Ethical Issues Facing Stock Analysts

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Much has been written about the bull market environment in the late 1990s that created numerous conflicts between the analysts' duty to the investor community and their firm's investment banking. But relatively little has been written about what those specific responsibilities were and why inevitable conflicts are so central to the position.

This article argues that the role of a sell-side analyst (sell-side analysts are securities research analysts that work for brokerage firms as opposed to those that work for money management firms) is inherently one of attempting to balance the interests of its various constituencies. Although the further regulatory separation of investment banking and sell-side analysis created by the passage of the Sarbanes-Oxley Act of 2002 and new regulations from the Securities and Exchange Commission (SEC) and National Association of Securities Dealers (NASD) helped to reduce such conflicts, this article argues that conflicts continue to exist and in some cases are likely never to be solved.

The author argues that, ultimately, the only constraint that will allow an analyst to do the right thing for all its constituents is a focus on the analyst's reputation. In the short-run it is possible for an analyst to sacrifice his reputation for gain, but in the long-run it is the favourable reputation of the analyst that ultimately entices clients to work with his stock brokerage company.

In this article, the author discusses what the author believes are the three primary responsibilities of the sell-side analyst, how those responsibilities conflict, and how these conflicts are likely never to be fully resolved. The article concludes that the sell-side analysts' role, by its very nature, is one of weighing conflicting responsibilities to a variety of constituents and that there is no simple rule of behaviour that will satisfy all concerned. *The Geneva Papers* (2005) 30, 451–466. doi:10.1057/palgrave.gpp.2510033

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Introduction

The responsibilities of sell-side analysts have become, in recent years, a widely discussed topic in the press. Sell-side analysts are securities research analysts that work for brokerage firms as opposed to those that work for money management firms. For the past couple of years, there has been a constant stream of newspaper articles discussing the apparent shortfall in ethical lapses of the sell-side analyst community and why such a shortfall happened.

Over the last several years, there has been increased concern regarding the changing role of research analysts. Certainly this issue has garnered national attention, and Attorney General Eliot Spitzer of New York has brought this issue into sharp focus. While sell-side analysts used to be perceived as objective forecasters of corporate prospects and providers of opinions, they have increasingly become involved in

marketing the broker's investment banking services. As markets have declined, and with the downfall of Enron, there is increased public concern about research analysts' conflicts of interest.¹

The author argues that the very nature of the sell-side analyst's job involves conflict and that it may not be possible to simply eliminate conflicts through regulation. Analysts must take each case individually and decide what is best.

This article includes a brief overview of what a sell-side analyst is, a framework in which to discuss his/her principal responsibilities, background on current controversies and a discussion of unusual, and in many cases, difficult to resolve conflicts that arise from conflicting responsibilities.

What is a sell-side analyst?

The public often confuses the various positions called analyst. The sell-side equity analyst is a person who provides equity research at a brokerage firm. A brokerage firm is principally in the business of conducting stock or bond trades for its clients. The brokerage firm makes money by either charging its customer a commission for handling the trade or by making a spread on the difference between what it pays for a security from one client and what the firm sells the security for to another client. These clients can be either individuals or institutions such as pension funds and mutual funds. Examples of brokerage firms are Merrill Lynch, Morgan Stanley, and Goldman Sachs.

The sell-side equity analyst typically provides free services – research reports, commentary and personal attention – to prospective or current brokerage clients in the hope that their services will entice the client to trade securities with their firm.

It is important to note that most brokerage firms are also investment banks. Investment banks make money through commissions charged for raising funds for clients – principally corporate clients – or through advisory fees typically related to mergers and acquisitions by the client. It is very difficult – practically impossible – for an investment bank to raise money for its corporate clients without a brokerage operation to sell the securities. This is why the two businesses are almost always closely linked.

For the purpose of this report, we will use the term securities firm to refer to any firm that is both a broker-dealer and an investment bank.

Further, most corporate clients see research expertise as a sign that the investment bank-brokerage firm has the expertise to distribute its securities to buyers. The better the quality of the securities research in an industry, the more qualified corporations in that industry feel the securities firm will be able to issue the corporation's securities. This leads to the much-discussed tie between equity research and investment banking. The relationship of the equity research analyst with the investment bank corporate client was and continues to be important to support investment-banking efforts for investment banks.

¹ SEC (2002).

