's individual performance (e.g., quality of research and productivity); (2) the correlation between the research analyst's recommendations and stock price performance; and (3) the overall ratings of the analyst from clients, sales force, independent rating agencies, and peers (but not from investment banking).<sup>192</sup> The compensation review committee may not consider as a factor the analyst's individual contributions to the investment banking business.<sup>193</sup> However, the new rules do permit analysts' compensation to be influenced by the firm's overall investment banking revenues, so long as that fact is disclosed in the research reports.<sup>194</sup>
- Research analysts are prohibited from participating in efforts to solicit investment banking business.<sup>195</sup> Accordingly, analysts are

---

maintain records for three years of any communication that, but for the Small Firm Exemption, would have been subject to NASD Rules 2711(b)(2), (3) or NYSE Rules 472(b)(2), (3). *Id.*

189. NASD Rules 2711(c)(1), (2); NYSE Rule 472(b)(4). A draft research report may only be provided to the subject company to verify the accuracy of information in the report and only if: (1) a complete draft of the report is submitted to the firm's legal or compliance department prior to sending it to the subject company; (2) the draft report actually sent to the subject company excludes the research summary, the research rating, and the price target; (3) after submission of the draft report to the subject company, the analyst is subject to additional procedures should she wish to change her proposed rating or price target; and (4) the firm may not inform a subject company of a proposed rating change until after the close of trading in the principal market of the subject company one business day prior to the announcement of the change. NASD Rules 2711(c)(2), (3); NYSE Rule 472(b)(4). It should be noted that the Small Firm Exemption does not apply to NASD Rule 2711(c) nor to NYSE Rule 472(b)(4). *See* NASD Rule 2711(k); NYSE Rule 472(m).

190. NASD Rule 2711(d)(1); NYSE Rule 472(h)(1).

191. NASD Rule 2711(d)(2); NYSE Rule 472(h)(2). While the New NASD/NYSE Regulations prohibit investment banking personnel from influencing analyst compensation decisions and require compensation review committees to review and approve analyst compensation, the new regulations do not indicate who is responsible in the firm for determining analyst compensation. *See infra* note 200 and accompanying text; *see also* SEC Release No. 34-48252, *supra* note 9.

192. NASD Rule 2711(d)(2); NYSE Rule 472(h)(2).

193. *Id.*

194. NASD Rule 2711(h)(2)(A)(i)(a); NYSE Rules 472(h)(1), (k)(1)(ii)(a)(2).

195. NASD Rule 2711(c)(4); NYSE Rule 472(b)(5). The prohibition does not apply to communications between the research analyst and the subject company that are solely for the purpose of due diligence. *Id.*

prohibited from, among other things, participating in “pitches” for prospective investment banking assignments.<sup>196</sup>

In addition to the New NASD/NYSE Analysts Regulations, the global settlement requires each of the ten investment banks to institute a number of additional structural reforms that are meant to strengthen the Chinese Wall.<sup>197</sup> While many of the reforms required by the global settlement have been superceded by the New NASD/NYSE Analyst Regulations, there are still a number of additional reforms. Highlights of these additional reforms include:

- Analysts are prohibited from participating in “roadshows” or other marketing or selling efforts in connection with investment banking transactions.<sup>198</sup>
- Each firm will create an oversight committee made up of research management (and may include others, but not personnel from investment banking) to monitor, among other things, the overall quality and accuracy of the firm’s research.<sup>199</sup>
- Compensation of analysts will be determined solely by the management of the research group and the firm’s senior management.<sup>200</sup> The firms also agreed to a number of principles that will guide analyst compensation, including: (1) analyst compensation may not be based directly or indirectly on investment banking revenues or results (provided that compensation may “relate to the revenues or results of the firm as a whole”) or on input from investment banking personnel; (2) a significant portion of an analyst’s compensation must be based on the quality and accuracy of the analyst’s research; and (3) analyst compensation criteria must be set forth in writing, and management will document each compensation decision for analysts subject to Regulation AC and for research management.<sup>201</sup> Finally, investment bankers cannot evaluate analysts.<sup>202</sup>

196. *Id.*

197. Final Judgments, *supra* note 168.

198. Addendum A to the Final Judgments, at §§ I.11.a, b [hereinafter Addendum A]; *see* Final Judgments, *supra* note 168. The “road show” is the issuer’s marketing trip to investors in a securities offering, and is typically organized by the issuer’s underwriters. *See supra* note 79 and accompanying text. Notably, within days after the announcement of the global settlement, Bear Stearns was soundly criticized for allowing one of its research analysts to promote the stock of an IPO candidate, iPayment, during a roadshow. *See* Ann Davis, *Bear Stearns Used Analysts to Tout IPO Despite Pact With Regulators*, WALL ST. J., May 12, 2003, at A1. Although the global settlement technically had not yet taken effect, Bear Stearns reacted by delaying the iPayment IPO and barring the analyst from covering iPayment. *Id.*

199. Addendum A, *supra* note 198, at § I.12.

200. *Id.* at I.5. Unlike the New NASD/NYSE Analyst Regulations, the global settlement specifies who is to determine the compensation for analysts. *Id.*

201. *Id.*

202. *Id.* at § I.6.



- Research must have its own dedicated legal and compliance staff, although such legal and compliance personnel may be a part of the firm's overall compliance/legal infrastructure.<sup>203</sup>
- Research's budget (and the allocation of research expenses) shall be determined "without input from Investment Banking and without regard to specific revenues or results derived from Investment Banking, though revenues and results of the firm as a whole may be considered . . . ."<sup>204</sup>
- Investment bankers will have no input into company-specific coverage decisions, including whether or not to initiate or terminate coverage for a specific company.<sup>205</sup> With certain exceptions, potential investment banking revenues may not be taken into account when making company-specific coverage decisions.<sup>206</sup>

b. Prevent promises of favorable research coverage

As a further measure to separate research from investment banking's influence, the New NASD/NYSE Analyst Regulations attempt to prevent the practice of trading research for investment banking fees.

- A firm may not offer favorable research, a specific rating or a specific price target to a company, or threaten to change research, a rating or a price target, as consideration or inducement for the receipt of business or compensation.<sup>207</sup>
- A firm may not (nor may any employee involved with its investment banking activities) retaliate against or threaten to retaliate against any research analyst for an adverse, negative, or otherwise unfavorable research report or public appearance written or made by the research analyst that may adversely affect the firm's present or prospective investment banking relationship with the company that is the subject of the research.<sup>208</sup>
- The new regulations impose "quiet periods" during which, subject to certain limited exceptions,<sup>209</sup> firms may not issue research reports on a company, and research analysts may not recommend or offer an opinion on the company's securities. If the firm acted as

---

203. *Id.* at § I.2.

204. *Id.* at § I.3.

205. *Id.* at § I.7.

206. *Id.*

207. NASD Rule 2711(e); NYSE Rule 472(g)(1).

208. NASD Rule 2711(j); NYSE Rule 472(g)(2).

209. Subject to federal securities laws and regulations, firms may permit the issuance of research reports and the provision of recommendations and opinions by a research analyst if such actions are due to significant news or events, provided that such research reports are pre-approved in writing by the firm's legal or compliance personnel. NASD Rule 2711(f)(1)(B)(i); NYSE Rule 472(f)(5).

manager or co-manager on an IPO for the company, the quiet period will extend for forty calendar days following the date of the offering.<sup>210</sup> Also, if the firm acted as manager or co-manager on a secondary offering for the company, the quiet period will extend for ten calendar days following the date of the offering of an inactively traded security.<sup>211</sup> If the firm acts as an underwriter (other than as manager or co-manager) or dealer on an IPO, the quiet period for that firm will be twenty-five calendar days after the date of the offering.<sup>212</sup>

## 2. Restrict Personal Trading of Analysts in the Companies They Cover

In order to address conflicts of interest between an analyst and her personal trading, the New NASD/NYSE Analyst Regulations provide a number of restrictions on personal trading by analysts and their “household members.”<sup>213</sup> Subject to certain limited exceptions,<sup>214</sup> no research analyst (or household member) may:

- Purchase or receive an issuer’s securities prior to its initial public offering (i.e., no pre-IPO shares) if the issuer is principally engaged in the same types of business as companies covered by the analyst.<sup>215</sup>
- Trade in the securities (or derivatives of such securities) of a company she covers for thirty calendar days prior to and five calendar after she issues a research report on the company or changes a rating or price target for the company.<sup>216</sup>

210. NASD Rule 2711(f)(1)(A); NYSE Rule 472(f)(1). The “date of the offering” is defined under the New NASD/NYSE Analyst Regulations as the later of the effective date of the registration statement or the first date on which the security was bona fide offered to the public. NASD Rule 2711(f)(3); NYSE Rule 472.120.

211. NASD Rule 2711(f)(1)(B); NYSE Rule 472(f)(2). An “inactively traded” security is one that does not qualify as actively traded under Rule 101(c)(1) of the Securities Exchange Act of 1934. *See* 17 C.F.R. § 242.101(c)(1) (2003). Rule 101 of the Securities Exchange Act is commonly referred to as being part of Regulation M. *See id.*

212. NASD Rule 2711(f)(2); NYSE Rule 472(f)(3).

213. A “household member” is defined as any individual whose principal residence is the same as the research analyst’s principal residence. NASD Rule 2711(a)(3); NYSE Rule 472.40.

214. Exceptions include transactions that are pre-approved in writing by the firm’s legal or compliance department due to unanticipated significant changes in the research analyst’s (or household member’s) personal financial circumstances and transactions in accounts not controlled by the research analyst (or household member). NASD Rules 2711(g)(4), (5); NYSE Rule 472(e)(4). However, each exception granted must be in compliance with policies and procedures adopted by the firm that are reasonably designed to ensure that transactions effected pursuant to these exceptions do not create a conflict of interest. NYSE Rule 472(e)(4); *see also* NASD Rule 2711(g)(4)(B), which requires the extra policies and procedures for only certain of the possible exceptions. Excepted transactions are also subject to additional record keeping requirements. *See* NASD Rule 2711(g)(4)(C); NYSE Rule 472(e)(6).

215. NASD Rule 2711(g)(1); NYSE Rule 472(e)(1).

216. NASD Rule 2711(g)(2); NYSE Rule 472(e)(2).

- Effect a trade contrary to the research analyst's most current recommendation (e.g., if the research analyst has a "buy" rating on a stock, she cannot sell the stock).<sup>217</sup>

In addition, research supervisory personnel (e.g. research directors), supervisory analysts,<sup>218</sup> and others who have direct influence or control in the preparation of research reports and the establishment or change in ratings or price targets may not effect trades in securities of companies that are the subject of such research reports, ratings, or price target changes without the prior approval of the firm's legal or compliance personnel.<sup>219</sup>

On a related note, the New NASD/NYSE Analyst Regulations prohibit the issuance of "booster shot" reports.<sup>220</sup> Specifically, the manager or co-manager of a securities offering may not issue a research report (nor make a public appearance) regarding an inactively traded security within fifteen days before or after the expiration, waiver, or termination of a lock-up agreement.<sup>221</sup> This thirty-day blackout period is meant to "mitigate and/or eliminate the incentive for" a sell-side analyst "to issue positive research reports" to "boost" the price of the stock while large and influential investors (or employees of the analyst's firm) may be trying to exit their positions from the company.<sup>222</sup>

### 3. Require Analysts to Certify Their Research

Regulation AC requires that research analysts formally take responsibility for the recommendations they make in research reports and in public appearances. The hope is that this requirement "creates an incentive for analysts to examine, even more carefully, the basis and foundations for his or her recommendations in preparing research reports."<sup>223</sup>

Specifically, Regulation AC requires, subject to certain exceptions,<sup>224</sup> that broker-dealers include in their research reports:

- A clear and prominent statement by the research analyst attesting that all of the views expressed in the report accurately reflect the

---

217. NASD Rule 2711(g)(3); NYSE Rule 472(e)(3).

218. Supervisory analysts are responsible for approving research reports to ensure their compliance with applicable laws and regulations. See NYSE Rule 472(a)(2).

219. NASD Rule 2711(g)(6); NYSE Rule 472(e)(5).

220. NASD Rule 2711(f)(4); NYSE Rule 472(f)(4).

221. *Id.* An "inactively traded" security is one that does not qualify as actively traded. 17 C.F.R. § 242.101(c)(1). Rule 101 of the Securities Exchange Act is commonly referred to as being part of Regulation M. *Id.* For a description of a lock-up agreement see *supra* note 119.

222. NASD and NYSE Rulemaking, Exchange Act Release No. 34-47110, 68 Fed. Reg. 826 (Dec. 31, 2002), available at <http://www.sec.gov/rules/sro/34-47110.htm> (last visited Oct. 31, 2003).

