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*Wall Street's Credibility Problem:
Misaligned Incentives and Dubious
Fixes?*

by
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Wall Street's Credibility Problem:
Misaligned Incentives and Dubious Fixes?

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During 2001, investors, politicians, regulatory agencies, and the media have voiced a common sentiment: Wall Street has a credibility problem. Specifically, can the investing public trust the research analysis and recommendations they receive from Wall Street analysts? At issue is the independence and objectivity of *sell-side analysts*, a term applied to analysts that work for brokerage firms.¹

Spring of 2001 brought media attacks on these analysts, with newspaper headlines such as *The Financial Times*' "Shoot All the Analysts" and *The Wall Street Journal*'s "Outlook for Analysts: Skepticism and Blame". *Fortune* even made analyst credibility a cover story with the title: "Can We Ever Trust Wall Street Again?"²

This paper attempts to address the question: What should we make of this brouhaha and what remedies are appropriate? It is quite clear that the major players, namely the brokerage firms, Congress, the Securities and Exchange Commission (SEC), and the Association for Investment Management and Research (AIMR), feel that *something* should be done and have already taken a number of actions. Several proposals have already been made through the trade association, the Securities Industry Association; and some individual brokerage firms have already unilaterally changed policies to stem the criticisms of ostensible conflicts of interest. Will the proposals offered by the brokerage industry fix what is broken? And perhaps more importantly, we should ask the important first question: *What if anything is broken?*

We argue that at the heart of the credibility controversy are the disparate incentives of investment banks' clients: while brokerage clients ("investors") want *unbiased* research, most corporate financing clients ("issuers") benefit from *optimistic* research. As corporate financing revenues dwarf brokerage commissions, investment banks face large incentives to maintain policies that favor issuers over investors. Furthermore, the managements of the corporations, the subjects of brokerage research, provide an additional incentive to analysts: issue positive research and maintain direct access to valuable future information or risk being shut out by management entirely. We conclude that while the fixes proposed and already undertaken may improve credibility, they are unlikely to be substantial remedies because they do not address the critical issue of these misaligned incentives.

We also conclude that institutional investors, aware of analysts' conflicts of interest, are able to de-bias the brokerage research they receive, and consequently maintain their own in-house research staffs and purchase independent research services. The disenfranchised are largely the individual investors, who lack the awareness or education necessary to adequately filter brokerage research recommendations.

We begin our examination by providing background on the controversy. We next summarize the evidence from relevant academic work that demonstrates the value brokerage research can have for investors and the limitations of that value. We then discuss explanations for optimism biases that have been documented for brokerage earnings forecasts and recommendations, including incentives by and pressures from the analyst's employer, from the companies the analyst reports about, and from institutional investors. Next, we analyze a number of proposals and actions that attempt to increase brokerage research objectivity and independence. Finally, we conclude by raising several issues that we believe are most critical to understanding the credibility controversy, and we cast doubt on the success of recently proposed fixes.

I. Background

Not only has the financial press written scathing attacks, but professional investment managers have also expressed increasing doubts over research they receive from Wall Street analysts. In the April 2001 issue of *Institutional Investor*, Deborah Kuenstner, chief investment officer for large-cap value stocks at Putnam Investments, stated: "Our approach to the market generally has been that sell-side analysts are serving so many masters besides us that we increasingly need to rely on our own research."³ Money managers also voiced concern that sell-side analysts' recommendations are less credible because the analysts sometimes have a personal stake in the stocks they recommend. Discussing whether analysts should be allowed to take positions in stocks of the companies they cover, Kenneth Bertsch, director of corporate governance for the pension and mutual fund group TIAA-CREF, said: "I think it removes some

of the credibility of the individuals who are doing it. There's definitely a different ethic on the sell side than there used to be, which is unfortunate.”⁴

Wall Street was quick to respond to questions about analysts' independence and objectivity. To media reports that their analysts “had been ordered to seek approval both from the companies they are analyzing and their banker colleagues should they be considering a change in their recommendations”, J.P. Morgan responded: “It was not about getting approval... just about communication, and a laudable determination not to make any factual errors.”⁵

Merrill Lynch, Credit Suisse, and Edward D. Jones addressed concerns that analysts could be influenced by their personal investments by announcing they would prohibit or limit analysts' ownership of stocks of companies they cover. Prudential Securities announced they would implement a new policy requiring their senior analysts to disclose if they own \$10,000 or more of the securities covered in their research reports.⁶