Sell-side securities analysts contrast with buy-side security analysts. A buy-side security analyst typically works at a mutual fund or pension fund. A buy-side analyst provides research on securities for portfolio managers and other money managers at their firms. A buy-side analyst's research is proprietary to their firm. Unlike a sell-side analyst whose work is typically widely disseminated among investors, a buy-side analyst's research is used only by their firm and is not disseminated in any way to the general public in most cases.

The role of the sell-side analyst

The sell-side investment analyst's role is very broad. The analyst is charged with

- ranking stocks (buy, sell, hold),
- writing research that supports his view,
- developing and maintaining brokerage client relationships with institutional investors,
- being an able and timely information source for retail and institutional brokers,
- developing and maintaining relationships with the companies with which the analyst writes research and, among other things,
- standing ready to provide expert opinion on the industry and companies within the analyst's industry expertise including providing due diligence for potential securities offerings.

Investment research is multi-faceted. The details of the analysis are highly significant to understanding the conclusion and it is difficult to discern the value of research when it is over-simplified. Typical research reports are many pages in length, but are often condensed by brokers or the media to no more than their conclusions: an earnings forecast or a buy, hold or sell recommendation. It is critical that investors understand that one-word ratings or recommendations do not provide sufficient information to justify buying or selling a security. Rather, investors should carefully weigh the investment characteristics in the entire research report (or conduct additional research) against their personal financial situation, investment objectives and constraints before making an investment decision.²

Broadly speaking, the sell-side analyst is part of the investment process for the firm's brokerage clients; his function is also to provide information for the broader market and to be an industry expert for internal use within the company.

In most brokerage firms, the analyst can be called upon for just about any project related to his field of expertise.

In the author's view, these responsibilities can be boiled down to three primary responsibilities that are sometimes in conflict:

- (1) Responsibility to the *firm* including its goals (such as to maximize the firm's profits);
- (2) Responsibility to the *brokerage client* to help to find profitable investments;

² CFA Institute (July 2001).

(3) Responsibility to the *corporate client* to provide information and analysis on the company's stock to potential investors.

These goals, of course, are constrained by the legal and ethical constraints common to all as well as those regulatory constraints specific to the brokerage business. The first standard of the CFA Institute's Standards of Professional Conduct puts it succinctly (in the author's view):

Members Shall:

- (a) Maintain knowledge of and comply with all applicable laws, rules and regulations (including AIMR's³ Code of Ethics and Standards of Professional Conduct) of any government, government agency, regulatory organization, licensing agency, or professional association governing the member's professional activities.
- (b) Not knowingly participate or assist in any violation of such laws, rules or regulations.

The CFA Institute is the principal educational investment analyst society for the investment industry. It is best known for its administration of the CFA exams. In order to hold a CFA designation, investment professionals must pass a series of challenging exams as well as subscribe to the CFA Institute's Code of Ethics and Standards of Professional Conduct. More than 70,000 investment practitioners and educators are members of the organization, which is why it is often considered the standard for the industry.

Conflicting duties – the responsibility to the firm

The first responsibility discussed above is simply, as an employee of the firm, to help the firm achieve its goals. For most stock brokerage companies, this means maximizing its profits. This may lead to many conflicts as responsibilities – such as those to the investment client – often run counter to the firm's goal of maximizing profits.

One can divide the business of most securities companies into two parts – the broker-dealer and the investment bank.

The brokerage-dealer's business is to entice investors (both institutional and retail) into trading securities through the broker-dealer. The broker-dealer will then make a profit derived from either the spread (broker) or commission (dealer). Either way, the role of the analyst is to service the clients in order to entice them to trade.

The most obvious conflict is that it is not necessarily in the best interest of the investor client to buy or sell a particular security at a particular price. It is important to recognize that it is not necessarily a common problem. Except in very rare cases, sell-side security analysts cannot force an investor to buy or sell a security. Whether to trade a security is left entirely to the discretion of the investor or investment manager, where analysts often run afoul of their responsibilities in recommending securities is in the temptation to provide inaccurate information that makes a recommendation look

³ The Association of Investment Management and Research or AIMR is the former name of the CFA Institute.

better than it should or to tout a stock by using exaggerating wording or hyperbolic language.

More typically in the United States, the reward for a sell-side analyst comes only after his work has been given to the investor client for free. The investor assesses the value of the work provided by the sell-side analyst and then that investor decides to trade through the analyst's broker-dealer.