223. Regulation AC Press Release, *supra* note 9.

224. Regulation AC does not apply to: (1) broker-dealers that distribute research prepared by a third party research analyst whose employer satisfies certain independence criteria; (2) foreign persons located outside of the United States who prepare reports pertaining to a foreign security; and (3) the news media. 17 C.F.R. §§ 242.501(b), 503, 505.

research analyst's personal views about the company and its securities.<sup>225</sup>

- A statement by the research analyst that discloses whether or not she has received any compensation, directly or indirectly, related to the specific recommendations or views in the research report.<sup>226</sup> If the analyst has received compensation based on her specific recommendations or personal views, additional detailed disclosure is required regarding the compensation.<sup>227</sup>

Of particular note, the official release statement for Regulation AC clarifies that the analyst's attestation applies to both her summary rating (e.g., buy, hold, or sell) and to the detailed analysis that explains the basis for the rating.<sup>228</sup> Because ratings are often delivered without the detailed analysis, the SEC clarified that in situations where the analysis significantly qualifies the rating, a communication by the firm or analyst of just the rating could be misleading.<sup>229</sup> Where the analysis actually contradicts the stated rating, both the analyst and the firm could be in violation of the anti-fraud provisions of the federal securities laws, and the analyst's certification could be deemed to be false and in violation of Regulation AC.<sup>230</sup>

With respect to public appearances, Regulation AC also requires that broker-dealers, subject to certain exceptions,<sup>231</sup> collect and maintain periodic certifications of research analysts that make public appearances.<sup>232</sup> The broker-dealer is required, within thirty days after any calendar quarter in which one of its analysts made a public appearance, to make a record that contains the following:

- A statement by the research analyst attesting that all of the views expressed by the analyst in all public appearances during the calendar quarter accurately reflected the research analyst's personal views at that time.<sup>233</sup>
- A statement by the research analyst attesting that no part of the analyst's compensation was, is, or will be, directly or indirectly related to the specific recommendations or views expressed by the research analyst in such public appearances.<sup>234</sup>

225. *Id.* § 242.501(a)(1).

226. *Id.* § 242.501(a)(2).

227. *Id.* § 242.501(a)(2)(ii).

228. Regulation AC Press Release, *supra* note 9.

229. *Id.*

230. *Id.*

231. *See supra* note 224.

232. 17 C.F.R. § 242.502.

233. *Id.* § 242.502(a)(1).

234. *Id.* § 242.502(a)(2).

#### 4. Increase Disclosure Requirements

The New NASD/NYSE Analyst Regulations require both more detailed and more frequent disclosure on a number of fronts from both the analysts and their firms. For example:

- The new regulations clarify that mandatory disclosure obligations apply not only to classic research reports, but also when analysts make public appearances,<sup>235</sup> such as when they recommend stocks on television programs (e.g., CNBC or Bloomberg TV), through printed media articles, or at investor conferences.<sup>236</sup>
- The following disclosures must be made by firms in each research report and by research analysts during each public appearance: (1) if, as of the last day of the month before the publication of the research report or the public appearance (or the end of the second most recent month if the publication or appearance is less than ten calendar days after the end of the most recent month), the firm or its affiliates beneficially own one percent or more of any class of common equity securities of the subject company;<sup>237</sup> (2) if the research analyst (or a household member) has a financial interest in the securities of the subject company, and the nature of the financial interest;<sup>238</sup> (3) if the subject company is a client of the firm, or was a client during the twelve-month period preceding the date of distribution of the report or date of the public appearance, and the types of services provided to the subject company;<sup>239</sup> (4) if the firm, or an affiliate of the firm, received any compensation from the subject company in the past twelve months from either investment banking or non-investment banking services;<sup>240</sup> (5) if

---

235. The prior NASD and NYSE regulations were not historically applied to recommendations made by research analysts through the media, such as recommendations made in television interviews or in the print media. SEC Release No. 34-45908, *supra* note 152. Television interviews of analysts, in particular, became common place in the late 1990s. It was a common occurrence on CNBC or CNN Finance for research analysts to provide "their best picks" with no disclosure given regarding possible conflicts of interest the analyst might be facing.

236. See NASD Rule 2711(a)(4); NYSE Rule 472.50.

237. NASD Rule 2711(h)(1)(B); NYSE Rules 472(k)(1)(i)(c), (k)(2)(i)(a).

238. NASD Rule 2711(h)(1)(A); NYSE Rules 472(k)(1)(iii)(b), (k)(2)(i)(b).

239. NASD Rules 2711(h)(2)(A)(iii)(b), (h)(2)(B)(iii); NYSE Rules 472(k)(1)(i)(d)(1), (k)(1)(ii)(b)(1), (k)(2)(i)(c)(1). The services may be described as investment banking services, non-investment banking-securities related services and non-securities services. NASD Rule 2711(h)(2)(A)(iii)(b); NYSE Rules 472(k)(1)(i)(d)(1), (k)(1)(ii)(b)(1), (k)(2)(i)(c)(1). The disclosure required for public appearances is subject to a knowledge qualifier by the research analyst. NASD Rule 2711(h)(2)(B)(iii); NYSE Rule 472(k)(2)(i)(c). Finally, firms and research analysts are not required to disclose a client relationship if such disclosure would require material non-public information regarding specific potential future investment banking transactions of the subject company. NASD Rule 2711(h)(2)(C); NYSE Rule 472(k)(3)(i).

240. NASD Rules 2711(h)(2)(A)(ii)(b), (h)(2)(A)(iii)(a), (h)(2)(A)(iv)-(v), (h)(2)(B)(i); NYSE Rules 472(k)(1)(i)(a)(2), (k)(1)(i)(d)(2), (k)(1)(ii)(b)(2), (k)(1)(iii)(a), (k)(2)(i)(c)(2). The disclosure to be made in public appearances is of a more limited nature than that required in research reports and is subject to a knowledge qualifier by the research analyst. The disclosure to be made in research reports is more detailed and, with respect to compensation received by an affiliate of the firm for

the research analyst received compensation for investment banking services from the subject company in the past twelve months;<sup>241</sup> (6) if the research analyst (or a household member) serves as an officer, director, or advisory board member of the subject company;<sup>242</sup> and (7) any other actual, material conflicts of interest of the research analyst or the firm which the research analyst knows of, or has reason to know of, at the time of the report or appearance.<sup>243</sup> Finally, firms are required to maintain records of public appearances by research analysts to demonstrate compliance with the regulations related thereto.<sup>244</sup>

- The new regulations also require a number of additional disclosures in all research reports (although this disclosure is not required by research analysts during public appearances). Specifically, firms must disclose: (1) if the research analyst has received compensation that is based on the firm's overall investment banking revenues;<sup>245</sup> (2) if the firm is making a market in the subject company's securities at the time that the research report was published;<sup>246</sup> (3) the valuation methods used to determine a price target;<sup>247</sup> (4) the meanings of each of the ratings the firm uses in its rating system;<sup>248</sup> (5) the percentage of securities assigned to buy/hold/sell categories and the percentage of companies that fall within each of these three categories for which the firm has provided investment banking services within the preceding twelve months;<sup>249</sup> (6) a price chart that graphically illustrates the histori-

non-investment banking services, is also subject to a knowledge qualifier and includes safe harbors for satisfying the requirement. NASD Rules 2711(h)(2)(A)(v)(a), (b); NYSE Rules 472(k)(1)(iii)(a)(1)–(3).

241. NASD Rules 2711(h)(2)(A)(i)(b), (h)(2)(B)(ii); NYSE Rules 472(k)(1)(ii)(a)(1), (k)(2)(i)(f).

242. NASD Rule 2711(h)(3); NYSE Rules 472(k)(1)(iii)(c), (k)(2)(i)(e).

243. NASD Rule 2711(h)(1)(C); NYSE Rules 472(k)(1)(iii)(d), (k)(2)(i)(d). Mandatory disclosure of conflicts of interest by research analysts is not a new concept. See § 17(b) of the Securities Act of 1933, 15 U.S.C. § 77q(b) (2000). Section 17(b) provides that:

It shall be unlawful for any person . . . to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.

*Id.*

244. NASD Rule 2711(h)(12); NYSE Rule 472(k)(2) (Interpretation—Communications With the Public).

245. NASD Rule 2711(h)(2)(A)(i)(a); NYSE Rule (k)(1)(ii)(a)(2).

246. NASD Rule 2711(h)(8); NYSE Rule 472(k)(1)(i)(b).

247. NASD Rule 2711(h)(7); NYSE Rule (k)(1)(i)(e). In addition, there must be a reasonable basis for any price objectives, as well as a discussion of the risks that may prevent achievement of the target. *Id.*

248. NASD Rule 2711(h)(4); NYSE Rule 472(k)(1)(i)(f). As well, each definition must be consistent with the plain meaning of the rating (e.g., "hold" must mean hold and not be a code word for "sell"). *Id.*

249. NASD Rule 2711(h)(5); NYSE Rule 472(k)(1)(i)(g).

cal price trends of the covered stock with indications of the dates on which the firm assigned or changed each rating or price target and what the rating was in each case;<sup>250</sup> (7) if, in the past twelve months, the firm managed or co-managed a public offering of securities for the subject company;<sup>251</sup> and (8) more detailed information relating to compensation received by the firm, or its affiliates, from the subject company in the past twelve months from either investment banking or non-investment banking services and if the firm expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months.<sup>252</sup>

- Each of the above disclosures that are required in a research report must be prominently presented on the front page of the research report or the front page must refer to the page on which the disclosures can be found.<sup>253</sup>
- The new regulations clarify that firms and research analysts, whether in a research report or in a public appearance, must provide all other disclosures that are required by applicable law or regulation, including the antifraud provisions of the federal securities laws.<sup>254</sup>
- Firms must publicly disclose their decisions to discontinue research coverage of a company.<sup>255</sup> Specifically, the firm must make available a final research report, subject to limited exceptions, on the subject company, and disseminate that report in the same manner that it ordinarily uses when providing customers with research reports on that company.<sup>256</sup> Subject to limited exceptions,<sup>257</sup> the final report must be comparable in scope and de-

250. NASD Rule 2711(h)(6); NYSE Rule 472(k)(1)(i)(h). The price chart requirement applies only to:

securities that have been assigned a rating for at least one (1) year, and need not extend more than three (3) years prior to the date of the research report. The information in the price chart must be current as of the end of the most recent calendar quarter (or the second most recent calendar quarter if the publication date is less than fifteen (15) calendar days after the most recent calendar quarter).

NYSE Rule 472(k)(i)(h); *see also* NASD Rule 2711(h)(6).

251. NASD Rule 2711(h)(2)(A)(ii)(a); NYSE Rule 472(k)(1)(i)(a)(1).

252. *See* discussion *supra* note 240 and accompanying text; *see also* NASD Rules 2711(h)(2)(A)(ii)(b)–(c), (h)(2)(A)(iii)(a), (h)(2)(A)(iv)–(v); NYSE Rules 472(k)(1)(i)(a)(2)–(3), (k)(1)(i)(d)(2), (k)(1)(ii)(b)(2), (k)(1)(iii)(a), (k)(2)(i)(c)(2). Firms are not required to disclose such investment banking services if such disclosure would require material non-public information regarding specific potential future investment banking transactions of the subject company. NASD Rule 2711(h)(2)(C); NYSE Rule 472(k)(3)(i).

253. NASD Rule 2711(h)(10); NYSE Rule 472(k)(1).

254. NASD Rule 2711(h)(9).

255. NASD Rule 2711(f)(5); NYSE Rule 472(f)(6).

256. *Id.*

257. A firm shall not be required to produce a comparable report where it is impracticable for the firm to do so (e.g., if the research analyst covering the company has left the firm or where the firm has terminated coverage on an entire industry or sector). NASD Rule 2711(f)(5); NYSE Rule

tail to prior research reports, and must include a final recommendation or rating.

The global settlement also requires the Ten Investment Banks to render enhanced disclosures in research reports that are in addition to the disclosures required by the New NASD/NYSE Analyst Regulations and Regulation AC.<sup>258</sup> These enhanced disclosures relate primarily to potential conflicts of interest that could impact the research and are meant to serve as a “buyer beware” label.<sup>259</sup> Specifically, the firms are required to include the following disclosures on the first page of each research report: (1) a statement that the firm “does and seeks to do business with companies covered in its research reports,” and “[a]s a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of [the] report;” (2) an advisory that customers can “receive independent, third-party research on the company covered in [the] report, at no cost to them, where such research is available;” and (3) a caution that “[i]nvestors should consider [the] report as only a single factor in making their investment decision.”<sup>260</sup>

To enable investors to evaluate and compare the performance of specific analysts, each of the Ten Investment Banks is also required to publish on its website “a chart showing its analysts’ performance, including each analyst’s name, ratings, price targets, and earnings per share forecasts for each covered company, as well as an explanation of the firm’s rating system.”<sup>261</sup>

### 5. Require Certain Firms to Provide Independent Research

“To ensure that individual investors get access to objective investment advice,”<sup>262</sup> each of the Ten Investment Banks is obligated to furnish independent research to its clients for a five-year period. Specifically, each of the Ten Investment Banks will be required to contract with no fewer than three independent providers of research and make available to its customers this independent research.<sup>263</sup> The firms must notify customers on their account statements, on the first page of research reports, on the firm’s website, and in connection with solicited orders that the independent research is available at no cost to the customer.<sup>264</sup> An independent consultant shall be appointed for each firm.<sup>265</sup> This independent con-

---

472(f)(6). However, the firm will still be required to provide a final recommendation or rating and the rationale for the decision to terminate coverage. *Id.*

258. Addendum A, *supra* note 198, at § II.1.

259. *See id.*

260. *Id.* at §§ II.1.a–c.

261. *SEC Fact Sheet*, *supra* note 173; Addendum A, *supra* note 198, at § II.2.

262. Press Release on Global Settlement, *supra* note 9.

263. Addendum A, *supra* note 198, at § III.1. There is, however, no requirement that there be at least three independent research providers for the common stock of each company that is covered by the firm’s research department. *Id.*

264. *Id.* at §§ III.1.c, III.1.g, III.1.4.

