

# Securities Analysts: Why These Gatekeepers Abandoned Their Post

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## INTRODUCTION

In the 1990s, the stock markets soared. Spurred by extremely favorable recommendations from the premier securities analysts,<sup>1</sup> both the Nasdaq Composite and the Dow Jones Industrial Averages reached record highs.<sup>2</sup> As the market quickly rose, so too did the collective status of securities analysts. Analysts such as Mary Meeker, Henry Blodget, and Jack Grubman rose to the status of celebrity or,

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1. Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1041 (2003). There are three different types of analysts. First, sell-side analysts are the employees of brokerage firms who produce research material for their investment clients and other institutional investors and whose reports are usually published to the public; in addition to investment clients, these brokerage firms make a substantial amount of their profits through investment banking. *Id.* Second, buy-side analysts work for institutional investors and their reports are not made public. *Id.* at 1041 n.18. Finally, the independent analysts provide research to their customers, both institutional and individual, but do not have a relationship with underwriting, investment banking, or the companies they cover. *Id.* This Note will focus on the sell-side analysts and the independent analysts.

2. E.S. Browning, *Nasdaq Raises the Bar Again, to 4784.08, as Tech Stocks Keep Things Jumping*, WALL ST. J., Mar. 2, 2000, at C1.

as one article describes, rock stardom.<sup>3</sup> However, with the bankruptcy of Enron, WorldCom, and other highly visible companies, coupled with the bursting of the Internet stock bubble, it became clear that many stocks were obscenely overvalued.<sup>4</sup> Hindsight has revealed that, rather than rock stars, analysts more closely resembled magical illusionists who, through sleight of hand and deception, persuaded their audience (i.e., investors) to believe in one thing, while knowing the opposite to be true.

Generally, market analysts have been perceived as serving a beneficial role in the United States capital markets. Both courts and academics have described the role of analysts as the “ferret[ing] out” of information in order to help investors make more informed decisions.<sup>5</sup> To fulfill this role, analysts collect information from various sources, including press releases and financial statements, analyze that information, and then make recommendations to investors based on that analysis.<sup>6</sup> Conventional wisdom holds that when investors have more information the market is more efficient.<sup>7</sup> Due to this information-gathering role, market analysts are seen as integral to a properly functioning capital market. Because of recent scandals involving some of the most illustrious investment firms, the perceived role of analysts is being questioned.

This recent scandal garnered public interest through an investigation of high profile securities analysts initiated by New York’s Attorney General, Eliot Spitzer.<sup>8</sup> This investigation revealed that analysts were publicly touting stocks to investors as sound investments, but were disparaging these same stocks privately.<sup>9</sup> An illustration of this behavior is set forth in a complaint filed by Mr. Spitzer against Bernie Ebbers, Chief Executive Officer of WorldCom, and others.<sup>10</sup> Among other allegations in this complaint, Mr. Spitzer discussed the research reports of Jack Grubman, a telecommunications analyst for Solomon Smith Barney.<sup>11</sup> In this capacity, Mr. Grubman was charged with reporting on Focal Communications.<sup>12</sup> On February 21, 2001, Mr. Grubman placed a “buy” rating on Focal’s stock while it was trading at \$15.50 per share.<sup>13</sup> When Focal complained about its ratings report, Mr. Grubman sent the following e-mail to two other Solomon Smith Barney employees: “If I so much as hear one more . . . peep out of them . . . we will put the *proper* rating ([i.e.,] 4 not even 3) on this stock which every single smart buysider . . . feels is going to zero.”<sup>14</sup> Despite Mr. Grubman’s belief that Focal was overrated

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3. Raymond L. Moss et al., *The Wall Street Analyst: Rise and Fall of a Rock Star*, in 2 SECURITIES ARBITRATION 2002: TAKING CONTROL OF THE PROCESS 99, 99 (2002).

4. *Id.* at 101.

5. *See, e.g.*, *Dirks v. SEC*, 463 U.S. 646, 658 (1983).

6. Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1025-26 (1990).

7. *Dirks*, 463 U.S. at 658 n.17.

8. Charles Gasparino, *Ex-Analyst Blodget is Barred by NASD, Will Pay \$4 Million*, WALL ST. J., Apr. 28, 2003, at C1.

9. *Id.*

10. Complaint filed by Attorney General of New York, *New York v. Anschutz*, at [www.oag.state.ny.us/press/2002/sep/sep30c\\_02\\_complaint.pdf](http://www.oag.state.ny.us/press/2002/sep/sep30c_02_complaint.pdf) (last visited Feb. 23, 2004) [hereinafter Complaint].

11. *Id.* at 13-21.

12. *Id.* at 17-18.

13. *Id.* at 17.

14. *Id.* at 18 (emphasis in original).

and “going to zero,” he continued his “buy” recommendation even as the stock plummeted from \$15 to \$1.24 per share.<sup>15</sup> While the investigation by the New York Attorney General focused primarily on high profile analysts, Enron’s story is more illustrative of the sell-side analysts’ collective behavior. By now, the story of Enron’s astronomical rise and its catastrophic fall into bankruptcy is well-known.<sup>16</sup> Less well-known is the way analysts treated Enron’s stock. Enron was treated as one of the rising stars of the late 1990s and early 2000s. From a mere \$19 per share in 1997, the stock price rose to a high of around \$90 in 2001 as analysts strongly recommended the stock’s purchase.<sup>17</sup> However, things were not as solid as Enron, or the analysts, portrayed them.<sup>18</sup> On October 16, 2001, Enron published a press release stating that it was taking a nonrecurring charge of over one billion dollars.<sup>19</sup> This was quickly followed by an October 22 press release stating that the SEC had decided to investigate Enron’s dealings.<sup>20</sup> Even *after* these releases, sixteen out of seventeen analysts who covered Enron continued to tout Enron as a “buy” or “strong buy.”<sup>21</sup> Less than two months later, Enron declared bankruptcy.<sup>22</sup>

While sell-side analysts consistently missed the mark with Enron, the track record of independent analysts was much more impressive. Of the eight independent analysts who covered Enron, six were encouraging their clients to sell long before sell-side analysts.<sup>23</sup> One of these independent research firms, Off Wall Street Consulting Group, Inc. (“Off Wall Street”), reported as early as May 6, 2001, that Enron’s \$60 share price was overvalued by over one-half.<sup>24</sup> Surprisingly, Off Wall Street cited the use of related-party transactions and declining profit

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15. *Id.*

16. See, e.g., Duane Windsor, *Business Ethics at “The Crooked E”*, in ENRON: CORPORATE FIASCOS AND THEIR LEGAL IMPLICATIONS 659, 663 (Nancy B. Rapoport & Bala G. Dharan eds., 2004).

17. *Id.* at 666.

18. Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulations*, 97 NW. U. L. REV. 135, 135 (2002).

19. Press Release, Enron, Enron Reports Recurring Third Quarter Earnings of \$0.43 Per Diluted Share; Reports Non-Recurring Charges of \$1.01 Billion After-Tax; Reaffirms Recurring Earnings Estimate of \$1.80 for 2001 and \$2.15 for 2002; and Expands Financial Reporting (Oct. 16, 2001) (on file with author). A nonrecurring charge is defined as a “[o]ne-time income or expense entr[y] on the income statement of a corporation . . . . For example, the . . . write-off of a loss.” Allan H. Pessin & Joseph A. Ross, WORDS OF WALL STREET: 2000 INVESTMENT TERMS DEFINED 152 (1983). In the case of Enron, the nonrecurring charges were for “various bad investments and early termination of arrangements ‘with a previously discussed entity’—the latter in fact being entities controlled by [Enron’s] CFO [Andrew] Fastow, called LJM.” Windsor, *supra* note 16, at 668.

20. Press Release, Enron, Enron Announces SEC Request, Pledges Cooperation (Oct. 22, 2001) (on file with author).

21. John C. Coffee, Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid”*, 57 BUS. LAW. 1403, 1407 (2002).

22. Press Release, Enron, Enron Files Voluntary Petitions for Chapter 11 Reorganization; Sues Dynegy for Breach of Contract, Seeking Damages of at Least \$10 Billion (Dec. 2, 2001) (on file with author) (stating that Enron filed for Chapter 11 on Dec. 2, 2001).

23. STAFF OF SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., REPORT ON FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS, at 59 (Comm. Print 2002) [hereinafter REPORT ON FINANCIAL OVERSIGHT OF ENRON].

24. *Id.*

margins as the reason for their sell recommendation.<sup>25</sup> Both of these factors, especially related-party transactions, played a significant role in Enron's unraveling.<sup>26</sup>

This Note explores why sell-side analysts missed what independent analysts caught. Part I focuses on factors that may have influenced sell-side analysts, including the lack of deterrence and the presence of conflicts of interest. This Part suggests that while these two factors played a significant role, another factor that led to the failure of sell-side analysts was their lack of incentive to accurately value stock. In Part II, the focus shifts to recent regulations that have been adopted to cure the perceived problems regarding analyst recommendations. This Part also evaluates the effectiveness of these regulations in preventing further analyst transgressions. Finally, Part III argues that while the current regulations may be sufficient to cure some of the ills of sell-side research, they do not cure them all. If the problem is lack of incentive to correctly price securities, as this Note suggests, then the regulations fail to prevent future inaccurate recommendations because they do not provide sell-side analysts with sufficient incentives to properly value securities. This Note theorizes that due to the lack of incentive to properly value securities, the only true way to protect investors is by a complete separation of research from investment banking.