By summer 2001, Congress had taken up the attack. The U.S. House of Representatives Financial Services Committee's Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises held hearings entitled “Analyzing the Analysts: Are Investors Getting Unbiased Research from Wall Street” on June 14, 2001, and “Analyzing the Analysts II: Additional Perspectives” on July 31, 2001. In his opening statement on June 14, 2001, Full Committee Chairman Michael G. Oxley said: “the important work of analysts does not do the marketplace, or investors, any good at all if it is compromised by conflicts of interest. There has been a great deal of concern raised by the media, by regulators, and by the market participants about the perception that analysts are not, in fact, providing the independent, unbiased research that investors, and the marketplace, rely on them for.”⁷ As part of his opening remarks that day, Subcommittee Chairman Richard H. Baker said: “As a free-market conservative, I am the last person interested in government putting the market on trial or contributing unnecessary barriers against a market recovery that keeps expanding opportunities for all Americans. However, the foundation of the free-market system is the free-flow of straightforward, unbiased information. And I must say I am deeply troubled by evidence of Wall Street's erosion of the bedrock of ethical conduct.”⁸

Laura Unger, Acting Chairman of the U.S. Securities and Exchange Commission, expressed the SEC's concern with the credibility of Wall Street analysts at the House Subcommittee hearings on July 31, 2001. In her testimony, she stated: "It has become clear that research analysts are subject to several influences that may affect the integrity and the quality of their analysis and recommendations."⁹

To inform individual investors of potential influences that face analysts, the SEC's Office of Investor Education and Assistance (OIEA) issued an Investor Alert, "Analyzing Analyst Recommendations".¹⁰

By Summer 2001, the Securities Industry Association (SIA) formed an Ad Hoc Committee on Analyst Integrity to address the growing controversy. They drafted a set of guidelines, presented in a monograph called "Best Practices for Research". The introductory remarks for these recommendations state: "These recommendations embody our industry's aspirations to strengthen ethical and professional standards for securities analysts, underscore broker-dealers' commitment to the best interest of our clients, and buttress the overall integrity of the securities markets. Endorsed by the SIA's board of directors, we expect that they will be carefully considered and appropriately implemented throughout the securities industry."¹¹ The document's mission statement states "integrity of research should be fostered and respected throughout a securities firm."¹²

During the summer, the self-regulatory arm of the National Association of Securities Dealers (NASD) concluded there was a need to respond to questions regarding research integrity. On July 2, 2001, NASD Regulation, Inc., requested comments on a proposed amendment to its "Rule 2210: Communications to the Public", indicating: "This proposed rule amendment is the result of ongoing efforts to address the potential conflicts of interest presented by analyst recommendations."¹³

The Association for Investment Management and Research (AIMR), a professional organization of over 150,000 investment professionals, also formed a Task Force on Analyst Independence. On July 10, 2001, they invited comments on their proposed issues paper "Preserving the Integrity of Research". The document indicates that AIMR: "is concerned that the deterioration of investor confidence in the objectivity of sell-side research, should it continue, could greatly undermine the integrity of this research and harm the reputation of the entire investment profession. Market participants have a mutual

responsibility to create and maintain an environment that enables research analysts to fulfill their responsibilities with independence and objectivity, exercise due diligence and thoroughness in conducting research, provide investment recommendations that have a reasonable and adequate basis and fully convey their true opinion. Only if the investing public believes that the information available to them is fair, accurate, and transparent can they have confidence in the integrity of the financial markets and the investment professionals who serve them.”¹⁴ The paper then discusses potential conflicts of interest for sell-side analysts that “may bias their research reports and recommendations”.¹⁵

Before we address the conflicts of interest identified by investors, regulators, politicians, the press, academics, and the industry itself, we first describe the roles of analysts, their research products, and the value they provide to investors.

II. The Brokerage Analyst’s Research Product

A. What do analysts do?

Jegadeesh, Kim, Krische, and Lee estimate that there are more than 3,000 sell-side analysts in the United States.¹⁶ In its August 2001 research report “The Roles and Responsibilities of Securities Analysts”, the Securities Industry Association provides the following job description for brokerage analysts: “A securities analyst, generally employed by a brokerage firm, bank or investment institution, has the principal task of performing diligent and thorough investigations of specific securities, companies and industries. The results of these investigations are presented as a research report, which serves as a basis for making an investment recommendation. Analysts examine all aspects of the current and prospective financial condition of certain publicly traded companies. These examinations should cover all pertinent publicly available information about the company and its businesses. This includes, but is hardly limited to financial statements, research on the company, industry, product or sector, and public statements by and interviews of executives of the company, its customers and suppliers. The analysis and opinions are generally presented on a relative basis -- comparing companies’ performance within a sector or

industry.”¹⁷ The report notes the distinction between analyst and financial advisor, stating: “Although analysts focus on a company’s value as an investment, it is not their job to advise individual investors on their portfolio holdings. That is the responsibility of the financial advisors and, of course, the investors themselves, who are familiar with investors’ portfolios, investment objectives and risk preferences.”¹⁸ Describing the expectations of analysts’ professional conduct, the report indicates that: “Analysts are expected to conform to individual firm and industry guidelines for the preparation and dissemination of these reports as well as to codes of professional conduct.”¹⁹ The report footnotes that these codes are those provided by the Association for Investment Management Research’s 1999 “Standards of Practices Handbook”.