Typically, most of the time spent by sell-side analysts is with experienced and knowledgeable investors. The vast majority of sell-side analysts deal directly with only institutional clients or registered representatives (National Association of Securities Dealers -NASD Series 7 licensed sales brokers) at their firm. Because the analyst has the most influence with institutional investors, most sell-side analysts focus a majority of their time on institutions.

The layman might think that the responsibilities of the sell-side analyst towards their brokerage client are very clear. If the analyst helps the institutional client purchase money-making investments either through recommendations or by providing helpful information and analysis, then the investor is likely to trade through the analyst's bank. This is often the case, but is not necessarily the situation, as discussed later.

The other half of the brokerage/investment banking company is where most of the conflict for the sell-side analyst lies – the investment bank. This conflict was much discussed in 2002 when the New York Attorney General (NYAG) investigated a number of the largest securities firms over sell-side analysts' conflicts of interests. In later testimony to Congress, the NYAG described the situation: "Some Wall Street analysts ignored their duty to investors by instead giving priority to the interest of their investment banking colleagues."⁴ Most stock brokerage companies are also investment banks. Investment banks primarily make money by providing advice for a fee or raising capital for corporate clients. It is in the raising of capital for corporate clients that the primary conflict of interests for sell-side analysts lies.

Investment banks have great monetary incentives to issue new securities for corporate clients because the commission associated with new issues is large – often as high as 7 per cent of capital raised. Analysts historically have had a large role in selling new corporate issues. Analysts have been responsible for developing the sales pitch to prospective investors and have often made sales pitches to large potential investors for the new issue. For example, according to the testimony of the Chairman of the SEC, William Donaldson, before the Senate Committee on Banking, Housing and Urban Affairs,

In May 2001, a technology research analyst at CSFB (Credit Suisse First Boston) wrote an email to the Head of Technology Research complaining of "Unwritten Rules for Tech Research: Based on the following set of specific situations that have arisen in the past, I have 'learned' to adapt to a set of rules that have been imposed by Tech Group banking so as to keep our corporate clients appeased. I

⁴ Spitzer (2003a).

believe these unwritten rules have clearly hindered my ability to be an effective analyst in my various coverage sectors.”⁵

Perhaps most importantly, the promise of further favourable research coverage was often a major selling point in getting a corporate client to issue securities through the analyst’s firm. This created an obvious conflict with the analyst’s investor clients if the analyst maintained undeserved positive investment ratings to benefit their firm’s investment bank.

In 2003, SEC Chairman William Donaldson described the example of Merrill Lynch’s use of allegedly biased research to promote the investment banking of internet stocks.

On April 8, 2002, NYAG (New York Attorney General) Eliot Spitzer commenced an action in the New York State court pursuant to New York’s Martin Act against Merrill Lynch & Co. Inc., Henry M. Blodget, and several other Merrill Lynch analysts. In papers filed with the state court, the NYAG alleged that since late 1999, the internet research analysts at Merrill Lynch had published ratings for internet stocks that were misleading in that, among other things, the reports did not reflect the analysts’ true opinions and Merrill Lynch did not disclose that the ratings were affected by conflicts caused by the analysts’ ties to investment banking. The NYAG included with his filing dozens of exhibits, including internal Merrill Lynch e-mails demonstrating the analysts’ conflicts of interest.

The NYAG reached a settlement with Merrill Lynch on 21 May 2002, pursuant to which the firm agreed to pay a penalty of \$100 million and, among other things, to sever the link between compensation for analysts and investment banking, prohibit investment banking input into analysts’ compensation, create a new investment review committee responsible for approving all research recommendations, establish a monitor to ensure compliance with the agreement, and disclose in Merrill Lynch’s research reports whether it received or was entitled to receive any compensation from a covered company over the previous 12 months.

In December 2002, the then-Chairman Harvey L. Pitt, NYAG Spitzer, NASAA President Christine Bruenn, NASD Chairman and CEO Robert Glauber, NYSE Chairman Dick Grasso, and state securities regulators announced an historic settlement-in-principle with the nation’s top investment firms to resolve issues of conflict of interest at brokerage firms. Following the announcement, the Commission staff worked diligently with other regulators and the firms to finalize the settlement-in-principle. The broad principles agreed to in December 2002 are reflected in the terms of the final settlements approved by the Commission, and announced in May 2003.⁶

While regulation has further separated the sell-side analysts from their firm’s investment bank, there is inherently a relationship between their firm’s ability to raise capital for its corporate clients and the quality of its securities research.