### I. WHAT CAUSED SELL-SIDE ANALYSTS TO MISS ENRON?

In the wake of Enron's collapse, Congress commenced hearings before the Committee on Governmental Affairs to explore the role of sell-side analysts in Enron's collapse and the resultant loss by investors.<sup>27</sup> The committee's purpose was to determine why the analysts were "blinded to the company's deceit and disintegration."<sup>28</sup> Senator Joseph Lieberman, the committee chairman, framed the issue in his opening statement by asking why "private analysts whose warnings could have, and many say should have, alerted investors to the fiscal fissures in Enron's foundation before everything crumbled . . . instead continued to urge investors to buy Enron stock even after the company began to crumble."<sup>29</sup> Indeed, many analysts and academics believe red flags existed that should have tipped analysts to the unstable foundation upon which Enron sat.<sup>30</sup>

Despite these red flags, the sell-side analysts taking part in the congressional hearing were quick to place blame on Enron and its deceptive use of partnerships to hide losses and other debts.<sup>31</sup> On the other hand, Howard Schilit, an independent

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25. *Id.*

26. Windsor, *supra* note 16, at 679.

27. *The Watchdogs Didn't Bark: Enron and the Wall Street Analysts: Hearing Before the Senate Comm. on Governmental Affairs*, 107th Cong. (2002) [hereinafter *Watchdogs Didn't Bark*].

28. *Id.* at 1 (statement of Joseph Lieberman, Chairman, Senate Comm. on Governmental Affairs).

29. *Id.*

30. See, e.g., Bala G. Dharan & William R. Bufkins, *Red Flags in Enron's Reporting of Revenues and Key Financial Measures*, in ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS, *supra* note 16, at 97.

31. See, e.g., *Watchdogs Didn't Bark*, *supra* note 27, at 27 (statement of Curt N. Launer, Managing Director, Global Utilities Research Group, Credit Suisse First Boston).

analyst (and founder and president of the Center for Financial Research and Analysis), believed that the problems at Enron should have been detected sooner.<sup>32</sup> In his testimony before Congress, Mr. Schilit responded to the claims by the sell-side analysts that they were defrauded like everyone else: "Everybody is saying they hid from us, they lied to us, they committed a fraud . . . I spent an hour of my time last night going through every quarterly filing proxy . . . and I have three pages of warnings, words like 'non-cash sales,' words like '\$1 billion of related-party revenue.'"<sup>33</sup> If Mr. Schilit, in just an hour, could find warning signs, why did sixteen out of seventeen sell-side analysts ignore them for months? This Part discusses some possible answers to this question, including the lack of deterrence in place for analysts who failed to accurately report and the various conflicts of interest that may have clouded the judgment of analysts. Yet, while both lack of deterrence and conflicts of interest played an important role, they do not completely explain the failures of the securities analysts. In addition to these problems, and indeed compounding them, analysts simply lacked any real incentive to accurately value securities.

#### *A. The Absence of Deterrence from Third Party Liability*

One theory that is offered to explain why gatekeepers failed to fulfill their role in the market is that there was not sufficient deterrence in place to keep them honest.<sup>34</sup> This theory argues that during the 1990s, the risk of third-party liability under the Securities Act declined to such an extent that it no longer served to inhibit fraudulent conduct.<sup>35</sup> In describing this theory, Professor John Coffee, Jr. stated that "Economics 101 teaches us that when the costs go down, while the benefits associated with any activity go up, the output of the activity will increase."<sup>36</sup> By giving investment-banking clients positive ratings, analysts encourage companies to keep their business with that firm.<sup>37</sup> At the same time, by giving buy ratings, the brokers encourage more investment by their clients, which raises their profits as well.<sup>38</sup> If the law does not supply enough deterrence, the theory holds, analysts are more likely to take part in this questionable behavior to increase profits.

Much evidence supports this theory. First, in 1995 Congress passed the Private Securities Litigation Reform Act ("PSLRA").<sup>39</sup> The passage of this act created a significant obstacle for any private cause of action for securities fraud. In passing the PSLRA, one of Congress's central objectives was to protect third-party

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32. *Id.* at 23, 40 (statement of Howard M. Schilit, President, Center for Financial Research and Analysis, Inc.).

33. *Id.* at 40.

34. Coffee, Jr., *supra* note 21, at 1409. Professor Coffee defines the term gatekeeper as "reputational intermediaries who provide verification and certification services to investors." *Id.* at 1405. These gatekeepers include security analysts, lawyers, auditing firms, and credit rating agencies. *Id.*

35. *Id.* at 1409.

36. *Id.*

37. *Id.* at 1411.

38. Fisch & Sale, *supra* note 1, at 1045.

39. Coffee, Jr., *supra* note 21, at 1409.

participants, including analysts.<sup>40</sup> This is evident from the Congressional Record which stated, “[u]nderwriters, lawyers, accountants, and other professionals are prime targets of abusive securities lawsuits. The deeper the pocket, the greater the likelihood that a marginal party will be named as a defendant in a securities class action.”<sup>41</sup>

To prevent abusive litigation, Congress increased the pleading requirements beyond those normally required in fraud cases.<sup>42</sup> The PSLRA requires that “with respect to each act or omission alleged to violate this chapter [plaintiff must] state with *particularity* facts giving rise to a strong inference that the defendant acted with the required state of mind.”<sup>43</sup> If a plaintiff cannot meet this heightened standard, the case must be dismissed.<sup>44</sup> One court found this section of the PSLRA to be the “most significant modification” to fraud cases.<sup>45</sup>

Even if the hurdles of the PSLRA can be overcome, a plaintiff must still prove fraud. The most common route to prove federal securities fraud is through § 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. To prove fraud under these sections, a plaintiff must prove the following four elements: “(a) the defendant made a false statement or omission of (b) a material fact (c) with scienter (d) upon which the injured party justifiably relied and that proximately caused the injured party’s damages.”<sup>46</sup> Further, because a stock recommendation is a statement of the analyst’s opinion, the only claim that can be brought is that the analyst *did not actually* hold that opinion.<sup>47</sup> In addition to the scienter requirement, the plaintiff must also prove that the statements or omissions were the proximate cause of the loss.<sup>48</sup> Thus, the presence of intervening factors causing the loss, such as an overall market decline, may allow the defendant to avoid liability.<sup>49</sup>

*In re Merrill Lynch & Co.*<sup>50</sup> demonstrates the difficulty facing plaintiffs who sue analysts based on their reports. In that case, investors in two different Internet companies, 24/7 and Interliant, brought suit against Merrill Lynch based on the recommendations of Merrill Lynch’s Internet analyst, Henry Blodget.<sup>51</sup> They based their suit on their purchase of stock, for which they relied on the published

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40. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 1995 U.S.C.C.A.N. (109 Stat. 737) 679, 688.

41. *Id.*

42. Coffee, Jr., *supra* note 21, at 1409.

43. 15 U.S.C. § 78u-4(b)(2) (2003) (emphasis added). This heightened standard is in contrast to Rule 9(b) of the Federal Rules of Civil Procedure which merely requires intent to be “averred generally.” FED. R. CIV. P. 9(b).

44. 15 U.S.C. § 78u-4(b)(3)(A).

45. *Queen Uno Ltd. v. Coeur D’Alene Mines Corp.*, 2 F. Supp. 2d 1345, 1355 (D. Colo. 1998).

46. James J. Armstrong et al., *Securities Fraud*, 33 AM. CRIM. L. REV. 973, 976 (1996) (citing *Myers v. Finkle*, 950 F.2d 165, 167 (4th Cir. 1991) (quoting *Bruschi v. Brown*, 876 F.2d 1526, 1528 (11th Cir. 1989))).

47. *Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1090-98 (1991).

48. *In re Merrill Lynch & Co.*, 273 F. Supp. 2d 351, 364-65 (S.D.N.Y. 2003), available at <http://www.nysd.uscourts.gov/RulingsOfInterest.htm> (last visited Feb. 27, 2004).

49. *Id.*

50. *Id.*

51. *Id.* at 358-59.

recommendations of Merrill Lynch.<sup>52</sup> They alleged that the recommendations were materially misleading because the “analysts misrepresented their true opinions in the reports” and therefore violated § 10(b).<sup>53</sup>

In dismissing this case under Rule 12(b)(6) of the Federal Rules of Civil Procedure, the court held that the plaintiffs failed to meet the heightened pleading standards of the PSLRA by failing to allege particular facts sufficient to show that Mr. Blodget did not actually hold the opinion that he had expressed regarding the particular stocks involved.<sup>54</sup> The court further held that the bursting of the Internet stock bubble was an intervening factor that caused the value of the stocks to drop.<sup>55</sup> According to the court, there was no link between Mr. Blodget’s reports and the Internet bubble bursting.<sup>56</sup> This case seems to be representative of the types of cases that will be brought against analysts, and its conclusion reveals the struggle facing plaintiffs in the future.<sup>57</sup>

In addition to the problems described above, another line of cases has placed a further limitation on plaintiff suits. In *Lampf v. Gilbertson*,<sup>58</sup> the United States Supreme Court significantly limited the statute of limitations for securities fraud. This case held that the statute of limitations for fraud cases is limited to one year from the time the plaintiff had knowledge, either actual or constructive, of the claim; or in any event no more than three years.<sup>59</sup> This leaves a very narrow window for plaintiffs to bring claims against analysts.