265. *Id.* at § III.2.



sultant (who must be approved by the SEC, the NYSE, the NASD, the President of the NASAA, the New York Attorney General, and the individual firm) shall be responsible for procuring the independent research providers, and will report annually to regulators on the independent research.<sup>266</sup>

## 6. Additional Measures

In addition to the five fundamental changes, the Regulatory Actions also seek to implement a few additional measures, including:

- The New NASD/NYSE Analyst Regulations now require that research analysts be registered with the NASD and the NYSE and must pass a qualification examination.<sup>267</sup> Research analysts are also subject to a continuing education requirement.<sup>268</sup>
- A senior officer of the firm must attest annually that the firm has adopted and implemented procedures to ensure compliance with the New NASD/NYSE Analyst Regulations.<sup>269</sup>
- The New NASD/NYSE Analyst Regulations define the term “research report” as “a written or electronic communication that includes an analysis of equity securities of individual companies or industries, and that provides information reasonably sufficient upon which to base an investment decision.”<sup>270</sup> Notably, the definition of research report does not require that the communication include a recommendation.<sup>271</sup>
- Under the global settlement, each of the Ten Investment Banks must retain, at their own expense, an “Independent Monitor” acceptable to the SEC, the NYSE, the NASD, the NASAA, and the New York Attorney General’s Office, for the purpose of ensuring that the reforms called for in the global settlement are “executed and implemented in a meaningful way . . . .”<sup>272</sup> Within eighteen months after the date of the entry of the Final Judgment, the Independent Monitor shall conduct a review of the firm’s compliance with the undertakings required by the global settlement and will

266. *Id.* at §§ III.2, III.3, III.5.

267. NASD Rule 1050; NYSE Rule 344. For purposes of these rules, the term “research analyst” refers to analysts who are primarily responsible for the preparation of the substance of a research report and/or whose name appears on the report. NASD Rule 1050; NYSE Rule 344.10.

268. NASD Rule 1120; NYSE Rule 345A.

269. NASD Rule 2711(i); NYSE Rule 351(f). The attestation must include a certification that research analyst compensation was reviewed and approved by a committee as required by NASD Rule 2711(d)(2) and NYSE Rule 472(h)(2), respectively. NASD Rule 2711(i); NYSE Rule 351(f).

270. NASD Rule 2711(a)(8); *see also* NYSE Rule 472.10(2).

271. *See* NASD Rule 2711(a)(8); *see also* NYSE Rule 472.10(2).

272. Donaldson Testimony, *supra* note 9; *see also* Addendum A, *supra* note 198, at § II.6.

submit a written report of his or her findings to the SEC, NASD, and NYSE.<sup>273</sup>

- Finally, seven of the Ten Investment Banks will collectively pay \$80 million to finance an investor education fund.<sup>274</sup> The investor education fund shall be used, in part, “to support programs designed to equip investors with the knowledge and skills necessary to make informed investment decisions.”<sup>275</sup> “The fund will make grants to organizations to develop wide-ranging, neutral, and unbiased investor education programs nationwide.”<sup>276</sup> The fund will be divided as follows: \$52.5 million of the fund shall be administered on a federal level by the SEC, NYSE and NASD, and the remaining \$27.5 million shall be provided to state securities regulators for investor education purposes.<sup>277</sup>

#### IV. THE CASE FOR INVESTOR SKEPTICISM

The foundation for the Regulatory Actions is the hypothesis that sell-side research analysts provided investors with poor investment guidance due to the severe conflicts of interest that they faced. Specifically, sell-side analysts were poor predictors of company and stock performance because they lacked independence, in particular from the interests of investment banking. The primary focus of the Regulatory Actions has been to render sell-side research more independent so as to promote the integrity of, and restore confidence in, sell-side research analysts.<sup>278</sup>

##### A. *Predictive Abilities of Sell-Side Analysts—Uncertainty Reigns*

The regulators got ahead of themselves with the Regulatory Actions. Prior to attempting to restore confidence in sell-side research, one must first ask the fundamental question: Is sell-side research valuable? The answer to this question turns out to be both “yes” and “maybe not.” Yes, sell-side analysts provide valuable information that assists the market to efficiently determine the appropriate price for a given stock. Maybe not, in that sell-side analysts have historically had difficulties with both forecasting the future performance of companies and making stock recommendations.

There is really no dispute that sell-side analysts serve a valuable function to investors in terms of information gathering and pure analysis.

273. Addendum A, *supra* note 198, at § II.6.a.

274. The seven firms are Bear Stearns, Goldman, J.P. Morgan, Lehman, Merrill Lynch, SSB, and UBS. Final Judgments, *supra* note 168. The investor education payments shall be made in five equal installments on an annual basis. *Id.*; see also *SEC Fact Sheet, supra* note 173.

275. *SEC Fact Sheet, supra* note 173.

276. William H. Donaldson, Chairman, Securities and Exchange Commission, Speech Prepared for Delivery at SEC Press Conference Regarding Global Settlement (Apr. 28, 2003), at <http://www.sec.gov/news/speech/spch042803whd.htm> (last visited Oct. 31, 2003).

277. *SEC Fact Sheet, supra* note 173.

278. See *supra* note 9 and accompanying text.

Sell-side analysts perform the primary information gathering function for a substantial number of the publicly-traded stocks in the United States. These analysts gather information (both publicly available and not publicly available) about the company, its industry, and its competitors, and this information serves as the foundation for many of the investment decisions that will be made regarding the specific stock. The Securities Industry Association describes this information as “the lifeblood of the markets and of those who participate in them.”<sup>279</sup> In addition to information gathering, sell-side analysts also perform the function of analyzing the information to help investors better understand the dynamics that will drive a company’s future performance. Both the SEC and the U.S. Supreme Court have stated that the “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.”<sup>280</sup>

The most difficult task of the sell-side analysts is to take that information and analysis, and put it into action by means of investment advice. It is one thing to serve as an investigator and describe the current situation. It is entirely another thing to predict how the situation will develop over time. In giving investment advice, however, sell-side analysts are being asked to predict the future, which is a very difficult task. The two quantifiable predictions that sell-side analysts make routinely in their research are earnings forecasts and stock recommendations (e.g., buy, hold or sell).

Are analysts very good at forecasting the future earnings of the companies they cover? The expected future earnings of a company are arguably the single most important factor affecting that company’s stock price.<sup>281</sup> While there are many methods that may be employed to value a given stock, the most traditional method employed is to examine the company’s future earnings potential. Future earnings potential is so important because it provides guidance as to the company’s ability to pay dividends, buy back stock, and/or accumulate a residual that can be distributed to shareholders upon liquidation.<sup>282</sup>

Academic studies have shown, however, that, as a class, sell-side analysts are not accurate forecasters of company earnings.<sup>283</sup> Rather, sell-

279. Fernandez, *supra* note 28, at 5.

280. Dirks v. SEC, 463 U.S. 646, 659 n.17 (1983) (quoting Revision of Investment Company Current Report Forms, Release No. 6283, Exchange Act Release No. 17479, 21 SEC Docket 1401, 1406 (Jan. 22, 1981)).

281. MALKIEL, *supra* note 126, at 173.

282. *See id.*

283. *See* Vijay Kumar Chopra, *Why So Much Error in Analysts’ Earnings Forecasts?*, FIN. ANALYSTS J., Nov./Dec. 1998, at 35; *see also* David Dreman & Michael A. Berry, *Analyst Forecasting Errors and Their Implications for Security Analysis*, FIN. ANALYSTS J., May/June 1995, at 30; DAVID DREMAN, *CONTRARIAN INVESTMENT STRATEGIES: THE NEXT GENERATION* 91 (1998) (up-

side analysts have demonstrated a consistent tendency for being significantly overoptimistic with their earnings forecasts.<sup>284</sup> In particular, these studies have shown that sell-side analysts have a tendency to substantially over-estimate current-year earnings at the beginning of the year, and then adjust them downwards towards actual earnings throughout the year.<sup>285</sup> Analysts also have a tendency to be overoptimistic when projecting earnings growth rates.<sup>286</sup>

Forecasting a company's future earnings is only one measure of an analyst's worth. For many, the advice they are seeking from an analyst is not an earnings number, but rather advice on whether the stock is a good investment or not. For such persons, the question is whether the analyst will provide them with sound stock picking advice. Academic theory suggests that investors should not be able to craft profitable trading strategies based on analyst recommendations as a result of the efficient market theory. Under the semi-strong form of the efficient market theory (which is the most widely accepted form by academics), it is believed that stock prices reflect all of the publicly available information at the time.<sup>287</sup> Since analyst recommendations are publicly available,<sup>288</sup> such

---

dating and reporting Dreman & Berry, *supra*, at 30) [hereinafter DREMAN, CONTRARIAN INVESTMENT STRATEGIES].

284. See Chopra, *supra* note 283, at 36-37; DREMAN, CONTRARIAN INVESTMENT STRATEGIES, *supra* note 283, at 91.

285. The Chopra Study reviewed current-year earnings forecasts for the S&P 500 from January 1985 through December 1997, and compared them to the actual earnings. Chopra, *supra* note 283, at 36. The Chopra Study found that sell-side analysts "overestimated current-year earnings by 6.1 percent in the 1985-97 period." *Id.* Analysts would typically start the year with extremely high estimates (on average earnings were over-estimated by 11.2 percent at the beginning of the fiscal year), and then adjust them downwards towards actual earnings throughout the year. *Id.* Finally, the Chopra Study found that the quality of analysts' earnings forecasts appear to have improved in the 1993 to 1997 period (the over-estimation was greatly reduced) compared to the 1985 to 1992 period. *Id.* at 35-37. The Dreman & Berry study reviewed 94,251 consensus analyst earnings forecasts that took place between 1971 and 1996, involving more than 1,500 NYSE, Nasdaq, and AMEX companies. See DREMAN, CONTRARIAN INVESTMENT STRATEGIES, *supra* note 283, at 91. Specifically, the study compared the consensus analyst earnings forecasts to the actual, reported earnings. *Id.* The study included approximately 500,000 individual analyst estimates. *Id.* The Dreman & Berry study found that "analysts' estimates were sharply and consistently off the mark . . ." *Id.* The Dreman & Berry study found that the average analyst error for the sampling (as a percent of reported earnings) was forty-four percent annually. *Id.* Finally, the study found that when analysts projections were wrong, they were four times more likely to be wrong on the high side (i.e., they were overly optimistic), than on the low side. *Id.* at 97-98. In contradiction to Chopra's findings, the Dreman & Berry study found that analysts' forecasts are getting worse. *Id.* at 91-92. Analysts' forecasts were off by fifty percent (as a percent of reported earnings) from 1988 to 1996, compared to forty-five percent from 1981 to 1988, and thirty percent from 1974 to 1980. *Id.*

286. See, e.g., Chopra, *supra* note 283, at 38 (finding the average consensus twelve-month EPS (earnings per share) growth forecast was "double the actual growth rate in [actual] earnings"); see also David Dreman, *Don't Count on Those Earnings Forecasts*, FORBES, Jan. 26, 1998, at 110 (discussing a study conducted by Dreman & Erik Lufkin); DREMAN, CONTRARIAN INVESTMENT STRATEGIES, *supra* note 283, at 98 (also referencing the Dreman & Lufkin study). The Dreman & Lufkin study examined analysts' estimates of earnings growth for companies in the S&P 500 between 1982 and 1997. *Id.* The actual growth annually was 7.8 percent, while the average projected growth by analysts at the beginning of each year was 21.9 percent. *Id.*

287. The other forms of the efficient market theory are: (1) Strong Form: which provides that the current stock price reflects all relevant information about the stock, even if not publicly avail-

information should immediately be encapsulated into the price of the relevant stock, and therefore, no abnormal investing advantage should be consistently garnered by following analysts' investment advice. Rather, investment returns should mirror the returns of the market as a whole (e.g., if the market increases by ten percent, a broadly-based portfolio of stock based on analysts' recommendations would be expected to increase by approximately the same amount).<sup>289</sup> Beginning with a landmark study conducted in 1933 by Alfred Cowles,<sup>290</sup> a number of academic studies were conducted that supported this theory and found that most sell-side analysts do not generate returns that beat the market.<sup>291</sup>

Most brokerage firms reject such a pure form of this theory, and have invested incredible resources in research departments with the purpose of generating returns for their clients that are superior to the returns of the market as a whole.<sup>292</sup> The measuring stick is beating the market (rather than just generating a positive return), because investing in individual stocks involves substantially greater risk than investing in a broadly diversified basket of stocks. The market as a whole is the broadest possible basket, and can be invested in by purchasing broad-market index funds (which simulate the performance of the market as a whole or certain segments of the market). In order to compensate investors for absorbing the additional risk of investing in individual shares, the investor should expect excess stock returns from following the sell-side analysts' recommendations.

More recently, a few studies have been conducted that have been more complimentary towards the investment value of sell-side analyst

able; and (2) Weak Form: which provides that the current stock price reflects all past market prices and data (in effect, technical analysis is of no use).

288. See, e.g., Boni & Womack, *supra* note 18, at 100. The authors explain that:

Many analysts' earnings forecasts and recommendations are now readily available to the general public. For example, the Nasdaq web site ([www.nasdaq.com](http://www.nasdaq.com)) currently provides the analyst recommendations (including upgrades, downgrades, and coverage initiation) from 90 firms for stocks listed on Nasdaq and the New York Stock Exchange (NYSE), updated three times a day. It also provides the consensus of analysts' recommendations and earnings forecasts as well as lists of stocks with the largest percentage change in analyst consensus of earnings forecasts and with the highest number of analysts' earnings revisions for the week.