Sell-side analysts also are an important part of the “due diligence”⁷ for investment banking deals – principally transactions that raise capital for corporations and are

⁵ Testimony Concerning Global Research Analyst Settlement (7 May 2003).

⁶ *Ibid.*

⁷ Due diligence refers to the process securities analysts and investment bankers use to insure a transaction is favourable for their customers, that risks associated with the transaction are understood and disclosed, and that information received from the security issuer is accurate.

sold to investors. Sell-side analysts attempt to determine if a transaction is favourable to investors as well as if the transaction can be completed. The analyst's work is critical to the firm in making sure that the transaction does not create a liability for the firm.

A frequent conflict of interests that arises for the analyst in the due diligence process is between the short-term need to make a transaction, such as an initial public offering (IPO) or secondary common stock offering, and the long-term need of the firm to avoid transactions that will fail and create a liability for the firm. The short-term need of the firm to maximize short-term profits by completing as many investment-banking transactions as possible also creates conflicts for the analyst's other responsibilities. Poor investment banking transactions can result in money-losing investments for investors (responsibility to investors). Since poorly performing investment banking transactions frequently result in costly lawsuits, it is in the best interest of all involved that only successful investment banking transactions take place.

Conflicting duties – responsibility to the brokerage client to recommend profitable investments

The following was taken from the website of the security broker Morgan Stanley concerning its commitment to the individual investor:

Our commitment

- We will put you and your interests first. We only succeed by helping you succeed.
- Your primary contact with us is through your financial advisor. We will put the resources of our firm behind your financial advisor to help you reach your goals.
- We are committed to understanding you, your personal financial needs, your tolerance for risk and any other factors that may affect our recommendations.
- We will help you understand your investment choices. We will help you set realistic expectations about the long-term performance and associated risk of those choices.
- If you have an issue or concern, we will make it our priority to address it. We have created the position of client advocate to help resolve any issues that are not promptly resolved by your financial advisor or his or her branch manager.
- We will be available for regular conversations with you about the status of your investments with us and changes in your personal profile.
- We will provide timely account and transactional information that accurately reflects the investment positions you hold with our firm.
- We will disclose information related to the way we are paid by you as a client, including commissions and fees associated with your account. We will answer questions you have about how your financial advisor is paid.
- We will share our policies and practices relating to the privacy of the personal information you provide us.
- We will do our best to build and justify your trust in us.⁸

Recommending profitable investments is the task laymen most often associate with securities research analysts. Although it is the goal of all securities analysts to

⁸ Morgan Stanley (2003).

recommend profitable investments, it is not precisely what analysts do. Instead the responsibility is better defined as helping the investor to find profitable investments.

The CFA Institute's Best Practice Guideline Governing Analyst/Corporate Issuer Relations states under the guidelines for analyst conduct that "Analysts must issue objective research and recommendations that have a reasonable and adequate basis supported by thorough, diligent, and appropriate research and investigation."

Analysts provide their own opinions (buy, hold, etc. recommendations), commentary on their investment thesis, offer ratings and assessments on the risk associated with investments, earnings and other financial projections, company descriptions and many other services to help investors find profitable investments.

This may surprise those outside of the securities brokerage business, but the responsibility to recommend profitable investments does lead to conflicts of interests.

For example, it is possible that downgrading a stock can cause a conflict of interests even without pressure from investment banking.

Sell-side analysts are often criticized for maintaining positive ratings for too long. In testimony to Congress, the NYAG's comments supported the public misconception that investment-banking conflicts are the only reason for a bias towards favourable ratings when he said, "Wall Street analysts rarely if ever issue a "sell" recommendation, because that would be contrary to the interest of bankers."⁹

The most often cited reason for this is investment-banking conflicts of interest. The analyst recognizes that maintaining a favourable rating increases the likelihood that a corporate client will choose their firm to purchase investment banking services. Even if a corporate client ignores the analyst ratings, it is easier for the firm to raise capital for its corporate client if the analyst has a favourable rating. "... The principle that we have articulated – that analysts need to tell the truth, analysts need to be surrounded by a cocoon that will permit them to be honest and straightforward – is readily stated."¹⁰