### B. Conflicts of Interest

Most of the blame for the failure of market analysts to accurately value stock has been placed on their suspected conflicts of interest.<sup>60</sup> While several types of conflicts have been suggested as causal, this Note focuses on two especially critical ones. The first conflict is the perceived influence of investment banking business. This is overwhelmingly considered the primary cause of analyst indiscretion. The second conflict is the informational conflict. This conflict arises because analysts often rely on the company itself for a large part of their information; thus, to publicly disparage stocks, however justified the disparagement, is to risk losing this important resource.<sup>61</sup>

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52. *Id.* at 359. Interestingly, the plaintiffs in this case were not claiming to have any contractual relationship with Merrill Lynch or Henry Blodget, in fact, they were not even claiming to have read the reports. *Id.* Instead, the plaintiffs were relying on a theory of fraud-on-the-market in which the plaintiffs relied on the recommendations when they made their purchases and this reliance was the cause of their loss. *Id.*

53. *Id.* at 360.

54. *Id.* at 372.

55. *Id.* at 364-65.

56. *Id.* at 365.

57. *See, e.g., In re Merrill Lynch & Co.*, 289 F. Supp. 2d 416 (S.D.N.Y. 2003) (holding that eight separate cases should be dismissed under summary judgment against Merrill Lynch and their Internet analyst, Henry Blodget), available at <http://www.nasd.uscourts.gov/courtweb/pdf/DO2NYSC/03-08769.pdf> (last visited Feb. 27, 2004).

58. 501 U.S. 350 (1991).

59. *Id.* at 364.

60. *See, e.g., Fisch & Sale, supra* note 1, at 1043; Robin Sidel & Susanne Craig, *Does Independent Research Translate Into Better Stock Picks?*, WALL ST. J., Oct. 31, 2002, at C1.

61. Fisch & Sale, *supra* note 1, at 1054-62.

## 1. Investment Banking Conflicts

As mentioned, sell-side analysts often work for brokerage houses that also do a substantial amount of investment banking business.<sup>62</sup> In the past, investment firms were supposed to have a “Chinese Wall” separating the research side (i.e., analysts) and the investment banking side of the business.<sup>63</sup> However, this “Chinese Wall,” or ethical wall, was not mandated by law or regulation.<sup>64</sup> As a result, even if a firm had a “Wall” between the two divisions, it was there only to prevent the flow of nonpublic information to analysts, which would put analysts at risk of violating insider-trading laws.<sup>65</sup> That is, the “Wall” was present to protect the analysts, not the investors. In practice, many analysts ignored the “Wall” and participated intimately in the investment banking business.<sup>66</sup> Some went so far as to accompany investment bankers on road shows<sup>67</sup> to help build a market for a company’s securities.<sup>68</sup> Companies, realizing the benefits that a positive recommendation could bring, often sought out those investment firms that employed the most recognized analysts.<sup>69</sup>

Analyst involvement in investment banking business often puts extreme pressure on analysts to give positive recommendations. This pressure arises in two ways. First, companies that are selling securities on the market strongly prefer a positive valuation. A negative rating from an analyst can cause a company to lose millions in the open market. Many companies realize this and seek out investment brokers whose analysts’ ratings can boost their stock price.<sup>70</sup> Alternatively, a company may take their investment business elsewhere—or at least threaten to do so—if analysts are not willing to improve their rating. Analysts’ reluctance to speak negatively about stocks is suggested by the fact that during 2001, “less than two percent of all sell-side analyst recommendations were ‘sell.’”<sup>71</sup>

An example of this conflict arose out of Enron’s use of Merrill Lynch for its investment banking business. In 1998 Enron was seeking a better rating from Merrill Lynch’s analyst.<sup>72</sup> Rather than trying to persuade the analyst with income statements, cash flows, or balance sheets, Enron simply threatened to take its investment business elsewhere.<sup>73</sup> Following these threats, the analyst following

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62. See *supra* note 1.

63. REPORT ON FINANCIAL OVERSIGHT OF ENRON, *supra* note 23, at 63.

64. *Id.*

65. *Id.*

66. Fisch & Sale, *supra* note 1, at 1041.

67. A road show is defined as “a series of meetings throughout the country, and frequently abroad, at which the company’s management will make presentations to invited groups of institutional investors, money managers, and securities salesmen.” CHARLES J. JOHNSON, JR. & JOSEPH MCLAUGHLIN, CORPORATE FINANCE AND THE SECURITIES LAWS 150 (2d ed. 1997).

68. Fisch & Sale, *supra* note 1, at 1041; see also Complaint, *supra* note 10, ¶ 36, at 10-11 (alleging that certain Solomon Smith Barney analysts were involved with road shows in which a public market was established for those securities).

69. Fisch & Sale, *supra* note 1, at 1041.

70. *Id.*

71. David Millon, *Who “Caused” the Enron Debacle?*, 60 WASH. & LEE L. REV. 309, 322 (2003).

72. *Id.*

73. See *id.*



Enron left Merrill Lynch and was replaced by an analyst who quickly changed the rating, thereby preventing Enron from taking its investment business to another firm.<sup>74</sup> Perhaps not surprisingly, all of the sell-side analysts who were questioned by Congress denied that the firm's investment banking business played a role in their ratings.<sup>75</sup>

The second pressure on analysts was that, in many cases, a portion of analysts' salaries and bonuses was based on investment banking business.<sup>76</sup> For example, Richard Gross of Lehman Brothers testified before Congress that at least part of his bonus was calculated based on the investment business of his firm.<sup>77</sup> Another example is Jack Grubman, who was rated by the SSB sales force as the worst SSB analyst for 2000 and 2001.<sup>78</sup> Despite this distinction, Mr. Grubman claimed over \$166 million dollars in investment bank business, generating an average compensation of around \$20 million.<sup>79</sup>

The idea that analyst recommendations are often clouded by the firm's investment banking business is not new. In fact, the issue of investment banking conflicts was being discussed before the bankruptcy of Enron.<sup>80</sup> On June 28, 2001, the SEC issued an investor alert "urging investors not to rely solely on analyst recommendations when deciding to buy . . . stock. Instead, investors should consult multiple sources of information while considering their own investment goals and tolerance for risk."<sup>81</sup> The SEC alert stated that many market analysts are subject to severe pressure from investment banking clients to give positive ratings.<sup>82</sup>

This is one of the most salient differences between sell-side and independent analysts. Independent analysts are called independent largely because the companies that employ them do not have investment banking business.<sup>83</sup> Unlike sell-side analysts, who work for companies whose primary income comes from investment banking, independent analysts are free to write objectively about a company's prospects without fear of reprisal.<sup>84</sup> At the same time, because

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74. *Id.*

75. REPORT ON FINANCIAL OVERSIGHT OF ENRON, *supra* note 23, at 65. While this is important to note, it is questionable how valuable this information truly is. It is difficult to believe that had these people truly biased their reports because of investment banking, they would be willing to divulge that information on the public record to Congress. Further, it is possible that the valuation based on conflicts of interest may have been more of a cognitive or subconscious choice as opposed to an intentional attempt to defraud. *See generally* Kenneth L. Fisher & Meir Statman, *Cognitive Biases in Market Forecasts*, 27 J. PORTFOLIO MGMT. 72 (2000).

76. *See* Millon, *supra* note 71, at 315.

77. *Watchdogs Didn't Bark*, *supra* note 27, at 47 (When asked what his bonus was dependent on, Gross responded: "Overall profitability of the firm, yes, and the investment bank is part of our firm.").

78. Complaint, *supra* note 10.

79. *Id.*

80. Press Release, SEC, Investor Alert Provides Tips for Assessing Analyst Recommendations and Decodes Commonly Used Disclosure (June 28, 2001), <http://www.sec.gov/news/press/2001-66.txt> (last visited Feb. 24, 2004).

81. *Id.*

82. *Id.*

83. Sidel & Craig, *supra* note 60.

84. *Id.*

investment banking business does not play a part in their salaries, they can more freely and objectively rate stocks.