Michaely and Womack categorize analysts’ “information dissemination tasks” as:

- 1.) collecting new information on the industry or individual stock from customers, suppliers, and firm managers;
- 2.) incorporating this new information into their analysis to form earnings estimates and recommendations; and
- 3.) providing recommendations and financial models to their customers through oral or written reports.²⁰

Analysts typically cover the stocks of a handful to several dozen companies, often specializing in a particular industry sector. Although analysts are not financial advisors, they typically assign a quasi-numerical rating, or “recommendation”, for the stock of each company they cover. Examples of recommendation categories are “strong buy”, “buy”, “hold”, and “sell”. Recommendation nomenclatures vary among brokerage firms. Each analyst also usually maintains a “buy list”, which frequently includes some but not all of the companies he covers.

Michaely and Womack indicate that most analysts’ recommendations, such as new “buy” recommendations, “are usually scrutinized by a research oversight committee or the legal department of the brokerage firm before release”.²¹ As a result, the analyst may have planned to make the

recommendation for several days or weeks before it could be released to customers. However, when analysts remove stocks from their “buy” lists, they often do so in response to urgent information.

In their 2001 Investor Alert “Analyzing Analyst Recommendations”, the SEC’s Office of Investor Education and Assistance emphasizes the power that analysts can have on stock prices: “They [analysts] exert considerable influence in today’s marketplace. Analysts’ recommendations or reports can influence the price of a company’s stock – especially when the recommendations are widely disseminated through television appearances or through other electronic and print media. The mere mention of a company by a popular analyst can temporarily cause its stock to rise or fall – even when nothing about the company’s prospects or fundamentals recently has changed.”²²

Academic research documents that analysts’ recommendations are associated with substantial impacts on stock prices, both in the short run and for weeks after analysts’ changes in recommendation. Womack finds that new recommendation changes such as “added to the buy list” and “removed from the buy list” have significant impacts on both price and volume. For example, on the day an analyst at a major brokerage firm issues a new buy recommendation (upgrading it from a lower rating category), the stock’s price increases 3 percent and its trading volume is twice normal, on average.²³

Historically, analysts’ reports and recommendations were provided to their institutional customers and wealthy individual clients by phone, fax, and mail. With growth of the Internet in the mid-1990s, securities firms increasingly made analysts’ reports and recommendations available electronically to institutional and retail clients through their web sites. Many analysts’ earnings forecasts and recommendations are now readily available to the general public. For example, the Nasdaq web site (www.nasdaq.com) currently provides the analyst recommendations (including upgrades, downgrades, and coverage initiation) from 90 firms for Nasdaq- and NYSE- listed stocks, updated 3 times per day. It also provides the consensus of analysts’ recommendations and earnings forecasts as well as lists of stocks with the largest percentage change in analyst consensus of earnings forecasts and with the highest number of analysts’ earnings revisions for the week. Other examples of Internet web sites that provide analysts’ research to the public are CBS.MarketWatch.com, Yahoo!Finance, and Earnings.com.

Analysts also play a key role in investment-banking activities of their brokerage firms. The SEC Investor Alert notes: “Many of the more popular sell-side analysts work for prominent brokerage firms that also provide investment banking services for clients – including companies whose securities they cover.”²⁴ Discussing analysts’ involvement with investment banking, the SIA report states: “Analysts’ role with regard to corporate financing departments varies widely across firms. Many securities firms do not do due diligence in order to further corporate financing objectives. Sometimes those departments have their own analysts. Securities analysts perform independent diligence as a balance and a check to determine the suitability of the firm proceeding with the underwriting deal. At other firms, securities analysts assist the corporate financing departments of their firms in securing and executing mandates, such as participating in ‘roadshows’. The most important contribution comes in assisting in carrying out due diligence responsibilities with regard to initial public offerings, private placements and secondary offerings... Only a small subset of the analyst community, specifically those employed by underwriting firms, undertakes this role, which reflects the high concentration observed in the underwriting business. The top 15 investment banking operations account for more than 95 percent of all lead or co-managed positions in securities underwriting.”²⁵

An analyst’s actions are affected by the guidelines established by his individual firm as well as those imposed by self-regulatory agencies and the SEC. The SIA report notes: “Internal monitoring of quality and compliance standards is complemented by supervisory and regulatory efforts of the self-regulatory organizations, all of which come under the purview of the Securities and Exchange Commission.”²⁶ The report footnotes that NYSE Rule 472 and NASD Rule 2210 are particularly applicable. These rules provide for various disclosures of analysts’ conflicts of interest. For example, research reports must disclose whether the analyst’s firm makes a market in the stock the analyst is recommending and whether the analyst’s firm recently has underwritten a public offering for the company the analyst is writing about.