*Id.*

289. On a similar note, the Random Walk Theory espouses that "short-run changes in stock prices cannot be predicted. Investment advisory services, earnings predictions, and complicated chart patterns are useless." MALKIEL, *supra* note 126, at 24. The Random Walk Theory is based on the notion that markets are moved by news, and news is random and unpredictable by definition. See *id.* Once the news is known, it is quickly digested by the market and incorporated in the stocks price. *Id.* at 197. As a result, a stock's price moves in a random and unpredictable manner. *Id.*

290. Alfred Cowles 3rd, *Can Stock Market Forecasters Forecast?*, 1 *ECONOMETRICA* 309 (1933).

291. See Clinton M. Bidwell, III, *How Good Is Institutional Brokerage Research?*, J. PORTFOLIO MGMT., Winter 1977, at 26; R.E. Diefenbach, *How Good Is Institutional Brokerage Research?*, FIN. ANALYSTS J., Jan./Feb. 1972, at 53; Dennis E. Logue & Donald L. Tuttle, *Brokerage House Investment Advice*, 8 FIN. REV. 38 (1973).

292. Brad Barber et al., *Can Investors Profit from the Prophets? Security Analyst Recommendations and Stock Returns*, 56 J. FIN. 531 (2001) [hereinafter Barber et al., *Prophets*].

recommendations, although with some important caveats. In 1996, Professor Kent Womack conducted a study on the investment value of sell-side analysts' recommendations based on an analysis of a large sample of analyst recommendations from major investment banks in the early 1990s.<sup>293</sup> The Womack study found that initiation of coverage by sell-side analysts and changes in their recommendations have "a substantial impact on stock prices immediately and in subsequent months."<sup>294</sup> Specifically, the study found an immediate price reaction to initiation of or changes in recommendations,<sup>295</sup> but that reaction was not complete (i.e., it was an under reaction) and was followed by a "drift in the direction recommended by the analysts for one to several months . . . creating potentially profitable trading strategies."<sup>296</sup> The study found that prices "react to both buy and sell recommendations in the direction predicted, but with sell recommendations, initial price changes are greater in magnitude and prices drift (down) for longer."<sup>297</sup> Interestingly, however, the Womack Study did not include the impact of transactions costs in its analysis, which, as demonstrated below, could substantially impact such potentially profitable trading strategies. In a similar study, Professor Scott Stickel also found a correlation between sell-side analyst upgrades and downgrades in stock price movement.<sup>298</sup>

In 2001, a study conducted by Professors Brad Barber, Reuven Levy, Maureen McNichols, and Brett Trueman analyzed "whether investors can profit from the publicly available recommendations of security analysts."<sup>299</sup> The study examined whether investors can earn abnormal returns (i.e., beat the market) by employing trading strategies based on consensus analyst recommendations.<sup>300</sup> The four researchers analyzed stock recommendations for the period from 1985 through 1996, and constructed hypothetical stock portfolios based on owning stocks with the most favorable consensus recommendations and shorting those with the least favorable consensus recommendations.<sup>301</sup> The study found that fol-

---

293. Womack, *supra* note 65. Specifically, the Womack Study examined 1,573 recommendation changes, by fourteen of the top U.S. brokerage firms, on 822 different companies, during the period from 1989-1991. *Id.* at 141-42.

294. *Id.* at 165.

295. The recommendation changes were grouped into four separate categories: (1) added to buy list; (2) removed from buy list; (3) added to sell list; and (4) removed from sell list. *Id.* at 142.

296. Boni & Womack, *supra* note 18, at 101, which summarized the findings of the earlier Womack Study.

297. *Id.*

298. Scott E. Stickel, *The Anatomy of the Performance of Buy and Sell Recommendations*, FIN. ANALYSTS J., Sept./Oct. 1995, at 25.

299. Barber et al., *Prophets*, *supra* note 292, at 531.

300. *Id.* at 531-32. Consensus analyst recommendations are "the average of several analysts' recommendations concerning the securities of a particular issuer." National Association of Securities Dealers, Inc., *Understanding Securities Analyst Recommendations: Glossary of Analyst Research Report Terms*, at [http://www.nasdr.com/analyst\\_glossary.htm](http://www.nasdr.com/analyst_glossary.htm) (last visited Nov. 12, 2003).

301. Barber et al., *Prophets*, *supra* note 292, at 540-42; see *supra* note 46 for the definition of "shorting" a stock. Using data from Zacks Investment Research, the study analyzed over 360,000

lowing such a strategy, "in conjunction with daily portfolio rebalancing and a timely response to recommendation changes, yield[ed] annual abnormal gross returns greater than four percent."<sup>302</sup> Abnormal return refers to a return that is in excess of that generated by the CRSP NYSE/AMEX/Nasdaq value-weighted market index,<sup>303</sup> which is meant to simulate the performance of the market as a whole. In essence, the study found that following this strategy resulted in returns that significantly beat the market. Because retail investors typically take some time to react to information changes, the study also analyzed the returns if portfolio rebalancing did not take place on a daily basis, or if the investor was delayed in reacting to the changes in the consensus recommendations and found that such delays substantially reduced the portfolio returns.<sup>304</sup> Most notably, however, the study found that the proposed investment strategies would:

require a great deal of trading, and generate correspondingly high transaction costs. After accounting for these costs, [the study found] that none of [its] strategies generated an abnormal net return that is reliably greater than zero. This strongly suggests that, although market inefficiencies exist, they are not easily exploitable by traders, thereby allowing these inefficiencies to persist.<sup>305</sup>

In 2003, the four authors updated their prior study by analyzing sell-side recommendations through 2001.<sup>306</sup> For the period from 1996 through 1999, the second study found market adjusted returns that were similar to those found in the first study.<sup>307</sup> Namely, on a gross basis, sell-side analysts' top stock picks significantly outperformed the CRSP NYSE/AMEX/Nasdaq value-weighted market index, while the least favored stocks significantly underperformed such index.<sup>308</sup> This follow-up study, however, did not examine the impact of transaction costs on such a trading strategy. For the years 2000 and 2001, the second study found a substantial divergence from the earlier results, with the stocks least favored by sell-side analysts substantially outperforming the market, and the stocks most highly favored substantially underperforming the market.<sup>309</sup> As a result, investors would have been wise to do the opposite of

---

analyst recommendations, from 269 brokerage firms and 4,340 analysts over this period. Barber et al., *Prophets*, *supra* note 292, at 533.

302. Barber et al., *Prophets*, *supra* note 292, at 531. This greater than four percent return was "after controlling for market risk, size, book-to-market, and price momentum effects." *Id.* at 561.

303. CRSP is the Center for Research in Securities Prices, a financial research center at the University of Chicago Graduate School of Business. Center for Research in Securities Prices, at <http://gsbwww.uchicago.edu/research/crsp> (last visited Nov. 12, 2003).

304. Barber et al., *Prophets*, *supra* note 292, at 551-53.

305. *Id.* at 562 (citation omitted).

306. Barber et al., *Analysts' Recommendations*, *supra* note 45.

307. *Id.* at 88-89.

308. *Id.* at 94.

309. *Id.* at 88. Specifically, the stocks least favored by sell-side analysts outperformed the CRSP NYSE/AMEX/Nasdaq value-weighted market index by 13.44 percent, while the stocks most

what analysts were recommending in 2000 and 2001. The study further concluded that “these poor results were driven, at least in part, by analysts’ tendency to recommend small-capitalization growth stocks during those years, despite the fall of those stocks from favor.”<sup>310</sup> The authors of the study raise the question of whether the sell-side analysts’ loyalty to the small-cap growth stocks may have been motivated by a desire to attract and retain potential investment banking clients.<sup>311</sup>

Researchers have also documented that sell-side analysts exhibit persistence in their relative stock picking ability.<sup>312</sup> Professors Michael Mikhail, Beverly Walther, and Richard Willis conducted a study which found that sell-side analysts “who performed well (poorly) relative to their peers in the past continue to outperform (underperform) in the future . . . .”<sup>313</sup> The study also found that “the length of an analyst’s track record is important—analysts with a five-year winning streak outshine the performance of those with shorter track records of superior performance.”<sup>314</sup> Notably, however, Professors Mikhail, Walther, and Willis were unable to develop a strategy for generating excess returns by following the recommendation revisions of higher performing analysts once transaction costs were figured into the equation.<sup>315</sup>

While the above studies are informative, whether sell-side analyst recommendations have consistent investment value remains an open question. Once transaction costs are included in the equation, it simply is unclear whether an investing strategy based on sell-side analyst recommendations can be developed that consistently beats the market.

### *B. Regulatory Actions Do Not Address Fundamental Conflicts*

Now that it is clear that sell-side analysts’ greatest value may not lie in their forecasts (which are generally overoptimistic) or their recommendations (of which the investment value is unclear), can anything be done to improve the analysts’ predictive capabilities? The regulators appear to think something can be done. The Regulatory Actions seek to make five fundamental changes to sell-side research, ostensibly with the goal of improving its results. Again, these five changes are: (1) clearly separate sell-side research from investment banking; (2) restrict personal trading of analysts in the companies they cover; (3) require analysts to

highly recommended by analysts underperformed by the CRSP NYSE/AMEX/Nasdaq value-weighted market index by 7.06 percent. *Id.* at 88-89.

310. *Id.* at 88.

311. *Id.*

312. See Michael B. Mikhail et al., *Do Security Analysts Exhibit Persistent Differences in Stock Picking Ability?*, Social Science Electronic Library (Jan. 2002), at <http://papers.ssrn.com/sol3> (last visited Feb. 13, 2004).

313. *Id.* at 19. The Mikhail, Walther, and Willis study examined “268,170 recommendation revisions issued by 4,923 analysts for 7,845 firms during 1985–1999.” *Id.* at 6.

314. *Id.* at 27.

315. See *id.* at 23-26.



certify their research; (4) increase disclosure requirements for research; and (5) require certain firms to provide independent research to their clients. Because the separation of sell-side research from the influences of investment banking is clearly the primary focus of the Regulatory Actions, this Article will address it last and first clear away the “other four” changes.

First, the restriction on the personal trading of analysts is really nothing more than a reaction to one well-publicized, and easy to criticize, practice. While the personal trading of analysts in contradiction to their ratings has led to a number of well-documented and embarrassing incidents for the research community,<sup>316</sup> it would be a far reach to argue that this practice was a primary driver of analyst underperformance. As a result, the restriction on the personal trading of analysts is not likely to have a material impact on analyst performance. On a similar note, requiring analysts to certify their research is also not core to the sell-side analyst issue, and is also not likely to result in any major change in analyst performance. Putting one’s name on a report is a heady experience, and it is highly unlikely that certification will materially cause analysts “to examine, even more carefully, the basis and foundations for his or her recommendations in preparing research reports” as is hoped by Regulation AC.<sup>317</sup> The personal trading restrictions and Regulation AC are mere window dressing, and are not likely to substantially impact analyst performance either positively or negatively. The concern, however, is that changes such as these will help to restore investor confidence in sell-side analysts, which this Article will argue is a substantial negative consequence. Part V of this Article will discuss the danger of restoring investor confidence and how to ensure that it does not occur.

Regarding the increased disclosure requirements called for by the Regulatory Actions, they show some promise and will be discussed in more detail below, in Part V, where the author argues for a more effective means of disclosure that should be the centerpiece of any new disclosure requirements. Finally, with respect to the provision of independent research by the Ten Investment Banks, it is solid evidence in favor of this Article’s argument that the Regulatory Actions do not in fact result in a clear separation of research from investment banking. If they did, there would be no need to require the Ten Investment Banks to provide independent research to their clients.

Although Part II of this Article catalogued a number of potential conflicts that plague sell-side research, the core conflict that faces sell-

---

316. A May 2001 New York Times article, for example, chronicled sales by a number of sell-side analysts of stocks they covered while maintaining “buy” ratings on the stocks. Morgenson, *Buy, They Say*, *supra* note 105.

317. See Regulation AC Press Release, *supra* note 9 and accompanying text. This conclusion is based on the author’s personal and professional experience with sell-side analysts.

side research is the competing pressures put on analysts by their firm's brokerage clients and investment banking clients.<sup>318</sup> As noted earlier, brokerage clients want "accurate" research that will assist them to invest profitably, while investment banking clients want "optimistic" research that will boost their stock price.<sup>319</sup> With investment banking revenues far outstripping brokerage revenues in recent years for the most prominent firms on Wall Street,<sup>320</sup> the fear is that their analysts, which are amongst the most high profile, are swayed more by their investment banking audience than their brokerage audience. The Regulatory Actions are meant to ease this pressure on sell-side analysts from the investment banking side of the business and allow them to focus on serving brokerage clients. While substantial verbiage is given by the regulators to "clearly separate" research from investment banking, the separation required by the Regulatory Actions is insubstantial in reality and will do little to alter sell-side analysts' motivations in the brokerage client/investment banking client conflict.