One example is the danger of upsetting large institutional clients when the analyst changes a rating. There is an adage among Wall Street analysts which goes, "Never downgrade a stock on January 31." This is because investors that own a security are often upset by new negative ratings or news. This is especially true at year-end, where the final day annual investment performance is measured for portfolio managers. Portfolio managers become angry when a sell-side analyst causes a stock to fall just as their annual stock picking performance is calculated. Analysts who downgrade a stock run the risk of upsetting holders of the stock who will, in turn, cease to trade stock through the analyst's firm. Since the vast majority of investors are "long only," or investors that do not short-sell securities, most investors have a bias to look upon downgrades unfavourably. "Long only" investors refers to investors that only own securities outright and cannot benefit through short-sales from falling securities prices. Short sales are investment transactions that benefit from falling securities prices. In a short sale, investors borrow a security at a set interest rate or margin rate and then sell the security. At some point, the short selling investor must return the borrowed

⁹ Spitzer (4 November 2003a).

¹⁰ Spitzer (16 April 2003b).

security by repurchasing the security in the financial market at (hopefully for the investor) a lower price. This is another reason besides investment banking conflicts why there tends to be positive bias for investment ratings.

Ironically, the more effective the analyst and, therefore, the more impact upon a security, the greater the conflict of interests between the analyst and investors when the analyst reports something negative about a security. Analysts with wide followings can sometimes impact the price of the security in the short-term. Investors who own a security impacted negatively by a well-regarded analyst can be the most upset because the change in the security price is greater when the analyst is well regarded by Wall Street.

Large investors often demand more than simply good information or thoughtful opinion. Often investors demand information before others have it. This can lead to “front running” of ratings, estimates and price target changes. Frontrunning refers to using new material information to trading securities by broker-dealers or money managers for their own account before that information is used to trade for their client’s account. Front running of material information about a security is illegal and it is up to the analyst to resist the demands of their client. Broker-dealers and money managers are supposed to favour their client’s accounts before their own.

Some securities firms have asset management or proprietary trading desks (units that manage the firm’s investments) that use the sell-side analyst’s work. There can be pressure brought to bear upon the analyst to give advice and information first to the asset management and proprietary traders. This can be another form of front running as the analyst may be giving useful information first to internal users instead of the firm’s brokerage clients.

There are a number of important conflicts of interests that arise because of the requirement to provide investments to investment clients that are suitable to the individual client.

It is well established that full-service broker-dealers have an affirmative fiduciary obligation to inform themselves of each customers’ investment objectives and general financial situation, so as to ensure that each security recommended is “suitable” to the customer’s investment objectives and financial situation.¹¹

¹¹ Gedicks (2005); 2310. Recommendations to Customers (Suitability):

- (1) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.
- (2) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers, where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:
 - (a) the customer’s financial status;
 - (b) the customer’s tax status;
 - (c) the customer’s investment objectives; and
 - (d) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.
- (3) For purposes of this Rule, the term “non-institutional customer” shall mean a customer that does not qualify as an “institutional account” under Rule 3110(c)(4).

Investors have different investment criteria and equity analysts must typically work with a single “buy” recommendation definition. Most sell-side analysts work with investment recommendations that require a one-year outlook. The rise of hedge funds has increased the number of investors interested in short-term trading opportunities. Hedge funds is a term broadly used to refer to private investment partnerships that often trade securities aggressively and frequently. Many times, it is the case that a purchase of a security is appropriate at the current price for investors with a one-year time horizon, but inappropriate for those with a one-week time horizon.

There are also investors – typically institutional investors – that run alternative investment strategies. One example would be “pair trade” investment strategies where all security purchases are linked to an offsetting short sales. The investor is trying to pair securities that will trade in a similar way but where one will rise in value more quickly than another. (Or alternatively where one security will fall in value less than another.) An analyst might believe that two stock prices will rise in the next 12 months, but anticipates more appreciation for one stock than the other. The pair trade investor would want to buy the first security and sell the second security despite the analyst having a “buy” recommendation on both securities. This puts the analyst in a difficult position. The best recommendation for the individual client would be a recommendation of a sale of a security on a buy-rated stock. For example, an analyst might project that ABC Corp’s stock will rise 30 per cent over the next year and XYZ Corp’s stock will rise 10 per cent over the next year assuming that the equity market’s valuation is unchanged overall. The same analyst might project that ABC’s stock will rise 20 per cent and XYZ’s stock will be flat if the stock market’s valuation falls 10 per cent. Assuming for the sake of simplicity that the stock market can only be unchanged or fall 10 per cent in the next year, an analyst might recommend to a pair trade investor that the investor buy ABC’s stock and pair it with an investment in XYZ’s stock. This would assure the investor of a 20 per cent return (ignoring any commissions or margin costs) regardless of the stock market performance.