## 2. Informational Conflicts

The second type of conflict is what this Note calls informational conflicts of interest. For many analysts, one of the greatest sources of information about a company will come from the company itself.<sup>85</sup> This can be done through conference calls, analyst conferences, and personal telephone calls.<sup>86</sup> Increasingly, analysts have come to rely on this type of information.<sup>87</sup> At the same time, however, companies are reluctant to divulge information to analysts who will use it to negatively evaluate the company's stock.<sup>88</sup> Because of this reluctance, the company may cut an analyst off from certain types of information—for example, not inviting them to conferences or not returning telephone calls—for writing a negative recommendation.<sup>89</sup> As Patricia Walters, Senior Vice-President of Professional Standards and Advocacy at the Association for Investment Management and Research ("AIMR"),<sup>90</sup> has described the conflict: "If an analyst knows a company may retaliate, that analyst can't do a good job, and will be reticent about making the company mad."<sup>91</sup>

The discussion of this conflict of interest is rife with anecdotal evidence. One of the clearest examples of agent blackballing is the case of Heather Jones, an analyst at BB&T Capital Markets.<sup>92</sup> Ms. Jones's job included reporting on Fresh Del Monte Produce Inc. ("Del Monte").<sup>93</sup> Citing risk from litigation and weakness in core business areas, Ms. Jones downgraded Del Monte's rating.<sup>94</sup> Subsequently, Ms. Jones asked a question during a conference call to which Mohammad Abu-Ghazaleh, CEO of Del Monte, responded "Let me tell you Heather, one thing please. You are covering us without our will and we would not like you to ask questions on this conference call, if you may."<sup>95</sup> When asked why she could not ask questions, Abu-Ghazaleh responded, "You can cover us the way you want, but you have not been covering us in an objective way and we thank you for being on this call, but we don't like to answer your question."<sup>96</sup> With this type of response to a

85. Fisch & Sale, *supra* note 1, at 1054.

86. *Id.*

87. *Id.*

88. *See id.*

89. Howard Stock, *SEC Plan to Prevent Blackballing Falls Flat*, INVESTOR REL. BUS., July 7, 2003, at 1.

90. The Association for Investment Management and Research is a nonprofit organization of over 68,000 investment practitioners with the stated mission of "serv[ing] its members and investors as a global leader in education and examining investment managers and analysts and sustaining high standards of professional conduct." AIMR, AIMR Description, available at <http://www.aimr.com/support/about/> (last visited Feb. 20, 2004).

91. Stock, *supra* note 89.

92. 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.

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.*

negative rating, it is understandable that analysts may be reluctant to make a negative recommendation and risk losing such a valuable resource.

### 3. Lack of Incentive

These two theories—lack of deterrence and conflicts of interest—help explain why many sell-side analysts failed to catch the collapse of Enron, and why many independent researchers caught the problems before Enron's bankruptcy. However, it is the position of this Note that these two factors do not completely explain analyst indiscretion. There are several reasons for this belief. First, it is true that such measures as the heightened pleading standards and the curtailed statute of limitations lessened the risk of liability, and therefore diminished an important source of deterrence.<sup>97</sup> However, there were other potential sources of deterrence that should have prevented this behavior.

Take, for example, the Global Settlement. The Global Settlement was based on an enforcement action brought by the SEC against ten broker dealers for "failing to ensure that the research they provided their customers was independent and unbiased by investment banking interests."<sup>98</sup> In addition to the enforcement action brought by the SEC, action was also brought by the NASD, the New York Stock Exchange, and the New York Attorney General.<sup>99</sup> The settlement of these administrative proceedings resulted in \$1.4 billion in penalties spread out among the ten firms.<sup>100</sup> In addition to monetary penalties, the Global Settlement also placed procedural requirements on firms.<sup>101</sup> While there may have been substantial protection from civil liability through the PSLRA and other rulings, the Global Settlement clearly shows that there was still substantial risk in the form of administrative punishment.

Second, another substantial deterrent should have been the risk of damaging one's reputation in the profession.<sup>102</sup> It was once believed that the risk of damaging one's reputation was alone sufficient to prevent fraud.<sup>103</sup> The argument was that no one client would be worth the damage to the analyst's reputation that would result

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97. See, e.g., Coffee, Jr., *supra* note 21.

98. Press Release, SEC, Statement Regarding Global Settlement Related to Analyst Conflict of Interest (Apr. 28, 2003), available at <http://www.sec.gov/news/speech/spch042803com.htm> (last visited Feb. 24, 2004) [hereinafter Statement Regarding Global Settlement].

99. *Id.*

100. Press Release, SEC, SEC, NY Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement to Reform Investment Practices (Dec. 20, 2002), available at <http://www.sec.gov/news/press/2002-179.htm> (last visited Feb. 24, 2004) [hereinafter SEC Press Release]. The ten firms (and their monetary liability) that were the targets of the Global Settlement are: Bear Stearns & Co. LLC (\$80 million); Credit Suisse First Boston Corp. (\$200 million); Deutsche Bank (\$80 million); Goldman Sachs (\$110 million); J.P. Morgan Chase & Co. (\$80 million); Lehman Brothers, Inc. (\$80 million); Merrill Lynch & Co., Inc. (\$200 million); Morgan Stanley (\$125 million); Salomon Smith Barney, Inc. (\$400 million); UBS Warburg LLC (\$80 million). *Id.*

101. *Id.* These procedural requirements are discussed more fully in the following section on regulations.

102. See Millon, *supra* note 71, at 315 (noting that analysts "who earned a reputation for unreliability would not survive").

103. *Id.*

from scandal.<sup>104</sup> While this theory has been called into question following Enron,<sup>105</sup> it is difficult to imagine that analysts such as Mary Meeker, Henry Blodget, or Jack Grubman will ever be taken seriously as analysts again.<sup>106</sup>

There is also evidence to suggest that the conflicts of interest alone could not cause analyst failure. First, while the investment banking conflicts theory does a solid job of explaining why firms that had substantial investment banking business with a company were motivated to inflate ratings, it does not sufficiently explain why the firms that had no investment banking business with a company were motivated to rate those companies above their actual ratings.<sup>107</sup> This view was shared by Anatol Feygin, the Senior Analyst and Vice-President at J.P. Morgan Securities.<sup>108</sup> In his testimony before Congress, Mr. Feygin was asked whether analysts have become more salespersons than analysts.<sup>109</sup> Mr. Feygin replied:

[H]ow much of an impact can I have as an analyst coming into a herd and agreeing with the herd? I don't believe that that will give my firm any leverage in any business and will in any way promote my franchise. So I have to bring something different and something new and something that will establish my credibility and value to the investment community, the institutional investor, my clients.<sup>110</sup>

Earlier in his comments, Mr. Feygin stated that his firm did not have any investment banking business with Enron.<sup>111</sup> While an analyst may be conflicted by the reprisal that a negative rating might bring, an analyst with no investment banking business would, theoretically, have a greater incentive to deviate from the "herd." However, Mr. Feygin—like most other analysts—sustained a buy rating on Enron long past the independent analysts even though he had no investment banking income from Enron.<sup>112</sup> In fact, in spite of the incentive to separate from the herd, only one of the sell-side analysts that covered Enron separated themselves.<sup>113</sup>

In addition, it does not appear that the threat of reprisal and denial of information should have been sufficient to prevent analysts from properly evaluating stocks. It is argued that companies are in no position to turn away large numbers of analysts.<sup>114</sup> The relationship between analysts and companies is

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104. *Id.*

105. *Id.*

106. In fact, not only will these analysts never be taken seriously, but the SEC reached settlements with Henry Blodget and Jack Grubman in which both received lifetime bans from practicing as analysts. Statement Regarding Global Settlement, *supra* note 98.

107. Jaimee L. Campbell, Comment, *Analyst Liability and the Internet Bubble: The Morgan Stanley/Mary Meeker Cases*, 7 *FORDHAM J. CORP. & FIN. L.* 235, 241 (2001).

108. See *Watchdogs Didn't Bark*, *supra* note 27, at 15.

109. *Id.* at 46 (statement of Joseph Lieberman, Chairman, Senate Comm. on Governmental Affairs).

110. *Id.*

111. See *id.* at 41 (stating that J.P. Morgan is "not involved in any equity underwriting for Enron").

112. *Id.* at 25 (statement of Joseph Lieberman, Chairman, Senate Comm. on Governmental Affairs).

113. Coffee, Jr., *supra* note 21, at 1407-08.

114. Stock, *supra* note 89.

symbiotic: each benefits from its relationship with the other.<sup>115</sup> Because companies “can only attract capital under a very bright spotlight,” they rely on securities analysts for publicity.<sup>116</sup> If a company were to limit analysts, they would also dim the spotlight on the company.

This Note contends that there is a third factor that played a significant role in sell-side analysts’ failure to see what many independent analysts saw: a lack of incentive for sell-side analysts to accurately evaluate stock value. The basis of this theory is that sell-side analysts, unlike independent analysts, have little to gain by their correct valuations, but instead have much more to gain by aggressively pushing “buy” ratings on stock.

The shift in analyst incentives began in the mid-1970s.<sup>117</sup> It was during this time that fixed trade commissions were eliminated.<sup>118</sup> Before this, firms could collect seventy-five cents commission per share on transactions.<sup>119</sup> However, the end of fixed commissions created a race to the bottom.<sup>120</sup> With new firms entering the picture, commission rates quickly dropped from the previous seventy-five cents per share to one-eighth cent per share.<sup>121</sup> This dramatically cut into the profit margins of investment firms, causing a shift in focus. In 1967, before the regulation of fixed commissions, commissions generated around fifty-seven percent of Merrill Lynch’s revenues; investment banking produced just a small fraction of profits.<sup>122</sup> In 1997, commissions only accounted for sixteen percent of revenue while investment banking profits had increased by a factor of fifty.<sup>123</sup> Where once the accuracy of research could generate revenue by bringing in a greater number of clients, and thereby commissions, commissions today are such a small portion of a company’s revenue that it is unlikely that more accurate research will increase profits of the company by any significant amount.