The Regulatory Actions attempt to separate research from investment banking primarily by reinforcing the Chinese Wall that separates these two departments and by implementing rules to prevent promises of favorable research coverage. While noble in spirit, it is doubtful that either of these objectives can be accomplished. Let us begin with reinforcing the Chinese Wall. What is most important to understand about Chinese Walls is that they are not perfect. A Chinese Wall is only as strong as the individuals who are the subject of the segregation. If the individuals are honest and law-abiding, which describes the vast majority of individuals in Wall Street firms, then the Chinese Wall works nicely. However, because it is impossible to monitor and detect all infractions of a Chinese Wall, it only takes a few individuals who view the Chinese Wall as a "formality" or "technicality," and the wall begins to develop cracks and breaches.<sup>321</sup>

The biggest weakness in the "reinforced" Chinese Wall is the very same weakness that is at the heart of the current furor: analyst compensa-

---

318. See *supra* notes 95-96 and accompanying text.

319. Boni & Womack, *supra* note 18, at 93.

320. In 1999, major firms generated \$24.6 billion in investment banking fees compared to \$9.5 billion in brokerage commissions. Sargent, *supra* note 96, at 72.

321. The author finds it curious that the regulators settled on Chinese Walls as the primary mechanism for restoring confidence in equity, sell-side research. The reason that the regulators have focused on the sell-side analyst problem was because a number of major investment banks and research analysts violated existing rules, including: "[i]n making a recommendation . . . a member must have a reasonable basis for the recommendation . . ." NASD Rule 2120(d)(2)(B)(i). So the solution to the problem is to establish a set of Chinese Walls that require a substantial amount of trust to implement. We could not trust Wall Street to follow the prior rules, but now we are being asked to trust that Wall Street will comply with the Chinese Walls. Interestingly, the Great Wall of China (for which Chinese Walls are named) was originally built as a defensive fortification to repel invaders from the north, but was eventually breached by both the Mongols and the Manchurians. TravelChinaGuide.com, *History of the Great Wall*, at [http://travelchinaguide.com/china\\_great\\_wall/history/index.htm](http://travelchinaguide.com/china_great_wall/history/index.htm) (last visited Nov. 1, 2003).

tion. If analyst compensation can be tied to the analysts' "cooperation" with the investment banking department (even if only indirectly), the other elements of the Chinese Wall (e.g., prohibiting investment bankers from reviewing pending research reports or supervising research analysts) amount to a one-foot high wall over which it is quite easy to step.

How is analyst compensation affected by the Regulatory Actions? Under the New NASD/NYSE Analyst Regulations, an analyst's compensation may not be tied to "specific" investment banking transactions.<sup>322</sup> More specifically, firms must establish committees (which must report to the firm's board of directors and may not include representatives from investment banking) to annually review and document research analyst compensation. The compensation review committee must consider the following factors, if applicable, when reviewing such research analyst's compensation: (1) the analyst's individual performance (e.g., quality of research and productivity); (2) the correlation between the research analyst's recommendations and stock price performance; (3) the overall ratings of the analyst from clients, sales force, independent rating agencies, and peers.<sup>323</sup> The compensation review committee may not consider, as a factor, the analyst's contributions to the investment banking business.<sup>324</sup> However, because part of the job responsibilities of a sell-side analyst involve advising "investment banking departments concerning such matters as whether a potential underwriting client is financially or operationally prepared for an initial public offering,"<sup>325</sup> the new rules do permit analysts to be compensated based upon (among other factors) the firm's overall investment banking revenues so long as that fact is disclosed in the research reports.<sup>326</sup> Here is an example of such a disclosure that was included in a recent Merrill Lynch research report: "The analyst(s) responsible for covering the securities in this report receive compensation based upon, among other factors, the overall profitability of Merrill Lynch, including profits derived from investment banking revenues."<sup>327</sup> Not surprisingly, this disclosure was included at the end of the Merrill Lynch report and is one of a number of disclosures that are labeled "important disclosures," but resemble instead boilerplate.<sup>328</sup>

For the Ten Investment Banks, they must also comply with the global settlement, which requires that compensation of analysts be determined solely by the management of the research group and the firm's

322. NASD Rule 2711(d)(1); NYSE Rule 472(h)(1).

323. NASD Rule 2711(d)(2); NYSE Rule 472(h)(2).

324. *Id.*

325. NASD and NYSE Rulemaking, Exchange Act Release No. 34-45526, 67 Fed. Reg. 11,526 (Mar. 8, 2002), available at <http://www.sec.gov/rules/sro/34-45526.htm> (last visited Nov. 1, 2003).

326. NASD Rule 2711(h)(2)(A)(i)(a); NYSE Rules 472(h)(1), (k)(1)(ii)(a)(2).

327. Merrill Lynch & Co., Inc., *Cisco Systems Comment—Reading Through the Noise* (Feb. 4, 2004) (on file with author).

328. *See id.*

senior management.<sup>329</sup> The global settlement also requires that the Ten Investment Banks comply with a number of principles that guide analyst compensation, including: (1) analyst compensation may not be based directly or indirectly on investment banking revenues or results (provided that compensation may “relate to the revenues or results of the firm as a whole”) or on input from investment banking personnel; (2) a significant portion of an analyst’s compensation must be based on the quality and accuracy of the analyst’s research; and (3) analyst compensation criteria must be set forth in writing, and management will document each compensation decision for analysts subject to Regulation AC and for research management.<sup>330</sup> Finally, investment bankers cannot evaluate analysts.<sup>331</sup>

So, what has changed under the Regulatory Actions regarding analyst compensation? Not very much. Firms must add additional layers of bureaucracy (e.g., the analyst compensation review committees), and if a firm wants to compensate an analyst for investment banking activities, the firm must include the above sentence in the analyst’s research reports, and must not tie the compensation to any “specific” investment banking deal or to the analyst’s “specific” contributions to the investment banking business. In addition, the firm must be careful to document the rationale for each analyst’s compensation, and to fit the compensation decisions into the individual performance, stock performance, and overall ratings criteria. Notably, there is no required weighting between the three broad categories. Finally, if the firm is one of the Ten Investment Banks, it must also be careful to comply with the analyst compensation principles that were agreed to in the global settlement. In total, there are a few technical requirements and a number of compensation principles, all of which can be satisfied while at the same time ignoring the spirit of the Regulatory Actions.

Let us look at an example to illustrate this point. Assume that the IPO market comes back strongly in a few years, and it is strongest for the widget industry. Brokerage Firm X has the most well-known sell-side analyst for the widget industry, Joe. The analyst is well known because he appears regularly on CNBC and is very well-connected within the industry. Joe’s forecasting and stock-picking capabilities, however, tend to be mediocre and it is felt within the firm that Joe may not conduct the most thorough due diligence of the companies he covers. The perception is that Joe finds “deals” much more interesting than conducting pure analysis. Recently, a number of prominent companies in the widget industry have conducted IPOs, and in each case hired Brokerage Firm X as an underwriter. The widget companies chose Investment Bank X primar-

---

329. Addendum A, *supra* note 198, at § I.5.

330. *Id.*

331. *Id.* at § I.6.

ily because they wanted Joe and his fame associated with their companies. The underwriting fees from the deals were roughly \$15 million to Brokerage Firm X, and substantial additional investment banking fees are expected over the next few years for further IPOs in the widget industry, as well as for financial advisory assignments and follow-on offerings. Because of Joe's popularity with widget investment banking clients, a number of brokerage firms are trying to hire Joe away from Brokerage Firm X.

How would we expect Brokerage Firm X to compensate Joe compared to another of its analysts, Jane, who is an extremely accurate forecaster, but who covers an industry that is out of favor, and therefore, generates almost no investment banking fees and mediocre brokerage commissions? Presumably, regulators hope that Joe's compensation would be inferior to, or at least in line with, Jane's compensation since Jane's research analysis is superior (although it generates less revenue for the firm). The management of Brokerage Firm X, however, might view things differently. It is not hard to imagine that the management at Brokerage Firm X desperately wants to keep Joe (and the accompanying investment banking revenue), and chooses to compensate him handsomely. Because compensating an analyst for her contribution to investment banking is improper under the new rules, such a rationale could not be stated. Joe's ability to generate substantial investment banking revenue would become the pink elephant in the room that no one would mention, but everyone would be aware was there. Of course Brokerage Firm X's analyst compensation review committee would need to come up with some rationale other than investment banking revenue for Joe's compensation. For example, the committee might focus more on the "quality" of Joe's research, which is a subjective criteria that should allow greater latitude (e.g., the committee could focus on the originality of Joe's investment thesis), and on Joe's ratings with outside services (which are particularly high with institutional investors because Joe is able to get them superior access to company management), than on Joe's accuracy. Moreover, the committee may even be able to credibly downplay Joe's current history of inaccuracy as being due to a short-term market inefficiency—namely, Joe is correct in his analysis and predictions, and it is just a matter of time before the market catches up to Joe's analysis.<sup>332</sup>

Would Joe's superior compensation be proper? If the regulators were able to demonstrate that Joe's compensation was based on his indi-

---

332. If Firm X were one of the Ten Investment Banks, it is possible that the Independent Monitors (who are charged with ensuring that the Ten Investment Banks execute and implement the reforms called for in the global settlement in a meaningful way, *see supra* notes 272-73 and accompanying text) could impede Joe's compensation. However, such an outcome would require the Independent Monitor to see a problem with Joe's compensation and to have the actual authority to stop the procedure (which is not yet clear). And, the Independent Monitors will only be reviewing the Ten Investment Banks for a six-month window that will take place eighteen months after the Final Judgment is entered, which dramatically reduces the scope of activity they will see.

vidual contributions to investment banking, then the compensation would be a clear violation of the Regulatory Actions.<sup>333</sup> Demonstrating Brokerage Firm X's inappropriate intent in its compensation decision, however, is not likely to be an easy task. It is not improper for firms to pay different analysts differently, and since the factors that a firm must consider in setting compensation are largely subjective (e.g., there is no requirement that the most accurate forecasters must be the highest paid), it should prove difficult to prove infractions of the new compensation rules absent some sort of smoking gun. Since firms have been formally put on notice of the requirements, direct evidence will likely be rare. Presumably, Wall Street officials will be more careful with their e-mails in the future, and it would be surprising if any of the documentation produced by the compensation review committees were incriminating. If anything, the new rules remind the firms to properly "paper" their decisions.

To compound matters, it has been argued that the regulators principally charged with enforcing the separation of research and investment banking, the NASD and the NYSE, suffer from a serious conflict of interest that may substantially impede their enthusiasm in enforcing the rules.<sup>334</sup> In a recent article, Professors Fisch and Sale argue that the "NYSE and the NASD are run by, and primarily are accountable to, their members, the brokerage firms. Given the importance of investment banking business for member firms, it is unrealistic to expect the [NASD and the NYSE] actively to curtail a structure that promotes these operations."<sup>335</sup>

At best, the new compensation rules are aspirational. Hopefully the brokerage firms will take the spirit of the rules to heart and will truly compensate analysts for good analysis, and not for investment banking business. Wall Street's history is checkered with examples of scandals and misbehavior.<sup>336</sup> The Regulatory Actions are simply another reaction

---

333. Specifically, Joe's compensation would violate the new analyst compensation rules set forth in NASD Rules 2711(d)(1)–(2) and NYSE Rules 472(h)(1)–(2). As well, both the firm and Joe would be in violation of the new NASD and NYSE disclosure requirements regarding compensation. If Investment Bank X is one of the Ten Investment Banks, Joe's compensation would also violate the global settlement. See Addendum A, *supra* note 198, at § I.5.

334. Fisch & Sale, *supra* note 130, at 1096.

335. *Id.*

336. It was a little more than five years ago that thirty-seven major securities firms (including each of the Ten Investment Banks) agreed to pay \$1 billion (a record at the time) to settle charges of alleged price-fixing in Nasdaq stocks. Times Wire Services, *30 Brokerages Agree to Pay \$1 Billion to Settle Class-Action Suit Litigation: Firms Deny Charges They Colluded to Fix Prices on Nasdaq. Move Is Called the Largest Civil Antitrust Deal in History.*, L.A. TIMES, Dec. 25, 1997, at D1. Even the recent regulatory attention is not limited solely to improper research analyst practices. The global settlement, for example, also charged two of the firms (CSFB and SSB) with "spinning" hot IPO allocations. Press Release on Global Settlement, *supra* note 9; see also *supra* note 171 for a detailed discussion of spinning. Suffice it to say that spinning can be characterized as a form of corporate bribery. Another current regulatory inquiry involves allegations that a number of firms "laddered" IPOs during the late 1990s and 2000. Randall Smith, *SEC 'Laddering' Inquiry Reaches Two Firms*, WALL ST. J., Nov. 6, 2002, at C1. Laddering refers to the practice of underwriters allocating stock in hot IPOs, to certain investors, in exchange for promises from these investors to purchase additional

to such misbehavior. Why should we believe that Wall Street, if given the opportunity, and a low probability of prosecution, will not misbehave again in the future? Moreover, if compensation can still be influenced by investment banking revenue, nothing fundamental has changed regarding the investment banking/research conflict. The sell-side analysts will remain aware of what the firm's investment banking interests are (which is typically publicly available information), with the knowledge that: (1) their research could help or hinder possible investment banking revenue opportunities; and (2) their cooperation (or lack thereof) could materially impact their compensation—regardless of the spirit of the new rules.