A new emphasis of regulatory agencies is on consistency of recommendation. While this makes sense if one is most concerned about analysts recommending stocks that the analyst actually believes should be recommended, it often ignores a very important consideration. Rules that restrict flexibility in recommendations ignore the fact that different clients have different investment criteria. For example, an analyst might be approached by an investor who is required to hold at least one bank stock in his or her portfolio. The analyst might be of the opinion that all bank stocks will fall in the next 12 months (the typical investment horizon used in the buy recommendation). Does this mean that the analyst cannot help the client because he cannot recommend any stock purchase? Under a very strict interpretation of rules requiring only the most consistently used interpretation of recommendations, it can be nearly impossible to recommend stock purchases for pair trade investment and other alternative investment strategies.

Conflicting duties – responsibility to the investment banking client

Today, the analyst’s direct role in investment banking is very limited. Essentially, the analyst can only be used as an internal information resource and provide due diligence to the firm on potential investment banking transactions.

But, indirectly, the analyst's role remains important. It is difficult for a stock brokerage company to raise capital for a company in an industry where the firm lacks an analyst. Its sales people will be unfamiliar with the peculiarities of the industry. The firm will typically lack close relationships with potential industry-specific buyers. Corporate clients will lack confidence that, without a visible presence in the stocks within the industry, the firm can achieve the best results for the corporate client.

Corporations also continue to see the sell-side research analyst as linked with corporate finance whether it is encouraged or not. Analysts are among the individuals at the securities firm most likely to be talking with senior corporate management on a continuous basis. Despite the publicity that new regulations have created, a clear separation of between analysts and investment bankers is often unrecognized by corporate client executives.

Sell-side analysts also rely on information provided by the corporation's senior management, visits to the firm and other sources of information provided by the corporation to them to write interesting and useful investment research. There is an inevitable conflict between corporations that want to be written about in a favourable light and the information they provide to analysts. Analysts can be "cut off" from corporations – limited in the information they receive and restricted in visiting the company – if the analyst writes or says negative things about the corporation.

Background: a changing environment – a renewed focus on the brokerage side of the business

In 1975, Congress deregulated brokerage commissions, a decision which ended the SEC's requirement of minimum commissions. This was very favourable to investors and security issuers by lowering the cost of securities trades. Today, large investors enjoy commissions as low as \$0.02 per share and individual investors can regularly trade through discount brokerage firms offering commissions below \$10 per trade.

The relentless pressure on commissions, and therefore profit margins, made it more important for stock brokerage firms to focus on investment banking and other related businesses such as asset management or proprietary trading to offset declining brokerage profits. This created an incentive for analysts to focus on promoting investment banking instead of stock trading.

In the 1990s, the rapidly rising stock market, combined with pressure on brokerage profit margins from commissions, increased the relative attractiveness of investment banking. Sell-side analysts were provided incentives to support investment banking transactions to the extent that it compromised their research and their responsibilities to their brokerage clients. When the bull market of the 1990s ended, the regulatory and legal community responded to the public outcry. New regulations were introduced to separate investment banking from securities research.

In recent years, new reforms introduced by the SEC and Sarbanes-Oxley Act of 2002 included, as described by Lori Richards of the SEC:

- Limitations on Relationships and Communications Between Investment Banking and Research Analysts. The rules prohibit research analysts from being supervised by the investment banking department. In addition,

investment banking personnel will be prohibited from discussing research reports with analysts prior to distribution, unless staff from the firm's legal/compliance department monitor those communications. Analysts will also be prohibited from sharing draft research reports with the target companies, other than to check facts after approval from the firm's legal/compliance department. This provision helps protect research analysts from influences that could impair their objectivity and independence.