Today, many sell-side analysts make their ratings available to the public for free.<sup>124</sup> In fact, many investment firms see research not as income generating, but instead as an expense to generate income from other sources.<sup>125</sup> Therefore, the value of research does not come from its accuracy but from its ability to generate revenue from other areas, such as investment banking or an increased number of transactions. This may explain why only two percent of all analyst recommendations during 2001 were sell recommendations.<sup>126</sup> The analysts’ only

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115. *See id.* (suggesting that blackballing analysts is the equivalent of “biting the hand that feeds”).

116. *Id.* (quoting Scott Wendall, CEO of Prospect Financial Advisors and former head of investment banking at Solomon Brothers).

117. Andy Kessler, *We’re All Analysts Now*, WALL ST. J., July 30, 2001, at A18.

118. *Id.*

119. *Id.*

120. *See id.* (“How did we come to this? Wall Street used to be such a cozy place—75-cent-per share commissions . . . . But in the mid-1970’s, the Big Bang hit, ending fixed commissions.”).

121. *Id.*

122. Fisch & Sale, *supra* note 1, at 1046.

123. *Id.*

124. *See, e.g.*, SmithBarney Access, Quotes, News and Research, at [http://www.smithbarney.com/port\\_hold/quote.html](http://www.smithbarney.com/port_hold/quote.html) (last visited Feb. 24, 2004).

125. ROBERT G. ECCLES & DWIGHT B. CRANE, *DOING DEALS: INVESTMENT BANKS AT WORK* 173 (1988).

126. Millon, *supra* note 71, at 322; *see also supra* text accompanying note 71.

incentive was to generate new income, either from the investment banking clients or from increasing the number of transactions. A sell rating would not aid in reaching either of these goals. Since there are more potential buyers of stock than sellers of stock, if the incentive is to generate more income, then the catalyst of that interest is to have a greater number of buy ratings than sell ratings.<sup>127</sup> It does not matter whether ratings are accurate, only whether they generate revenue.

Even if all conflicts of interest are eliminated and deterrence is increased, sell-side analysts still will have no incentive to accurately value stocks. Further, the elimination of conflicts of interest may erode the incentive to research stocks altogether. Deregulation of fixed commissions created an incentive void by substantially decreasing the profitability of research. The investment banking business filled that void; unfortunately, accuracy of research was not crucial to that incentive. Eliminating conflicts of interest would eliminate the incentives created by investment banking, but the lack of an incentive for accuracy would remain. Moreover, even if the conflicts of interest are eliminated, other nefarious incentives to value stock will emerge to replace it, or sell-side research will start to disappear. There is evidence that the latter has already begun. Some of the largest broker-dealers have drastically cut back on research, and some of them believe that sell-side research will eventually cease altogether.<sup>128</sup>

Another intervening factor that exacerbated the decline in incentives to accurately value stock was the rise of the stock market bubble.<sup>129</sup> The stock bubble created a "euphoria in which gatekeepers became temporarily irrelevant."<sup>130</sup> It is argued that the stock bubble presented a serious problem to analysts because it was "dangerous to be sane in an insane world. The securities analyst who prudently predicted reasonable growth and stock appreciation was quickly left in the dust by the investment guru who prophesized a new investment paradigm . . ."<sup>131</sup> At the same time, a "star" analyst could help a company generate more investment banking business.<sup>132</sup> Therefore, the incentives shifted from accurately reporting on stocks to gaining a reputation as a "star" analyst. This was not done by conservatively valuing stock based on revenue and profits; instead, it was achieved by obtaining celebrity status.<sup>133</sup>

Tied very closely to this is the idea that analyst compensation was increasingly based on investment banking business.<sup>134</sup> Since research is not in itself a revenue-generating undertaking, the money had to come from investment banking.<sup>135</sup> This gave the analysts a greater incentive to pursue investment deals forcing them to spend less time following the companies to which they were assigned.<sup>136</sup> Because

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127. Fisch & Sale, *supra* note 1, at 1045.

128. Emily Thornton et al., *(Still) Pity the Poor Little Guy: Wall Street's Research Deal Will Ease Egregious Conflicts, but Small Investors Remain Far from Protected*, BUS. WK, May 19, 2003, at 40, 40. In the two years prior to the April 28, 2003 global research settlement, the number of covered companies dropped from 5500 to 4300. *Id.*

129. Coffee, Jr., *supra* note 21, at 1412-13.

130. *Id.* at 1412.

131. *Id.*

132. *Id.* at 1412-13.

133. *Id.*

134. ECCLES & CRANE, *supra* note 125, at 174-75.

135. *Id.*

136. *Id.*

analysts were spending less time evaluating stocks, there was greater incentive to follow the herd.<sup>137</sup> If an analyst does not have the time to correctly evaluate stocks then it becomes relatively easier to simply issue the same rating as the other analysts are giving to companies. It allows them to hide among the herd, rather than drawing attention to themselves.

This lack of incentive may be the greatest difference between sell-side analysts and independent analysts. Independent analysts generally make 100% of their revenue from the accuracy of their recommendations.<sup>138</sup> Unlike sell-side analysts, independent analysts generate no revenue from investment banking.<sup>139</sup> Some independent analysts sell their recommendations and reports to institutional investors such as mutual funds or individual clients.<sup>140</sup> If the quality of the research does not meet the buyer's expectations then investors can take their business to other analysts. Other independent analysts provide research to individuals in exchange for making certain transactions such as buying and selling stock.<sup>141</sup> Again, if they fail to provide accurate reports, clients can simply choose another investment company.

Many institutional investors have seen this difference in incentives and have chosen to use the research of independent analysts over that of sell-side analysts.<sup>142</sup> For example, Ed Halderman, the co-head of investing at Putnam, said "[sell-side analysts'] importance to us has been declining. There will be shrinkage on Wall Street in research."<sup>143</sup> Another hedge fund manager said that he only pays for researchers who "work to eat."<sup>144</sup> This highlights the greater incentive that independent analysts have: if they fail to satisfy their clients with the accuracy of research, they cannot fall back on investment banking to supplement their incomes.

## II. CURRENT REGULATIONS AND THEIR IMPACT ON ANALYST INCENTIVES

Congress and the SEC were quick to respond to the perceived problems of the securities analyst. Through the passage of the Sarbanes-Oxley Act, and the NASD and NYSE rules that followed, as well as Regulation Analyst Certification ("AC"), both Congress and the SEC addressed the issue of analyst conflicts of interest. In fact, the SEC was interested in analyst behavior even before the recent scandals involving analysts. In 2000, the SEC passed Regulation Fair Disclosure ("FD") in order to prevent the selective disclosure of information to analysts.<sup>145</sup> This Part discusses these three attempts to regulate analyst behavior, along with a discussion of each attempt's perceived effectiveness and effect on analyst incentives to accurately value securities. This Part also discusses the Global Settlement, which,

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137. See Millon, *supra* note 71, at 323.

138. Sidel & Craig, *supra* note 60.

139. *Id.*

140. *Id.*

141. *Id.*

142. Beth Healy, *\$1.4b Wall St. Settlement Finalized: Big Players Are Turning Away from Stock Research Services*, BOSTON GLOBE, Apr. 29, 2003, at D1.

143. *Id.*

144. *Id.*

145. See Robert J. Shiller, *Outlaw Selective Disclosure?—Yes, Markets Must Be Fair*, WALL ST. J., Aug. 10, 2000, at A18.

while not a regulation that applies to all sell-side analysts, will play an important role in policing analyst behavior.

### A. Regulation FD

The SEC adopted Regulation FD in August of 2000,<sup>146</sup> with the intention of stopping companies from selectively disclosing information to analysts.<sup>147</sup> The goal of this regulation is to level the playing field between analysts and individual investors.<sup>148</sup> This goal is achieved by requiring companies to publicly disclose material nonpublic information that it provides to analysts.<sup>149</sup> It is important to note that Regulation FD regulates issuers of information and not analysts.<sup>150</sup> The disclosure requirement of Regulation FD can be triggered in two different ways. First, if the nonpublic information is intentionally conveyed to an analyst, then the issuer must simultaneously disclose the information to the public.<sup>151</sup> On the other hand, if the information is disclosed unintentionally, then the issuer must disclose the information to the public promptly.<sup>152</sup> Because information must be made public, this regulation will help prevent the informational conflicts discussed above.<sup>153</sup> Since issuers must make all material information public, issuers can no longer selectively disclose material information to those analysts who give them positive ratings and ignore the analysts who rate their company negatively; in theory, every analyst should have equal access to information.

As noted, issuers must convey information publicly when it is material.<sup>154</sup> The SEC has yet to define "material information," but they have given examples, including information relating to earnings, mergers and acquisitions, new product discoveries, changes in control of management, changes in auditors, and bankruptcy or receivership.<sup>155</sup> One area that is of particular concern to the SEC is one-on-one discussions between analysts and issuers about earnings estimates.<sup>156</sup>

The SEC has made it clear that a violation of Regulation FD will not create new liability under § 10(b) or Rule 10b-5.<sup>157</sup> Thus, a violation of Regulation FD alone does not create a private right of action. In fact, the SEC has stated that an issuer must have "acted recklessly or intentionally in making selective disclosure. What this means is that [the SEC is] not going to second-guess close calls

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146. J. Scott Colesanti, *Bouncing the Tightrope: The S.E.C. Attacks Selective Disclosure, but Provides Little Stability for Analysts*, 25 S. ILL. U. L.J. 1, 2 (2000).