A similar weakness exists in the prohibition against promises of favorable research. Procedural changes are likely to occur, but not substantive ones. For example, while investment bankers cannot make specific promises to potential IPO clients of favorable research or a specific rating,<sup>337</sup> there has been no indication that sell-side analysts will not continue the customary practice of issuing “buy” ratings on companies their firms take public, even if the quiet period has been lengthened.<sup>338</sup> Neither should the new rules substantially curb the practice of issuers engaging new underwriters for follow-on public offerings (e.g., further offerings of their common stock following the IPO) in order to “buy additional and influential [research] coverage from the new lead underwriter[s].”<sup>339</sup> In each case, what is likely to occur will simply be a change in the procedure: (1) pitch books will have disclaimers in bold stating that no promises regarding research are being made; (2) winks, nods, and body-language will replace direct statements and promises by investment bankers regarding future research coverage; and (3) research analysts will be excluded from pitches.

While the Regulatory Actions' separation of research from the influences of investment banking is insubstantial, Wall Street will likely avoid any truly egregious behavior for the next few years. For example,

---

shares, in the open-market, at higher prices. *Id.* The additional purchases at higher prices assist in driving up the price of the stock (sometimes 200 or 300 percent in a single day), at which point the investors can sell their shares and realize substantial profits—in particular from the shares received in the IPO allocation. The underwriters were allegedly able to share in these profits by receiving extremely high commissions for trades from these investors, which gives the appearance of kickbacks. Kara Scannell, *Deals & Dealmakers: Bid to Dismiss IPO-Market Suits Is Denied by Judge*, WALL ST. J., Feb. 20, 2003, at C5. CSFB, Robertson Stephens, and J.P. Morgan have already been charged by, and settled with, regulators as a result of laddering and accompanying IPO profit-sharing violations. Randall Smith, *Morgan Stanley May Face Charges In IPO Investigation*, WALL ST. J., July 14, 2003, at C1. It has been reported that the SEC is currently investigating four to five other firms for such practice, including Morgan Stanley. *Id.*

337. NASD Rule 2711(e); NYSE Rule 472(g)(1).

338. What the author does expect to see are boilerplate insertions in all IPO pitch books that quote the specific language of NASD Rule 2711(e) or NYSE Rule 472(g)(1). For example, the pitch book may state that the firm may not “offer favorable research, a specific rating or a specific price target, or threaten to change research, a rating or a price target, to a company as consideration or inducement for the receipt of business or compensation.”

339. See Laurie Krigman et al., *Why Do Firms Switch Underwriters?*, 60 J. FIN. ECON. 245, 245 (2001).

it would not be surprising to see firms make a point to favor accurate forecasters and recommenders in compensation decisions for the short term. The regulatory spotlight remains very bright on Wall Street, and firms and employees will likely be on their best behavior over the next few years. However, with investment banking business currently down, there is little impetus on the part of firms to push the edges of the new rules, and it is easy for firms to behave. The test will not come until investment banking business returns, at which point the lessons of the last few years may have already started to fade from everyone's memories. One important characteristic about Wall Street is that it is primarily an environment for the young, and it involves significant personnel turnover on a yearly basis. As a result, the lessons of the past are often lost on the Wall Street personnel of the present. As the late 1990s begin to fade from memory, and investment banking makes a strong comeback, the practices of the past are likely to resurface.

With the amount of money in investment banking fees that are at stake, the only way to truly eliminate investment banking's influence over research is to completely sever research from brokerage firms that conduct investment banking. If you want to separate research from investment banking's influence in a meaningful way, it would require a Glass-Steagall<sup>340</sup> type of separation, whereby brokerage firms that conduct investment banking activities may not be affiliated with research activities. Anything less and the influences of investment banking will still be very clearly felt by research. It is inevitable. But, and this is a big "but," the ramifications of such a forced separation would be substantially worse than the status quo arrangement. As will be discussed in Part IV.C of this Article, rendering sell-side research independent may not be the panacea that regulators seem to think it is.<sup>341</sup> There are other fundamental factors that will continue to plague the predictive abilities of sell-side analysts, and it is foolish to believe that making research independent will solve all of the problems.

While the benefit of a complete separation of research from investment banking may not be certain, the cost is certain, and it would be very high. As noted earlier, sell-side research is not typically a self-supported department within a brokerage firm.<sup>342</sup> Sell-side research is given to cli-

---

340. The Bank Act of 1933, also known as the Glass-Steagall Act, was aimed at restoring confidence in the U.S. banking system by forcing a separation between commercial banks (e.g., those that accept deposits) and brokerage firms. See *The National Bank Act of 1933*, Pub. L. No. 73-66, 48 Stat. 162 (1933) (codified in various sections of 12 U.S.C.). The Glass-Steagall Act was effectively repealed in 1999 by the Graham-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended at 12 U.S.C. §§ 1811-1832).

341. See also Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 *YALE L.J.* 269 (2003). Professors Choi and Fisch question whether independent analysts are truly independent and whether they are more accurate forecasters than analysts affiliated with investment banks. *Id.* at 284-85.

342. See *supra* note 60 and accompanying text.



ents for free, with the goal of recovering the cost of the research through brokerage commissions and investment banking fees. If investment banking fees are removed from the equation, the basic business model for providing sell-side research would have to be dramatically changed. Sell-side research would be required to either find a new source of revenue to support it, or decrease the cost of providing research. The most likely new source of revenue would be to sell the research, rather than give it away for free, but it is not clear whether there is a substantial enough market for sell-side research that is not free.<sup>343</sup> If the demand is not there, the outcome would be a substantial scaling-back of sell-side research, both in number of analysts and analyst compensation, which is likely to lead to a significant decrease in the quality of such research. Since sell-side analysts provide the market with a substantial amount of the information and pure analysis that goes into determining the stock price for a significant portion of publicly-traded stocks, reducing the quality of the research harms both companies and investors.<sup>344</sup>

### *C. Value of Rendering Sell-Side Research More Independent is Unclear*

The above analysis assumes that rendering sell-side research more independent will substantially improve the quality of such research. This assumption seems logical, and is supported by a large amount of anecdotal (and highly inflammatory) evidence that was obtained in the investigation for the global settlement.<sup>345</sup> While the global investigation demonstrated that there were a number of bad actors amongst the thousands of sell-side analysts on Wall Street, and while it is clear that research operates in the middle of a fundamental conflict of interest between a firm's investment banking clients and its brokerage interests,<sup>346</sup> it remains nec-

---

343. See Boni & Womack, *supra* note 18, at 121; see also Choi & Fisch, *supra* note 341, at 286. Professors Choi and Fisch explain that sell-side research is difficult to sell for full value because it has the quality of a public good.

Once an analyst's research has been released to some investors, other nonpaying investors may learn of the research, either directly from the initial purchasers (who have every incentive to disseminate the information once they have traded based on it), or indirectly through changes in stock price. Subsequently, the analyst can no longer sell the information.

*Id.* (citations omitted).

344. See Draho, *supra* note 70.

345. For example, some of the more oft-quoted e-mails that came out of the Merrill Lynch investigation include the following from a Merrill Lynch Analyst:

if 2-2 [accumulate/accumulate rating] means that we are putting half of merrill retail into this stock because they are accumulating it then i don't think that's the right thing to do. we are losing people money and i don't like it. john and mary smith are losing their retirement because we don't want todd [Tappin, GoTo CFO] to be mad at us.

....

the whole idea that we are independent from banking is a big lie—without banking this would be a 3-2.

Dinallo Affidavit, *supra* note 139, at 26.

346. See *supra* notes 95-96 and accompanying text.

essary to ask the following question: Does the influence of investment banking result in a consistent and significant bias in sell-side research?

A number of academic studies have been conducted which shed some light on the impact of investment banking on the performance of sell-side analysts. While these studies cover periods prior to the late 1990s (when investment banking's pressure on research appears to have been at its greatest), they still provide some useful information. One example is a study published by Professors Roni Michaely and Kent Womack in 1999, which examined "buy" recommendations on 391 IPOs, during 1990 and 1991.<sup>347</sup> The study found that "buy" recommendations from sell-side analysts of the investment banks that underwrote the IPO performed "more poorly than 'buy' recommendations by unaffiliated brokers prior to, at the time of, and subsequent to the recommendation date."<sup>348</sup> Specifically, the study found that:

1. When the lead underwriter recommends "buy," the IPO stock increases 2.7% on average at the time of the "buy" recommendation. When analysts from non-lead banks recommend "buy," the increase is 4.4%.
2. In the months before a "buy" recommendation, the stocks recommended by lead underwriters had gone down 1.6% on average. In contrast, stocks recommended by non-lead bank analysts had gone up 4.1%.
3. In the one-year period after the buy recommendations, the underwriter recommended stocks underperformed the market by 5% on average, while the stocks recommended by non-underwriters outperformed the market by 13%.
4. For twelve out of fourteen brokerage firms . . . examine[d], the average one-year market-adjusted return after buy recommendations where they were the lead underwriter was lower than the return after their recommendations on other banks' IPOs.<sup>349</sup>

The report concluded that "recommendations by underwriter analysts show significant evidence of bias."<sup>350</sup> It should be noted that the Michaely and Womack study focused solely on sell-side recommendations in relation to IPOs,<sup>351</sup> which represents a very small fraction of companies receiving research coverage.

The Michaely and Womack study, however, only begins the discussion on the impact of investment banking's impact on research. Assuming that Michaely and Womack's findings can be more broadly general-

---

347. Michaely & Womack, *supra* note 28, at 660.

348. *Id.* at 653.

349. *Id.* at 684 (emphasis omitted).

350. *Id.* at 653.

351. Michaely & Womack, *supra* note 28.

ized for all “investment banking” analysts, how strong is this bias, and how severely does it impact the investment quality of the research?<sup>352</sup> A 1998 study by Professors Hsiou-wei Lin and Maureen McNichols examined “the effect of underwriting relationships on [sell-side] analysts’ earnings forecasts and recommendations.”<sup>353</sup> The study analyzed 2,400 follow-on equity offerings (i.e., public equity offerings that take place after the IPO) that took place in 1989–1994, and found that growth forecasts and recommendations from sell-side analysts of the firms who acted as lead or co-underwriter for a company were significantly more favorable than those made by unaffiliated analysts—although their near-term earnings forecasts were not generally greater.<sup>354</sup> Notably, however, the study found that “although affiliated analysts’ recommendations are more favorable on average, an investor would not experience weaker investment performance by following their recommendations than by following unaffiliated recommendations.”<sup>355</sup> A study published in Fall 1995 by Professors Amitabh Dugar and Siva Nathan also found that sell-side analysts of firms that provide investment banking services to a company “are optimistic, relative to other (noninvestment [sic] banker) analysts, in their earnings forecasts and investment recommendations.”<sup>356</sup> However, the Dugar & Nathan study also found that returns earned by following the investment recommendations of investment banker analysts are not significantly different from those of non-investment banker analysts.<sup>357</sup> Finally, the Dugar & Nathan study found that in spite of the greater optimism of investment banker earnings forecasts, their “forecasts are, on average, as accurate as those of noninvestment [sic] banker analysts.”<sup>358</sup>

While the academic studies support the notion that “investment banker” sell-side analysts exhibit an over-optimism compared to non-investment banker analysts, how strong that bias is appears to be debatable. More importantly, however, is the question of whether the investment banking conflict is the sole answer for analyst underperformance. If the Regulatory Actions were to truly eliminate the pressures of investment banking on sell-side research (which they do not), should we expect a dramatic improvement in the research? Or, are there other factors that

---

352. Professors Michaely and Womack considered the “credible alternative theory”—that an investment banking relationship could positively impact sell-side research, rather than bias it, due to a superior information advantage for underwriter analysts. *Id.* at 656.

353. Hsiou-wei Lin & Maureen F. McNichols, *Underwriting Relationships, Analysts’ Earnings Forecasts and Investment Recommendations*, 25 J. ACCT. & ECON. 101, 101 (1998).

354. *Id.* at 124.

355. *Id.* at 125.

356. Amitabh Dugar & Siva Nathan, *The Effect of Investment Banking Relationships on Financial Analysts’ Earnings Forecasts and Investment Recommendations*, 12 J. CAN. ACAD. ACCT. ASS’N 131, 131 (1995). The study analyzed 102 companies having relationships with eighteen different brokerage firms from 1983–1988. *Id.* at 137-38. The non-investment banker analysts came from an additional thirty-three brokerage firms. *Id.*

357. *Id.* at 131.

358. *Id.* at 154.

impact the performance of sell-side research that are just as important, if not more important, than the investment banking conflict? Would sell-side analysts continue to struggle with the predictive function of their jobs in an environment without investment banking conflicts? There are a number of factors that both professionals and academics have long understood to impact the accuracy (or inaccuracy) of sell-side analysts' forecasts and recommendations other than conflicts of interest, including:

- *Efficient Market Theory and Random Walk Theory* – The efficient market theory espouses that market prices reflect all of the publicly available information at the time. Since analyst recommendations are publicly available,<sup>359</sup> such information should immediately be encapsulated into the price of the relevant stock, and therefore, no abnormal investing advantage should be consistently garnered by following analysts' investment advice.<sup>360</sup> Rather, investment returns should mirror the returns of the market as a whole (e.g., if the market increases by ten percent, a broadly-based portfolio of stock based on analysts' recommendations would be expected to increase by approximately the same amount). As a result, a random selection of securities should perform just as well as a portfolio chosen upon the advice of research analysts. On a similar note, the Random Walk Theory provides that "short-run changes in stock prices cannot be predicted. Investment advisory services, earnings predictions, and complicated chart patterns are useless."<sup>361</sup> The Random Walk Theory is based on the notion that markets are moved by news, and news is random and unpredictable by definition.<sup>362</sup> Once the news is known, it is quickly digested by the market and incorporated in the stock's price.<sup>363</sup> As a result, a stock's price moves in a random and unpredictable manner,<sup>364</sup> and analysts should not be expected to have extraordinary forecasting abilities.
- *Human Tendency to be Overoptimistic* – Some have pondered whether sell-side analysts' failures may be due, at least in part, to the basic human tendency to be overoptimistic. For example, David Dreman, in his book "Contrarian Investment Strategies," wrote that:

[T]he literature on overconfidence turns up three major reasons for a wide-ranging optimistic bias. First, people have

---

359. Boni & Womack, *supra* note 18, at 99.

360. See *supra* notes 287-89 and accompanying text (discussing the efficient market theory).

361. MALKIEL, *supra* note 126, at 24. Taken to its logical extreme, under the Random Walk Theory, analysts' predictions (whether regarding stock recommendations or earnings forecasts) are viewed to be useless. *Id.*

362. *Id.* at 197.