- **Analyst Compensation Prohibitions.** The rules bar securities firms from tying an analyst's compensation to specific investment banking transactions. Furthermore, if an analyst's compensation is based on the firm's general investment banking revenues, that fact will have to be disclosed in the firm's research reports. Prohibiting compensation from specific investment banking transactions significantly curtails a potentially major influence on research objectivity.
- **Firm Compensation.** The rules require a securities firm to disclose in a research report if it managed or co-managed a public offering of equity securities for the company, or if it received any compensation for investment banking services from the company in the past 12 months. A firm also will be required to disclose if it expects to receive or intends to seek compensation for investment banking services from the company during the next 3 months. Requiring securities firms to disclose compensation from investment banking clients can alert investors to potential biases in their recommendations.
- **Promises of Favorable Research are Prohibited.** The rules prohibit analysts from offering or threatening to withhold a favorable research rating or specific price target to induce investment banking business from companies. The rule changes also impose "quiet periods" that bar a firm that is acting as manager or co-manager of a securities offering from issuing a report on a company within 40 days after an initial public offering or within 10 days after a secondary offering for an inactively traded company. Promising favorable research coverage to a company would not be as attractive if the research will follow research issued by other analysts.
- **Restrictions on Personal Trading by Analysts.** The rules bar analysts and initial public offering if the company is in the business sector that the analyst covers. In addition, the rules require "blackout periods" that prohibit analysts from trading securities of the companies they follow for 30 days before and 5 days after they issue a research report about the company. Analysts also will be prohibited from trading against their most recent recommendations. Removing analysts' incentives to trade around the time they issue research reports should reduce conflicts arising from personal financial interests.
- **Disclosures of Financial Interests in Covered Companies.** The rules require analysts to disclose if they own shares of recommended companies. Firms also will be required to disclose if they own 1 per cent or more of a company's equity securities as of the previous month end. Requiring analysts and security firms to disclose financial interests can alert investors to potential biases in their recommendations.

- **Disclosures in Research Reports Regarding the Firm's Ratings.** The rules require firms to clearly explain in research reports the meaning of all ratings terms they use, and this terminology must be consistent with its plain meaning. Additionally, firms will have to provide the percentage of all ratings that they have assigned to buy/hold/sell categories and the percentage of investment banking clients in each category. Firms will also be required to provide a graph or chart that plots the historical price movements of the security and indicates those points at which the firm initiated and changed ratings and price targets for the company. These disclosures will assist investors in deciding what value to place on a securities firm's ratings and provide them with better information to assess its research.
- **Disclosures During Public Appearances by Analysts.** The rules require disclosures from analysts during public appearances, such as television or radio interviews. Guest analysts will have to disclose if they or their firm have a position in the stock and also if the company is an investment banking client of the firm. This disclosure will inform investors, who learn of analysts' opinions and ratings through the media rather than in written research reports, of analyst conflicts.¹²

The new regulations reduce many of the conflicts of interests discussed in this article. But the regulations do not eliminate them as we can see with the many examples described in this article.

The larger impact of conflicts on securities research

We have discussed a number of different examples of specific conflicts of interests for the sell-side security analyst. Now we turn briefly to some examples of how these conflicts impact the securities business in aggregate.

More than anything, the numerous conflicts of interests require time to be resolved. Time is spent determining in advance if the appropriateness of a securities recommendation is adequately documented. Information obtained by the sell-side analyst must be analyzed to determine if the information is public and/or material. An example of new regulation that requires a significant time commitment by the sell-side analyst and their firm is the SEC's Regulation AC. Regulation AC requires that "brokers, dealers, and certain persons associated with a broker or dealer include in research reports certifications by the research analyst that the views expressed in the report accurately reflect his or her personal views, and disclose whether or not the analyst received compensation or other payments in connection with his or her specific recommendations or views."¹³ In addition, Regulation AC requires broker-dealers to keep records and certifications related to public appearances. This means that every

¹² SEC (2002).

¹³ Securities and Exchange Commission, 17 CFR PART 242 [Release Nos. 33-8193; 34-47384; File No. S7-30-02], RIN 3235-AI60, Regulation Analyst Certification.

time a sell-side analyst publishes a report and makes a public appearance, the sell-side analyst must provide a certification and include detailed disclosures of that certification. Given the volume of research produced by the typical analyst, this means creating certification disclosures multiple times during the typical day.

The process of managing conflicts of interests is especially true in the current environment, where even the appearance of conflict is questioned. The sell-side analyst is forced to spend time determining if an action is going to appear to be improper. For example, most securities firms have extensive processes for determining if there is a pending or potentially pending investment banking relationship that would make any change in a security's price appear improper – regardless of the independence of research and investment banking.

There is also the widespread and continued use of “soft language” in securities research. Securities never fall in price; instead they come “under pressure”. Financial results are never bad; instead they are “disappointing,” or “less favourable than expected”. The use of soft language is a way to decrease the anger of the reader who disagrees with the securities analysts. Corporate senior executives can take criticism of their corporation very personally. Large owners of securities prefer gentle criticism of securities owned so that the impact to the securities' prices is more modest.