147. LAURA S. UNGER, SEC, SPECIAL STUDY: REGULATION FAIR DISCLOSURE REVISITED (2001), at <http://www.sec.gov/news/studies/regfdstudy.htm> (last visited Feb. 24, 2004).

148. *Id.*

149. 17 C.F.R. § 243.100 (2003).

150. *Id.*

151. *Id.* § 243.100(a)(1).

152. *Id.* § 243.100(a)(2).

153. See *supra* note 85-96 and accompanying text.

154. 17 C.F.R. § 243.100(a).

155. Selective Disclosure and Insider Trading, Securities Act Release No. 33-7881, Exchange Act Release No. 34-43154, 17 CFR §243 (2003).

156. *Id.*

157. 17 C.F.R. § 243.102.



regarding the materiality of a potential disclosure.”<sup>158</sup> Therefore, any punishment for a violation of Regulation FD will likely arise only in the most egregious cases and will result in only an administrative penalty.

Regulation FD has generated considerable debate concerning its effectiveness. Many analysts and institutional investors believe that the regulation will have a “chilling effect” on the amount of information that issuers will be willing to disclose.<sup>159</sup> Even if the quantity of information does not change, many analysts fear that quality of information will decrease.<sup>160</sup> One analyst has stated that “companies are stating too few facts in too many words, making their press releases overly long. Clearly an example of information overload, the press releases have produced a watershed of useless information.”<sup>161</sup> In a survey by the Securities Industry Association (“SIA”), seventy-two percent of analysts believe that information from issuers is lower in quality than pre-regulation FD information.<sup>162</sup>

While this may have been the atmosphere in the months or years following passage of the regulation, there is more recent research suggesting the information available now is better than pre-regulation information.<sup>163</sup> One study reveals that price discovery has actually improved while price volatility has decreased.<sup>164</sup> Since Regulation FD is a relatively new regulation, more time is needed to determine its actual level of effectiveness, but recent studies show that Regulation FD is having a positive effect on the information available to the market.

Regardless of the impact of Regulation FD on the quantity and quality of information available to investors, the regulation will have little effect on the incentives for analysts to accurately value securities. This is true for several reasons. First, Regulation FD is not aimed directly at analysts but instead at issuers of information.<sup>165</sup> In addition it creates no private right of action for a violation.<sup>166</sup> Therefore, nothing in the regulation addresses analyst behavior. Perhaps most importantly, the regulation fails to address analyst compensation issues and the close relationship between analysts and investment banking business. By failing to address these issues, Regulation FD does nothing to address the lack of analysts’ incentive to properly value securities. Nor does it address the void in incentives that would be created by eliminating conflicts of interest. Because of these failures, Regulation FD will not have a tremendous impact in improving the accuracy of sell-side analyst recommendations.

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158. Richard H. Walker, Speech Before the Compliance & Legal Division of the Securities Industry Association (Nov. 1, 2000), available at <http://www.sec.gov/news/speech/spch415.htm> (last visited Feb. 24, 2004).

159. *Id.*

160. UNGER, *supra* note 147, at § III.B.2.

161. *Id.*

162. *Id.*

163. Fisch & Sale, *supra* note 1, at 1066-67.

164. *Id.*

165. 17 C.F.R. § 243.100 (2003).

166. *Id.* § 243.102.

### B. Regulation AC

The SEC adopted Regulation AC on April 14, 2003.<sup>167</sup> Regulation AC states that when a broker, dealer, or covered person<sup>168</sup> furnishes research "prepared by a research analyst to a 'person in the United States,'" the research must include two different statements by the research analyst.<sup>169</sup> In the first statement, the analyst must certify that the research being provided truly reflects the analyst's opinion.<sup>170</sup> Second, the analyst must disclose to what degree, if any, her compensation is directly or indirectly dependent on a specific recommendation tied to investment business.<sup>171</sup> If part of the analyst's compensation is based on the specific recommendation, the analyst must disclose the source and amount of that income as well as the fact that the recommendation could be biased by the analyst's compensation.<sup>172</sup> Again, it is important to note that this regulation is targeted at brokers and dealers, not at the analysts themselves. Also, like Regulation FD, Regulation AC does not create a private right of action under § 10(b).<sup>173</sup>

Regulation AC is so recent that it is difficult to predict how effective it will be, but there are indications that the regulation will not have a tremendous impact on analyst behavior. The goal of Regulation AC is to "promote the integrity of research reports and investor confidence in the recommendations contained in those reports."<sup>174</sup> While Regulation AC may cause some analysts to have second thoughts about issuing reports that do not truly reflect their opinions,<sup>175</sup> some in the SEC believe that this is merely a temporary fix to a deep and pervasive problem. For example, SEC Commissioner Harvey Goldschmid has taken the position that "[Regulation AC] is little more than a 'patch' on a system that is 'badly broken' and that the SEC needs to go further and undertake comprehensive rule making in this area."<sup>176</sup> Commissioner Goldschmid also warns that certification "is not a seal of approval" and that investors would still benefit from doing their own analysis.<sup>177</sup>

In addition to the concerns of Commissioner Goldschmid, Regulation AC also fails to address the issue of analyst incentives. Much like Regulation FD, Regulation AC is not aimed directly at analysts, but instead targets broker-dealers.<sup>178</sup> It also lacks a private right of action.<sup>179</sup> Thus, there is no motivation for analysts to change their behavior. More importantly, Regulation AC still allows for,

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167. Final Rule: Regulation Analyst Certification, Securities Act Release No. 33-8193, Exchange Act Release No. 34-47384, 17 CFR § 242.500-242.505 (2003).

168. "Covered Persons" is defined as an associated person of that broker or dealer, with some exceptions. 17 C.F.R. § 242.500.

169. *Id.* § 242.501(a).

170. *Id.* § 242.501(a)(1).

171. *Id.* § 242.501(a)(2)(i)-(ii).

172. *Id.* § 242.501(a)(2)(ii)(A), (B).

173. Fisch & Sale, *supra* note 1, at 1069.

174. Regulation Analyst Certification, Securities Act Release No. 33-8119, Exchange Act Release No. 34-46301, 17 CFR § 242.500-242.505 (2003).

175. Deborah Solomon, *SEC Requires Analysts Certify Their Research*, WALL ST. J., Feb. 7, 2003, at A.2.

176. Lynn Hume, *Regulation: SEC Narrows Scope of Final Rule Requiring Analysts to Certify Views*, BOND BUYER, Feb. 7, 2003, at 5.

177. Solomon, *supra* note 175.

178. 17 C.F.R. § 242.501(a).

179. Fisch & Sale, *supra* note 1, at 1069.

and even anticipates, analyst recommendations based to some degree on their involvement with investment banking business.<sup>180</sup> The regulation merely requires disclosure of the degree to which the analyst's compensation is based on the analyst's involvement with certain investment banking business.<sup>181</sup> This leaves the analyst free to continue issuing biased recommendations with the simple disclaimer that the report may be biased in some way.

### *C. Self-Regulatory Organizations and the Sarbanes-Oxley Act*

Another form of regulation applicable to market analysts comes from self-regulatory organizations ("SRO"). Self-regulatory organizations, in this case the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers ("NASD"), are charged with setting rules and disciplining its members.<sup>182</sup> The SEC must approve any rules of these organizations before they become effective.<sup>183</sup> Under current federal regulation, almost all broker-dealers working in the United States must be members of the NASD and are therefore subject to the NASD regulations.<sup>184</sup> Both the NYSE and the NASD first adopted rules in the spring of 2002 to govern analyst conflicts of interest. However, since the passage of the Sarbanes-Oxley Act in the fall of 2002, these rules have undergone significant change. Since these two sets of rules are meant to reach the same result, they will be discussed together.<sup>185</sup>

In May 2002, the SEC approved rule changes filed by the NYSE and the NASD that dealt with analyst conflicts of interest.<sup>186</sup> The primary objective of these rules was to negate the influence that investment banking exerted on analyst recommendations.<sup>187</sup> These regulations prohibited analysts from promising positive ratings in exchange for investment banking business.<sup>188</sup> The rules also dealt with problems associated with analyst compensation by preventing analysts' compensation from being tied to any particular investment deal.<sup>189</sup> These regulations also attempted to make analyst conflicts more public by requiring disclosure of all potential conflicts of interest.<sup>190</sup> Along these same lines, these rules required the firms to disclose a record of all ratings in order to help individuals track how the investment firm rated stocks and to test whether they were overly positive.<sup>191</sup>

In July 2002, President Bush signed the Sarbanes-Oxley Act, calling it the "most far-reaching reform[] of American business practices since the time of

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180. 17 C.F.R. § 242.501(a)(2)(ii)(A).

181. *Id.*

182. 15 U.S.C. § 78s(d) (2003).

183. 17 C.F.R. § 240.19b-4.

184. *Watchdogs Didn't Bark*, *supra* note 27, at 50 (testimony of Robert R. Glauber, Chief Executive Officer, National Association of Securities Dealers, Inc.).