363. *Id.*

364. *Id.*

unrealistic optimism about future events. Second, they have unrealistically positive self-evaluations. Third, they have unrealistic confidence in their ability to control a situation. . . . People also overestimate the skills and the resources at their disposal to ensure a favorable outcome, while they underestimate the likelihood of problems affecting them personally.<sup>365</sup>

While an analyst may be aware of the negative repercussions for overly optimistic projections and of the tendency for a significant percentage of companies to miss projections, it could be that the analyst is simply too confident in her ability to pick the good companies from the bad, and does not adequately discount for bad things to occur.

- “*Inside*” View – Some researchers have argued that decision makers tend to have an over-optimism bias due to their strong tendency to adopt an “inside view” when reviewing problems.<sup>366</sup> Under the “inside view,” the decision maker views problems as unique, rather than treating them as “an instance of a broader category,” which characterizes the “outside view.”<sup>367</sup> Under the inside view, problems are viewed individually, and are resolved by considering the specific details of the problem and then constructing future scenarios and outcomes based on those details.<sup>368</sup> Under the outside view, the specific details of the individual problem are largely ignored, and instead the decision is reached by focusing “on the statistics of a class of cases chosen to be similar in relevant respects to the present one.”<sup>369</sup> Essentially, under the outside view, the problem is treated as one instance in “an ensemble of similar problems.”<sup>370</sup>

The result of applying a predominantly inside view is an over-optimism bias, due to the decision maker ignoring past failures in similar instances.<sup>371</sup> It turns out that research analysts tend to approach their forecasts and recommendations from an inside view.<sup>372</sup> For example, if the analyst is trying to develop an earnings forecast for a company, she would typically consider the company’s historical earnings and earnings growth rate, the company’s expected market share, expected growth rate, general eco-

---

365. DREMAN, CONTRARIAN INVESTMENT STRATEGIES, *supra* note 283, at 115.

366. Daniel Kahneman & Dan Lovallo, *Timid Choices and Bold Forecasts: A Cognitive Perspective on Risk Taking*, 39 MGMT. SCI. 17 (1993).

367. *Id.* at 29-30.

368. *Id.* at 25.

369. *Id.*

370. *Id.*

371. *See id.* at 26-27; *see also* DREMAN, CONTRARIAN INVESTMENT STRATEGIES, *supra* note 283, at 110.

372. DREMAN, CONTRARIAN INVESTMENT STRATEGIES, *supra* note 283, at 110.

conomic outlook, and other similar matters.<sup>373</sup> If the analyst were to take an outside view (which is not typical), she might consider “how accurate earnings forecasts have been overall, or how accurate they have been for a specific industry or for the company itself, in deciding how precisely the analyst can estimate and the reliance that can be placed on the forecast.”<sup>374</sup> While neither the inside nor the outside view is perfect, the major problem with the inside view is that it is based on the idea that the analyst can predict all of the relevant factors for a particular company, comprehend how each of these factors will interrelate, and predict their outcome. Unfortunately:

[t]he number of possible outcomes when dozens or hundreds of factors interact in the marketplace is almost infinite. Even if one could foresee each of the possibilities, the probability of any particular scenario is negligible. Yet this is precisely what the analyst is trying to accomplish with a single, precise prediction.<sup>375</sup>

- *Overreaction/Underreaction to Information Shocks* – Research has shown that analysts have a tendency to overreact to current news (i.e., they overweight the significance of recent news and underweight the significant of prior data).<sup>376</sup> When applied to analysts, this tendency results in analysts disproportionately adjusting their forecasts due to short-run economic developments.
- *Inaccurate Data Provided by Companies* – If the data that analysts are employing to analyze companies are inaccurate, it is highly likely that the analysts’ conclusions will be inaccurate as well. While deliberate falsification of data by companies occurs on occasion (e.g., Enron and WorldCom) and receives lots of attention, it is the exception and not the rule.<sup>377</sup> The more troublesome source of inaccurate data arises from companies’ use of aggressive accounting techniques when reporting their results. Recent examples have involved the overuse by companies of “non-recurring charges”<sup>378</sup> and “pro forma results.”<sup>379</sup> Other areas of

373. *Id.*

374. *Id.*

375. *Id.* at 111.

376. Werner F. M. De Bondt & Richard H. Thaler, *Do Security Analysts Overreact?*, 80 AM. ECON. REV. 52 (1990).

377. Fernandez, *supra* note 28, at 6.

378. A non-recurring charge is a one-time charge that is not meant to occur again. Non-recurring charges are broken out from a company’s financial statements, to allow investors to understand how the company would perform in a normal year without such extraordinary charges. Some companies have taken to over-using these non-recurring charges (i.e., normal charges are labeled non-recurring), which inflates the expected prospects for the company.

379. Pro forma results are a description of a company’s financial statements based on a set of assumptions. Pro forma results are often used in conjunction with non-recurring charges to show what the company’s performance would have been without the non-recurring charges.

concern include goodwill accounting, accounting for employee stock option plans, and the general transparency of financial statements.<sup>380</sup>

- *Herding Effect* – It has long been presumed that “herding” may influence the forecasts and recommendations of research analysts. “Herding,” with respect to research analysts, refers to such analysts possibly underweighting (or ignoring) private information at their disposal, and instead conforming their forecasts and recommendations with the consensus. The idea is that if an analyst is going to be wrong, it is much more comfortable if everyone else was wrong with her.<sup>381</sup>
- *Loss of Best Sell-Side Analysts to Other Positions* – Many of the best sell-side analysts are hired away by institutional investors to become portfolio managers. Not surprisingly, there is generally more prestige and better pay to be the person “running the money,” rather than acting as the adviser.<sup>382</sup>

While there is little doubt that the conflicts faced by research analysts have had some negative impact on their performance, it is entirely unclear what the extent of this impact has been and whether the conflicts substantially impacted the investment value of sell-side research as a whole. A likely explanation is that analysts’ difficulty in forecasting the future is a combination of many of the above factors, which are not mutually exclusive. Predicting the future will always entail a substantial amount of error.

## V. A SIMPLER SOLUTION TO THE SELL-SIDE RESEARCH ISSUE— ELIMINATE THE INFORMATION GAP

### A. Retail Investors Are in the Dark

The concept that the true value of sell-side analysts may lie in their information gathering and analysis, rather than their one-word summary ratings (e.g., buy, hold, or sell) or earnings forecasts, is well understood by certain investors, but unfortunately, not all. Broadly speaking, investors can be grouped into two categories: institutional investors and retail investors. Institutional investors are entities with large amounts of money to invest, such as mutual funds, insurance companies, pension funds, and investment banks. Retail investors are basically everyone other than

---

380. The concept is that some corporate executives will try to boost their company’s share price by manipulating its earnings numbers and earnings growth rates, even though nothing has changed in the company’s underlying business to increase its actual profitability or growth rate.

381. Studies that examine herding include: Ivo Welch, *Herding Among Security Analysts*, 58 J. FIN. ECON. 369 (2000); Harrison Hong, et al., *Security Analysts’ Career Concerns and Herding of Earnings Forecasts*, 31 RAND J. ECON. 121 (2000).

382. MALKIEL, *supra* note 126, at 183.

institutional investors.<sup>383</sup> Of note, retail investors constitute a significant and ever-growing portion of the stock market, as “[a]lmost half of all households own stock, up by 60% in the past 15 years.”<sup>384</sup>

The Regulatory Actions should do little to change the confidence of institutional investors in sell-side research because, as a general rule, institutional investors have traditionally discounted the value of investment advice from sell-side research analysts.<sup>385</sup> The predictive difficulties of sell-side research analysts have not been a secret to institutional investors, as most claim: (1) to have long understood the biases under which sell-side analysts operate;<sup>386</sup> and (2) that they are able to “de-bias” the research. Such an outcome should not be surprising when you look at how institutional investors operate. Institutional investors (or, at least good institutional investors) are professional investors who make their own investment decisions and who often employ their own buy-side analysts to assist with investment decisions. Rather than use sell-side analysts for pure investment decisions, institutional investors use sell-side analysts for information, analysis, and ideas.<sup>387</sup> Sell-side research is only one of many factors that an institutional investor typically will consider in making an investment decision. A New York Times editorial described the relationship between sell-side analysts and institutional investors as follows: “Fund managers are not schoolchildren looking for instructions on what to buy. They look to [sell-side] analysts for specific information and general insight.”<sup>388</sup>

Where investor confidence levels are likely to be impacted are with retail investors. However, that confidence may be misplaced, and is likely to prove to be a substantial harm to those investors. Where institutional investors appear able to de-bias sell-side research, retail investors have not shown such an ability.<sup>389</sup> To explain this concern, it is useful to break down the sell-side analyst issue into its fundamental components, which are roughly as follows:

383. One could also include government entities and corporate (but non-institutional) investors as additional types of investors, but for simplicity’s sake, this Article focuses solely on the institutional investor/retail investor split.

384. United States Senators Max Baucus, Charles Grassley, and John McCain, *A Second Betrayal*, WALL ST. J., Mar. 13, 2003, at A12.

385. Cheryl Winokur Munk, *Settlement Does Little to Improve Street’s Credibility on Research*, WALL ST. J., May 14, 2003; see also Boni & Womack, *supra* note 18, at 104; Dinallo Affidavit, *supra* note 139, at 10; Leslie Boni & Kent L. Womack, *Solving the Sell-Side Research Problem: Insights from Buy-Side Professionals* 10 (Aug. 8, 2002), at <http://www.unm.edu/~boni/RPAWP/RPAWP.htm> (last visited Nov. 14, 2003).

386. These biases include those caused by investment banking influences and others discussed *supra* Part IV.C.

387. See Laurie Meisler, *Why Investors Pick Thinkers Over Stock Pickers*, (June 19, 2000), TheStreet.com, Inc., at <http://www.thestreet.com/markets/analystrankings/962962.html> (last visited Nov. 14, 2003).

388. Sernovitz, *supra* note 19.

389. Boni & Womack, *supra* note 18, at 115.



- Prior to the recent stock market meltdown, sell-side analysts enjoyed a privileged status on Wall Street, primarily with average retail investors, as “informal advisers and stock-picking gurus to the masses.”<sup>390</sup>
- The stock market suffered a substantial meltdown, beginning in March 2000, resulting in the loss of trillions of dollars of market capitalization.
- Sell-side analysts failed to warn investors of the market meltdown.
- Historically, sell-side analysts have had difficulty at forecasting and making recommendations. Conflicts of interest have likely had some impact on this weakness of sell-side analysts, although the extent of this impact is unclear.
- To truly render sell-side research independent would require a complete separation of research from investment banking, which would likely have a very negative impact on sell-side research.
- It is unclear whether rendering sell-side research more independent would provide a substantial benefit.
- Confidence in sell-side analysts appears to have decreased for retail investors. As an example of retail investors’ increased skepticism, a 2002 Wall Street Journal/NBC News poll found that only thirty-seven percent of Americans “believe that recommendations from financial advisers are ‘primarily motivated’ by a desire to help their clients make money.”<sup>391</sup> It does not appear that confidence in sell-side analysts was ever that substantial for institutional investors.

Given this state of events, it appears that the market was properly taking care of the sell-side analyst issue. Retail investors were getting on the same page as institutional investors and becoming aware that sell-side analysts cannot be viewed as oracles when it comes to investing advice. It was an extremely expensive lesson to learn, but it was being learned.

While many ideas have been floated as to why sell-side analysts as a class have underperformed, we simply do not yet know the answer. And, since we do not yet know the cure for resolving sell-side analysts’ underperformance, it is reckless for the regulators to establish a large and well-publicized regulatory schema with the stated purpose of restoring

---

390. Regan, *supra* note 21.

391. John Harwood, *Americans Distrust Institutions in Poll: Low Marks Go to Corporate Executives, Brokers, Drug and Oil Industries, the Catholic Church*, WALL ST. J., June 13, 2002, at A4.

confidence in sell-side analysts. The Regulatory Actions perpetuate a very dangerous information imbalance that was beginning to erode. Institutional investors will continue to understand the limitations of sell-side research, while retail investors are encouraged to once again have confidence in a very fallible system. By implementing a major overhaul of the sell-side research regulatory environment, the regulators have given the message that sell-side research has been materially improved. As a result, when the bulls retake control of Wall Street, retail investors will be primed to once again unquestioningly believe in the words of the sage sell-side analysts, only to be disappointed when the next bear market strikes.