Questions for the securities industry

One of the more prominent questions being debated is what the right level of regulation is. Critics of the securities industry will cite the numerous problems during the strongly rising stock market of the late 1990s. But as we have suggested above,² some conflicts create situations where legitimate clients conflict in their interests. An example would be the large owner of a security that does not want the sell-side analyst to harshly criticize their favourite security.

Heavy levels of regulation can increase the cost of providing useful information to investors. Sell-side analysts provide enormous amounts of research and commentary to their clients. New disclosure rules require most research reports to include at least two pages of disclosure. This increases the cost of preparing and printing such reports. It reduces the time analysts could otherwise spend on providing more and better quality analysis. We are aware of no study quantifying the additional costs the recent additional regulation for securities analysts creates, but a comment by one large corporation on the increased cost of the regulations introduced by the Sarbanes-Oxley Bill illustrates how expensive regulation can be. The American International Group (AIG), the largest insurance company in the world, said that new regulations from the Sarbanes-Oxley Bill will cost the corporation about \$300 million per year.

In the author's view, regulation cannot solve all the problems. There are too many examples of conflicts of interests within the securities business that cannot be solved without eliminating the business entirely. Ultimately, every securities transaction is between one buyer that thinks the value of the security will appreciate and one seller that thinks the value of the security will fall. In between the buyer and the seller is the broker-dealer's sell-side security analyst that probably feels one side is getting a better

deal than the other. If the analyst thinks the value of the security will rise, he thinks the buyer is better off. If the analyst thinks the value of the security will fall, he thinks the seller is better off.

Why is it important for the sell-side analyst to exist?

While not a focus on this article, the author believes the sell-side analyst plays an important role in the securities market. Expectations for financial results and future financial market performance are publicly set by the sell-side analytical community. Sell-side analysts are one of the principal mechanisms by which relevant information is transmitted to investors. In the short run, the stock market reacts to changes in sell-side analyst ratings. If this were not the case, then the regulatory changes that were put in place to bolster independent research would be useless. The regulations would regulate actions that did not matter.

The public clearly finds the information useful as well. For example, if sell-side research were not useful, consensus earnings expectations for a company would not be of any interest to investors or the public. Yet, every morning, news services like CNBC or Bloomberg spend hours discussing the financial results of corporations relative to the expectations held by sell-side analysts.

And clearly, corporations value the publicity and analysis conducted by sell-side analysts. If this were not the case then analysts would not be important in swaying corporations to do business with securities firms. The principal criticisms of the scandals that shook the securities industry and were triggered by the investigations of the NYAG were focused on analyst's writing research that supported their firm's investment banking efforts. If corporations did not value the research, there would not have been the temptation to write biased research.

The bottom line for most securities firms is that the brokerage business (trading securities) is a commodity business where the execution of trades differs very little between firms. Further, the execution of investment banking transactions can be very similar between investment banks. Securities research is not a commodity business because it depends upon the unique opinion and reputation of the securities analyst. Securities research becomes one of the few ways a securities firm can distinguish itself from its competitors.

A direction for solutions: focus on reputational risk

Many of the conflicts of interests described above, in the author's view, cannot be easily resolved with regulation. For example, no single buy recommendation of a security will suit all investors due to differing investment criteria. Analysts that are the first to bring bad news of a falling security price to the market will always be looked upon unfavourably by investors that already own the security.

The author believes the focus of any discussion of solutions to conflicts for sell-side analysts should focus on the analysts' reputation. If analysts are rewarded for their good reputation, they will naturally balance conflicting interests to maximize their good reputation.

Disclosure of performance and compensation packages that focus on accountability and use the analyst's reputation as the primary criteria offer analysts the ability to handle conflicting responsibilities on a case-by-case basis and do not require detailed regulations that will inevitably lead to new conflicts. Examples of useful disclosure might include stock-picking performance, research production and indications of recognition from major accounts.

Analysts should also be recognized and compensated for their due diligence efforts. Analysts should be compensated for the number and thoroughness of due diligence on potential investment banking transactions. Analysts should be recognized for the transactions that were turned down and problems avoided due to the efforts of the securities analyst. Individuals unfamiliar with the securities industry might be surprised to learn that sell-side analysts regularly block investment-banking transactions from happening.

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