185. NASD and NYSE Rulemaking, Exchange Act Release No. 34,48252, 68 Fed. Reg. 45,875, 45,875-76 (Aug. 4, 2003), available at <http://www.sec.gov/rules/sro/34-48252.htm> (last visited Feb. 24, 2004).

186. *Id.* at 45,876.

187. *Id.*

188. *Id.* at 45,877.

189. *Id.*

190. *Id.*

191. *Id.*

Franklin Delano Roosevelt.”<sup>192</sup> The Sarbanes-Oxley Act was Congress’s attempt to deal with the scandal that rocked corporate America following the collapse of major public companies such as Enron, WorldCom, and others.<sup>193</sup> In addition to addressing issues such as independence on the board of directors and executive loans, Congress also included a section dealing with analyst independence.<sup>194</sup> Section 501 of the Sarbanes-Oxley Act requires that “[t]he Commission, or upon the authorization and direction of the Commission, a registered securities association or national securities exchange, shall have adopted . . . rules reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances.”<sup>195</sup> In order to achieve this mandate, the SEC delegated responsibility to the NYSE and the NASD.<sup>196</sup> On July 29, 2003, the SEC approved these SRO proposals.<sup>197</sup>

Again, since these rules are less than six-months old, it is difficult to accurately assess or predict their effectiveness, but of all the regulations, these may have the greatest effect on analyst incentives. Section 2711(d), which deals with analyst compensation, is the most important section of the NASD rules regarding the issue of analyst incentives. Section (d)(1) of this regulation states that “[n]o member [of the NASD] may pay any bonus, salary or other form of compensation to a research analyst that is based upon a specific investment banking services transaction.”<sup>198</sup> Section (d)(2), added to comply with the demands of the Sarbanes-Oxley Act, further regulates how analyst compensation should be determined.<sup>199</sup> This section requires a broker-dealer to establish a committee to review and approve all analyst compensation. To prevent further conflicts of interest, no member of the firm’s investment banking business can be a member of this committee.<sup>200</sup> Among other factors, this committee is to consider the “correlation between the research analyst’s recommendations and the stock price performance.”<sup>201</sup> The effect of this is to increase the incentive to accurately evaluate securities. If an analyst can improve his compensation, not by his involvement in the investment banking business but by the accuracy of his recommendations in relation to stock performance, the analyst should have greater incentive to accurately value securities. Professor John Coffee, Jr., in testimony before the Senate, called these regulations a “serious and commendable effort to

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192. Remarks on Signing the Sarbanes-Oxley Act of 2002, 38 WEEKLY COMP. PRES. DOC. 1283, 1284 (July 30, 2002).

193. Michael Chakarun, *The Sarbanes-Oxley Act of 2002*, THE NAT’L PUB. ACCT., Oct. 2002, at 6.

194. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 301, 402, 501, 16 Stat. 745, 775-77, 787-88, 791-93 (2002).

195. *Id.* § 501.

196. NASD and NYSE Rulemaking, *supra* note 185.

197. Press Release, NYSE, Rule 472-Amendments to Disclosure and Reporting Requirements (Aug. 25, 2003) (on file with author).

198. NASD, *Rules of Association*, § 2711(d)(1), at [http://cchwallstreet.com/NASD/keyword\\_index/toc\\_mg.asp](http://cchwallstreet.com/NASD/keyword_index/toc_mg.asp) (last visited Feb. 21, 2004).

199. *Id.* § 2711(d)(2).

200. *Id.*

201. *Id.* § 2711(d)(2)(B).

police the conflicts of interest that exist within broker-dealer firms that both underwrite securities and provide securities research and recommendations."<sup>202</sup>

While the SRO rules will have a positive impact on analyst incentives, they still have several shortfalls. For example, it is argued that the regulations will be difficult to police.<sup>203</sup> Because compensation of analysts is such a uniquely personal determination, it may be difficult to determine the true motives behind changes in analysts' compensation. In addition, not all coercion comes through memos or e-mails to the analyst. Coercive pressure can come in far subtler forms, such as changes in voice inflection and a raised eyebrow during conversations.<sup>204</sup> While overt pressure can be policed, many subtler forms of coercion, in all likelihood, cannot.<sup>205</sup>

In addition to this policing problem, another problem surfaces. While an analyst's compensation may not be based on a specific investment banking deal, an analyst may still receive compensation based on the overall profitability of the entire broker-dealer, the majority of whose income is from investment banking business. In fact, § 2711(h)(2) even anticipates that research analysts' compensation will still be based to some degree on investment banking business.<sup>206</sup> This section requires disclosure of any compensation of the analyst that is based in part on investment banking revenue.<sup>207</sup> Because of the failure of the regulation to prevent investment banking business from impacting analyst compensation, analysts still have an overall incentive to boost the overall profitability of the firm, which includes increasing investment banking.

#### *D. The Global Settlement*

The Global Settlement Related to Analyst Conflicts of Interest was an enforcement action brought by the SEC, in conjunction with the NASD, NYSE, New York Attorney General, and other state agencies, against ten of the largest broker-dealer firms in the country.<sup>208</sup> While the Global Settlement is not a regulation, it will still play an important role in policing analyst behavior. In addition to the monetary sanctions discussed above,<sup>209</sup> the Global Settlement also required several procedural changes with the intention of further insulating analysts' recommendations from the pressure and influence of investment banking.<sup>210</sup>

First, the Global Settlement requires investment firms to sever ties between the investment banking side and the research side.<sup>211</sup> The result is to mandate the "Chinese Wall," at least for these ten companies, where it was not previously

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202. John C. Coffee, Jr., *Auditors and Analysts: An Analysis of the Evidence and Reform Proposals in Light of the Enron Experience*, in ENRON: CORPORATE FIASCOS AND LEGAL IMPLICATIONS, *supra* note 16, at 160-61.

203. *Id.* at 162.

204. *Id.*

205. *Id.*

206. *See* NASD, *supra* note 198, § 2711(h)(2).

207. *Id.*

208. SEC Press Release, *supra* note 100.

209. *See supra* text accompanying notes 98-100.

210. Statement Regarding Global Settlement, *supra* note 98.

211. SEC Press Release, *supra* note 100.

mandated. Additionally, each firm must disclose its ratings and price forecasts, allowing investors to evaluate accuracy over time.<sup>212</sup> Finally, one of the most influential sections of the Global Settlement is the requirement that all broker-dealers supply their customers with independent research for the next five years.<sup>213</sup> Any time that the broker-dealer gives a customer research by its own analysts, it must also supply the research of independent analysts.<sup>214</sup> This gives the customer an opportunity to compare the possibly biased opinion of the sell-side analyst with that of an independent analyst.

Like most other remedies discussed in this Note, the efficacy of the Global Settlement is still uncertain. The Global Settlement could have at least two distinctly different effects on analyst incentives. The Global Settlement may increase incentive to properly value securities because customers now have access to independent research.<sup>215</sup> This would mean that the shortcomings of sell-side analyst reports would be readily apparent to investors. Sell-side analysts' research will not be of any value to investors unless these analysts increase the accuracy of their reporting to compete with independent analysts.

On the other hand, the availability of independent research to investors may actually lessen sell-side analysts' incentive to properly value securities. Because independent research must be given to clients regardless of the accuracy of the sell-side research, it may lead sell-side analysts to spend less time in researching stocks or to stop researching altogether. The cost of research may become duplicative. If analysts are already providing customers with research, the time and financial burden of improving sell-side research to be competitive with that of independent research may outweigh the benefit to both the broker-dealer and the investor.

Regardless of which of these two effects the Global Settlement has on analyst research, there are other factors that have the potential to make the Global Settlement less effective. First, the Global Settlement only applies to ten firms, not the entire industry.<sup>216</sup> This leaves some investment firms free to continue to publish biased research. Additionally, not all the people who read the recommendations of sell-side analysts are afforded the luxury of independent research. The Global Settlement only requires independent research to be given to customers of the broker-dealers.<sup>217</sup> This leaves a large segment of those who may read the recommendations—that is, investors who read the recommendations that have been made available free to the public, but who are not customers—vulnerable to biased research of sell-side analysts.

### III. SUGGESTED REGULATIONS

While the regulations discussed above are positive steps in advancing investor security and restoring confidence in the market, they do not address all the possible causes of negative analyst behavior. As noted, they do not adequately address the lack of analyst incentives to properly value securities. This Note contends that the only way to truly protect investors from the biases of analysts is to completely

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212. *Id.*

213. *Id.*

214. *Id.*

215. *See id.*

216. *See id.*

217. *Id.*

separate analyst research from investment banking. This would be similar to what the Sarbanes-Oxley Act did with auditors and consulting; however, "the conflict [involving analysts] might be . . . even more serious because the empirical evidence does suggest that the advice given by conflicted analysts is different from the advice given by independent analysts."<sup>218</sup>

A separation of investment banking business from research would cause a shift in incentive. The two greatest differences between independent analysts and sell-side analysts are the ties to investment banking business and incentives that do not depend on the accuracy of research. If a research department wants to continue to function after the split from investment banking, they will have to do so by providing accurate research. This would put them in the same position as independent analysts, who must "work to eat."<sup>219</sup> By separating research from investment banking, the regulation would eliminate the conflicts of interest and also create greater incentive to accurately rate securities.