The global settlement did include \$80 million for investor education programs.<sup>392</sup> Presumably, one purpose of these programs will be to educate retail investors that sell-side analysts should not be relied upon blindly. While such programs serve as nice talking points for politicians, this author is extremely skeptical that anything effective will come from the investor education programs. To demonstrate this point, one need only look at the results from an investor survey that was recently conducted by the NASD.<sup>393</sup> In the survey, the NASD “asked 1,086 [retail] investors more than 50 basic . . . questions about investing in stocks, bonds and mutual funds.”<sup>394</sup> Some of the more shocking findings of the survey include:

- Nearly 50 percent [of respondents] thought stock market losses were insured.
- Seventy percent of investors failed to understand that when you buy on margin, you can lose all of your investment even if the value of your shares does not go to zero.
- Nearly 80 percent did not understand fully the meaning of “no load” mutual funds.<sup>395</sup>

Based on the NASD survey, retail investors appear to be so poorly informed about basic investment information that it is simply not realistic to believe that they can be educated sufficiently to debias the weaknesses and conflicts that plague sell-side research.

---

392. See *supra* notes 274-77 and accompanying text.

393. NASD Investor Literacy Research (Executive Summary), Prepared by Applied Research & Consulting LLC (2003), available at <http://www.nasdr.com/pdf-text/surveyeyecsum.pdf> (last visited Jan. 31, 2004); see also NASD News Release, *NASD Announces \$10-Million Education Fund—Investor Survey Underscores Importance of Education*, Dec. 2, 2003, available at [http://www.nasdr.com/news/pr2003/release\\_03\\_054.html](http://www.nasdr.com/news/pr2003/release_03_054.html) (last visited Jan. 31, 2004) [hereinafter NASD News Release].

394. NASD News Release, *supra* note 393.

395. *Id.*

*B. Mandatory Warning Label*

Until now, this Article has focused on criticizing the approach taken by the Regulatory Actions to address the sell-side analyst problem. Now it is time to offer a dramatically simpler solution to the problem. The most effective solution is the most traditional one: disclosure. As Louis Brandeis so eloquently put it, "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."<sup>396</sup> Sell-side research should be required to carry a warning label ("Mandatory Warning Label") that clearly points out the possible failings of sell-side research, and puts retail investors, as much as possible, on the same informational footing as institutional investors. The Mandatory Warning Label should read roughly as follows:

SEC WARNING: The Securities and Exchange Commission warns investors that: (1) it is unclear whether investing strategies based on research analysts' recommendations will consistently outperform the market; (2) research analysts have consistently proven to be overly optimistic about the future performance of the companies they cover; and (3) research analysts operate under a multitude of conflicts and biases that negatively impact the quality of their research. Before making an investment decision, you should conduct your own research, rather than rely solely on the advice of a research analyst. If you are not capable of conducting your own research, you should consider less risky investments than individual stocks.

Since sell-side analysts' forecasting and recommendation functions have shown consistent and material weaknesses,<sup>397</sup> and since it is unclear whether there is a ready fix to these weaknesses,<sup>398</sup> the solution to the sell-side research issue should focus on warning research recipients of these weaknesses. For investors that are able to conduct their own research and de-bias the sell-side research of its weaknesses, they have been clearly warned and can take appropriate precautions when considering sell-side research. They can profit from the value of the research, while at the same time protect themselves from the weaknesses. For those investors who are not capable of conducting such independent research, they have been formally warned that it may be advisable to find a less risky investment than individual stocks. Rather than leave vulnerable investors to deal with myths and misunderstandings about the value of sell-side research, the Mandatory Warning Label would clearly and succinctly put them on notice.

---

396. LOUIS D. BRANDEIS, *OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT* 92 (Frederick A. Stokes Comp., 10th prtg. 1934).

397. See discussion *supra* Part IV.A.

398. See discussion *supra* Parts IV.B and C.

The Mandatory Warning Label would also serve to better align the desired behavior of both the recipients and producers of sell-side research. For the recipients of sell-side research, the desire should be that they not behave recklessly in their investment decisions. As noted above, the Mandatory Warning Label clearly and succinctly puts them on notice of the weaknesses of sell-side research. For the producers of sell-side research, the desire should be that they produce an abundance of accurate research. Therefore, any approach to the sell-side research issue should avoid overly burdening the producers of research (which would lead to substantially reduced resources being committed to sell-side research), while at the same time encouraging the producers to find ways to improve the accuracy of their product. Rather than have regulators theorize about what is necessary to improve research, the Mandatory Warning Label would squarely place the burden of improving the quality of research on the producers. Forcing producers of research to carry the Mandatory Warning Label should provide ample incentive (at least for those who market their research to retail investors) to develop concrete mechanisms and evidence that demonstrates the value of their research, so as to overcome the Mandatory Warning Label.

To give the Mandatory Warning Label maximum effect, it should be given by the SEC. Just as the Surgeon General is able to lend credibility to the warnings on cigarette packages, the SEC, as the most prominent administrative agency that oversees the capital markets, should be able to provide a similar function for the Mandatory Warning Label. Moreover, the SEC should be charged with continuing to follow the research analyst issue and adjusting the Mandatory Warning Label as new developments arise.

Because the Mandatory Warning Label is aimed at retail investors, it is crucial that it be clear and concise. While there is an abundance of disclosure regarding research analysts and their historical performance in the Regulatory Actions, it is likely that much of this disclosure will be lost on retail investors. As is so often the case with new disclosure requirements, the focus of the requirements is on producing a large volume of raw data, rather than providing easily digestible information.<sup>399</sup> For example, the New NASD/NYSE Regulations require firms in each research report (and research analysts during each public appearance) to make a number of different disclosures which are meant to indicate possible conflicts of interest that the research analyst or her firm might have

---

399. See Joseph Bartlett, *Sarbanes-Oxley: Too Much Disclosure?*, VC EXPERTS (Dec. 10, 2002), at <http://vcexperts.com> (examining the issue of too much disclosure) (subscription required) (article on file with author). In the article, Joseph Bartlett ponders whether new disclosure requirements are motivating companies to produce so much disclosure that it becomes virtually "unreadable to anybody other than a financial professional." *Id.* To illustrate his point, Mr. Bartlett discussed a recent public disclosure filing by AT&T in connection with the merger of AT&T Broadband with Comcast which was 800 pages long. *Id.*

vis-à-vis the subject company, including: (1) equity ownership in the subject company by either the firm or the research analysts;<sup>400</sup> (2) client relationships, and compensation arrangements, with the subject company,<sup>401</sup> and (3) officer, director, or advisory board positions held by the research analyst in the subject company.<sup>402</sup> While such information may be valuable to an institutional investor who is experienced at de-biasing sell-side research (and knows where to look for it in the research report), it is not so clear how helpful it is to retail investors. First, while such disclosure indicates possible conflicts of interest that the analyst may have, it provides no explanation of the correlation between those conflicts and their historical impact on sell-side research. For disclosure to be meaningful, it must be plain and clear, rather than simply technically accurate. Is every retail investor supposed to know that sell-side analysts of firms, which have an investment banking relationship with the covered company, have demonstrated a historical tendency to be over-optimistic in their forecasts and recommendations? Some informed academics have considered as a credible theory that "investment banking" sell-side analysts might be "not only unbiased but also more accurate," due to a superior information advantage.<sup>403</sup>

Even some of the more interesting new disclosure requirements will likely be hard to understand for most retail investors. For example, the New NASD/NYSE Regulations require that firms disclose in all research reports (although this disclosure is not required by research analysts during public appearances): (1) the percentage of securities assigned to buy/hold/sell categories and the percentage of companies within each of these three categories for whom the firm has provided investment banking services within the past twelve months;<sup>404</sup> and (2) a price chart that graphically illustrates the historical price trends of the covered stock, with indications of the dates on which the firm assigned or changed each rating or price target, and what the rating was in each case.<sup>405</sup> Once again, this can be very valuable raw data that can be very beneficial to sophisticated investors who are skilled at de-biasing research. However, it too falls short of the needs of less sophisticated retail investors, who need more than raw data. For many investors, their need is digested conclusions, which is the whole reason that they became so reliant on the advice of the research analysts in the first place. The Mandatory Warning

---

400. NASD Rules 2711(h)(1)(A)-(B); NYSE Rules 472(k)(1)(i)(c), (k)(1)(iii)(b), (k)(2)(i)(a)-(b).

401. NASD Rules 2711(h)(2)(A)-(B); NYSE Rules 472(k)(1)(i)-(iii), (k)(2)(i)(b), (c), (f).

402. NASD Rule 2711(h)(3); NYSE Rules 472(k)(1)(iii)(c), (k)(2)(i)(e).

403. Michaely & Womack, *supra* note 28, at 656; *see also* Joseph McLaughlin, *The Changing Role of the Securities Analyst in Initial Public Offerings*, INSIGHTS, Aug. 1994, at 6 (discussing the benefits of having sell-side analysts involved in the IPO process).

404. NASD Rule 2711(h)(5); NYSE Rule 472(k)(1)(i)(g).

405. NASD Rule 2711(h)(6); NYSE Rule 472(k)(1)(i)(h); *see also supra* note 250 and accompanying text.

Label is meant to provide these most vulnerable investors some very valuable digested conclusions—namely, that analysts can be wrong.

Finally, the new disclosure falls prey to a constant nemesis of meaningful disclosure—it looks like boilerplate. With respect to the new disclosure in written reports, it more closely resembles the fine print on the back of a contract of adhesion<sup>406</sup> than it does meaningful information. Since the New NASD/NYSE Regulations permit the new disclosure to be included anywhere in the research report (including on the last page), so long as the front page indicates where the disclosures can be found, it is not surprising that most firms have taken to burying the disclosure on the last page, where it is unlikely to be read by any but the most sophisticated investors. The disclosures made in public appearances by research analysts fare no better in the battle against boilerplate. Much of the required disclosure (such as buy, hold, and sell ratios, and historical performance of the research analyst) is not required to be made in public appearances;<sup>407</sup> presumably because it is too long and cumbersome for such a forum. Even for the disclosure that is made in public appearances, all one has to do is watch a few analyst interviews on CNBC to see the bored expression of both the analyst and the interviewer as the analyst recites her prepared disclosure statement.

The Mandatory Warning Label, which is as easily delivered in print as it is orally, is meant to break through the impact of such bored recitals, and instill skepticism in the class of investors that most needs to take a skeptical approach when investing in individual stocks. Retail investors should be aware of the substantial amount of risk that is involved when investing in individual stocks—that analysts do not have mystical fortune-telling powers, and that less risky alternatives are available. With respect to written reports, the Mandatory Warning Label should be included at the top of the front page (no exceptions), in large, clear font-type, of any research report that includes a projection, recommendation, or price target. The Mandatory Warning Label should also be required for: (1) any public appearance by a research report where a projection, recommendation, or price target is delivered; and (2) any conversation (including via telephone) where a broker refers to a research report when recommending a particular investment strategy to a client. Since many investors receive their investment advice from talking with their broker, rather than from reading a research report, it is critical that broker conversations be subject to the Mandatory Warning Label requirement.

---

406. A contract of adhesion is a standard form printed contract that is typically not negotiable. 1 ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 1.4 (3d ed. 1993). They are “take-it or leave-it” contracts, such as insurance policies, the contract you sign to open a bank account, the contract you sign to purchase a television, etc. *See id.*

407. *See* NASD Rules 2711(h)(5)–(6); NYSE Rules 472(k)(1)(i)(g)–(h), (k)(2).

The Mandatory Warning Label would operate nicely with much of the Regulatory Actions, including the increased disclosure requirements, the personal trading restrictions, and Regulation AC. As noted earlier, while the new analyst trading restrictions and Regulation AC are not likely to materially improve the quality of sell-side research, neither are these changes likely to result in major negative repercussions, so long as they do not materially restore investor confidence in sell-side research (which should be taken care of by the Mandatory Warning Label). With regards to the Regulatory Actions that involve separating research from investment banking, they should be largely eliminated. We need to be honest about what can be enforced and what cannot be enforced. Setting up rules that can be easily circumvented is likely to further the information imbalance that the Mandatory Warning Label would be addressing (since more knowledgeable investors are more likely to become aware that the rules are being circumvented). Additionally, easily circumvented rules degrade respect for securities regulations amongst Wall Street professionals as lack of true compliance with the rules becomes more prevalent.

#### CONCLUSION

Not every problem is fixable. Sometimes the best solution is simply to provide an effective warning. The key to understanding what to do about sell-side research is to recognize it for what it is. Sell-side research is a product, and like many products, it has both strengths and weaknesses. Take aspirin for example. Aspirin is an incredibly valuable drug with numerous applications to assist in furthering the health and well-being of people. Aspirin also has a number of very serious side effects, including the ability to kill people who take too much aspirin. How do we deal with the side effects for aspirin? Do we require aspirin manufacturers to fundamentally change how aspirin is manufactured, but in the process risk destroying the value of aspirin? Or even worse, do we give false comfort that the dangers of aspirin have been removed? Of course not. Instead, we require aspirin manufacturers to disclose the risks of using aspirin, allowing consumers to make an informed choice on whether or not to take it. There is no reason to treat sell-side research any differently. By providing a clear warning of sell-side research's weaknesses, maybe retail investors could then view sell-side analysts more realistically—they are valuable sources of information, not clairvoyants with the ability to see the future.