One potential problem with this solution is that because sell-side research is not a revenue generating activity it may simply disappear.<sup>220</sup> While those that lost millions based on inaccurate analyst recommendations may celebrate this result, the loss of this resource may pose certain problems.<sup>221</sup> For instance, many courts and academics see analysts as serving a vital role in the market.<sup>222</sup> The analyst is supposed to serve the market by taking large volumes of incomprehensible information from issuers and compiling it into a more understandable report.<sup>223</sup> The fear is that losing sell-side analysts will cause a decrease in market efficiency.<sup>224</sup>

This Note does not challenge the validity of the market efficiency theory, although academics are beginning to do just that.<sup>225</sup> However, this Note does challenge the role that sell-side analysts play in that system. Analysts are only valuable to the extent that their recommendations are based qualitatively on the information coming from the company.<sup>226</sup> If analysts are not basing their recommendations on this information in a constructive way, then they add nothing to market efficiency and should not receive special treatment.<sup>227</sup> Recent research has revealed that analysts are not basing their recommendations on the available information.<sup>228</sup> However, even if sell-side analysts are basing their reports on

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218. Coffee, Jr., *supra* note 202, in ENRON: CORPORATE FIASCOS AND LEGAL IMPLICATIONS, *supra* note 16, at 161. Section 201 of the Sarbanes-Oxley Act of 2002 prohibits any public accounting firm that is going to perform an audit for any securities issuer from also performing other certain consulting duties such as bookkeeping, actuarial services, investment advising, or legal services. § 201,116 Stat. at 771.

219. *See supra* text accompanying note 144.

220. *See* Coffee, Jr., *supra* note 202, in ENRON: CORPORATE FIASCOS AND LEGAL IMPLICATIONS, *supra* note 16, at 161.

221. *See id.*

222. *See id.* at 162.

223. *See id.*

224. *Id.*

225. Langevoort, *supra* note 18, at 140-43.

226. *See id.* at 152.

227. *See id.*

228. *See, e.g.,* Brad Barber et al., *Reassessing the Returns of Analyst Stock Recommendations*, FIN. ANALYST J., Mar./Apr. 2003, at 88, 94; Bradford Cornell, *Is the Response of Analysts to Information Consistent with Fundamental Valuation? The Case of Intel*, FIN. MGMT., Spring 2001, at 113, 133-34; Fisher & Statman, *supra* note 75, at 72.

available information, research suggests that sell-side analysts whose interests are not entirely aligned with investors cannot credibly convey information to those investors.<sup>229</sup>

In 2000 and 2001, sell-side analysts' "buy" ratings underperformed the market by more than seven percent.<sup>230</sup> Perhaps more telling, however, is the fact that "sell" ratings outperformed the market by approximately thirteen percent.<sup>231</sup> This means that investors would have seen better gains by doing *exactly the opposite* of what sell-side analysts recommended. An interesting study by Professor Bradford Cornell sheds light on why this may have been the case.<sup>232</sup> Professor Cornell took a case study approach to a press release issued by Intel on September 21, 2000.<sup>233</sup> Prior to the issuance of this press release, almost all of the twenty-eight analysts then following the stock strongly recommended purchase of Intel's securities; Intel was trading at around seventy-four dollars per share at this time.<sup>234</sup> Following the press release of September 21, however, the stock dropped approximately thirty percent to around forty dollars per share.<sup>235</sup> As the stock price fell, many analysts downgraded the stock, some even by multiple levels.<sup>236</sup> According to Professor Cornell, the information in the press release was not sufficient to cause such a sharp decline.<sup>237</sup> Professor Cornell's study revealed that when Intel was trading at seventy-four dollars per share it was overvalued; however, Intel was one of the most highly recommended stocks on the market.<sup>238</sup> Following the drop in price, the stock was trading at a price that more accurately reflected its true value; yet, analysts had significantly downgraded the stock.<sup>239</sup> Professor Cornell believes that when the analysts failed to "focus on fundamental value, and by not presenting explicit . . . valuation models, analysts short change[d] investors."<sup>240</sup>

Instead of focusing on important price predictors such as fundamental value and valuation models, analysts appear to have allowed their recommendations to follow the market.<sup>241</sup> If the stock price rose, analysts recommended the stock; if the stock price dropped, so did the recommendations of analysts.<sup>242</sup> This created a cycle. As stock prices rose, so did analyst recommendations, which in turn increased investor confidence about the stock, causing prices to rise higher.<sup>243</sup>

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229. John Morgan & Phillip C. Stockton, *An Analysis of Stock Recommendations*, 34 *RAND J. OF ECON.* 183, 184 (2003).

230. Barber et al., *supra* note 228, at 88.

231. *Id.*

232. Cornell, *supra* note 228, at 113.

233. *Id.*

234. *Id.* at 115.

235. *Id.* at 113.

236. *Id.* at 132.

237. *Id.* at 133.

238. *Id.* at 115, 125, 132 (stating that "Intel was . . . a darling of the analysts. By the end of August 2000, Bloomberg's summary index of analyst recommendations stood at 4.85 out of 5.0 compared to an average of 4.24 for the S&P 500. A Bloomberg index of that level indicates that virtually every analyst who followed Intel was highly recommending purchase of the stock.").

239. *Id.* at 133-34.

240. *Id.* at 134.

241. *Id.*

242. *Id.*

243. *Id.*



However, when the price dropped, the opposite occurred, driving prices further down.<sup>244</sup> This exacerbated price volatility by creating drastic swings between highs and lows.<sup>245</sup>

Even when sell-side analysts base their recommendations on information available from the company, it is doubtful that they can credibly relay that information to investors. A recent study reveals that when there is any investor uncertainty about incentives of analysts, full revelation of information is impossible.<sup>246</sup> This study argues that if individuals believe that analyst incentives are misaligned with their own incentives, a responsive stock price is impossible.<sup>247</sup> This means that where analyst incentives differ from those of investors, the reports of the analysts are discounted even if completely accurate.<sup>248</sup> Dissimilar incentives lead investors to “strategic ‘filtering’ of information contained in the reports to correct for bias.”<sup>249</sup> If analysts cannot accurately convey information to investors without a large degree of skepticism, then sell-side analyst reports add little to the efficiency of the market. Requiring the separation of research and investment banking would work to more closely align analyst incentives to those of investors, thereby making information easier to effectively disseminate.

Analysts play an important role in the market by collecting information and then relaying that information in a clear and reliable manner to investors.<sup>250</sup> It is for this reason that many argue against the separation of research and investment banking business.<sup>251</sup> However, the research discussed here suggests that analysts were not relying on the available information in formulating their opinions.<sup>252</sup> Additionally, even if analysts desired to accurately convey information to investors, their interests are not aligned with investors, causing high levels of skepticism.<sup>253</sup> By separating the investment banking side from the research side, regulation would create greater incentives to accurately report information and align analysts’ and investors’ incentives so that those reports can be credibly relayed to investors.

#### CONCLUSION

The collapse of Enron and the resultant revelation of sell-side analyst misconduct revealed a critical gap in the system of analyst regulation. The difference between the way that sell-side analysts and independent analysts treated Enron suggests that something in the structure of sell-side research created less accurate research. Many reasons for this difference have been suggested including lack of deterrence and conflicts of interest. However, these reasons do not fully

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244. *Id.*

245. *Id.*

246. Morgan & Stockton, *supra* note 229, at 184.

247. *Id.* The researchers state that a stock price is responsive if “all of the information available to an analyst is reflected in the stock price, then equilibrium stock prices will reflect this information and be continuous and strictly increasing over this interval of values.” *Id.* at 188.

248. *See id.* at 199.

249. *Id.*

250. *See* Coffee, Jr., *supra* note 202, in ENRON: CORPORATE FIASCOS AND LEGAL IMPLICATIONS, *supra* note 16, at 162.

251. *Id.* at 161-62.

252. Cornell, *supra* note 228.

253. *See* Morgan & Stockton, *supra* note 229, at 199.

explain why sell-side research was less accurate than independent research. Sell-side analysts, unlike independent analysts, lack incentive to properly value securities. Independent analysts must rely on the accuracy of their research to generate revenue; sell-side analysts can rely on investment banking business to generate profits, and analysis of securities is simply a tool with which more investment banking business can be generated.

The regulations promulgated since the scandal involving analysts came to light have made positive strides towards preventing future analyst indiscretion. However, without addressing the issue of analysts' lack of incentive, the regulation is incomplete. While sell-side research over the past year has been more bearish, this is more a result of a struggling market and extreme media and litigation pressure arising from past indiscretion.<sup>254</sup> To protect investors in the future and prevent future analyst misbehavior, more robust measures should be taken. The best way to cleanse the taint of investment banking business from analyst ratings, while at the same time giving analysts an incentive to properly value securities, is a complete separation of investment banking business from research. This would place sell-side analysts on the same footing as independent analysts and force sell-side analysts to "work to eat."

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254. Cheryl Winokur Munk & Lynn Cowan, *Investors See Flaws in Analysts' Work*, WALL ST. J., Nov. 27, 2002, at B3A (stating that "it is a lot easier to be negative when stocks are downtrodden—and the real test will be when a bull market returns"). While sell ratings have increased to around nine percent, many institutional investors still feel that "the quality of the analysis still tends to be superficial." *Id.*