B. Do analyst recommendations have investment value?

As described above, one of the most widely disseminated and visible research products that brokerage analysts provide are their stock recommendations. Brokerage house clients presumably assume that using this information will improve their investment returns. In contrast, some research academics have argued that markets are semi-strong efficient: prices incorporate all publicly available information, and, therefore, investors who use such information, such as analysts' earnings forecasts and recommendations, will not be able to earn above-average returns.

Womack analyzed analysts' recommendations in some detail for a large sample of major investment banks' recommendations in the early 1990s.²⁷ Womack finds that prices react immediately following recommendations and continue to drift in the direction recommended by the analysts for one to several months following changes in recommendations, creating potentially profitable trading strategies. Prices react to both buy and sell recommendations in the direction predicted, but with sell recommendations, initial price changes are greater in magnitude and prices drift (down) for longer. Using a similar approach, Stickel finds similar results, confirming the potential benefit of trading strategies based on analyst recommendation upgrades and downgrades.²⁸

In a different test of whether recommendations have investment value, Barber, Lehavy, McNichols, and Trueman examine whether investors can earn abnormal returns if they use trading strategies based on the consensus level (average rating) of analysts' stock recommendations.²⁹ Using stock recommendations from the Zacks Database for 1986 to 1995, they construct hypothetical portfolios to model strategies in which investors adjust their portfolios each day to be long stocks with the most favorable consensus recommendations or short stocks with the least favorable consensus recommendations. These portfolios earn above average returns before taking into account transactions costs. After accounting for transactions costs and risk, Barber *et al* conclude investors might not earn better than average net returns using these strategies.³⁰ A reconciliation of the results just described is that the value of brokerage information is short-lived, dissipating over one to six months. Therefore, the average *level* of recommendation has little investment value, but the *changes* in level (upgrades and downgrades) are valuable for a limited time.

Another study by Barber, Lehavy, McNichols, and Trueman updates the analysis of recommendations through 2000.³¹ Interestingly, for the year 2000, the market-adjusted return of the portfolio of *most* favorably recommended stocks is *negative* 31.2%, which is more than five standard deviations lower than the average annual market-adjusted return on the most highly favorable stocks in the other 14 years. Perhaps even more odd is that for the year 2000, unlike any other years, the market-adjusted returns of the *least* favorably recommended portfolio of stocks *exceeded* the market-adjusted returns of the *most* favorably recommended portfolio of stocks.

Researchers have documented an *optimism bias* in the recommendation levels of analysts.³² Specifically, analysts tend to issue more recommendations to buy stocks than to sell stocks. Barber *et al* find 54.1% of analysts' recommendations are "strong buy" or "buy" in the period 1986 to 1995 while only 6.5% are "strong sell" or "sell". Barber *et al* find the ratio of buys to sells increases during 1996 to 2000.³³ While "strong buy" and "buy" recommendations increase from 65.3% in 1996 to 70.8% in 2000, "strong sell" and "sell" recommendations decrease from 3.4% in 1996 to 1.8% in 2000.³⁴

III. The Concerns about Analyst Independence and Objectivity

Perhaps it is not surprising given the poor performance of the stock market in general and of analysts' recommendations for the year 2000 that analysts' independence and objectivity would come under attack in 2001. Although a variety of criticisms have been leveled against analysts' independence and objectivity, the important issues can generally be categorized as concerns that analysts are influenced by:

- 1.) Internal pressures from the analyst's firm, particularly with respect to increasing brokerage commissions, investment banking business, or proprietary trading profits.
- 2.) Pressures from the management of the companies the analyst covers.
- 3.) Pressures from the analyst's institutional investor clients.
- 4.) Conflicts created by the analyst's personal investments.

5.) The analyst's "cognitive failures" such as an "inside view" or an "overreaction to information shocks".

6.) Influence by or competition with the research opinions of other sell-side analysts.

Although these concerns may have found a wider and more critical audience in 2001, they are not new.

In the following sections, we examine each of these concerns along with relevant empirical evidence and academic research.

A. The objectives of the analyst's firm

The income of full-service brokerage firms is primarily derived from three sources:

1) brokerage activities, 2) corporate financing activities, and 3) proprietary trading. Each of these activities can create conflicts of interest for analysts.

A.1. Brokerage business conflicts

The SEC notes that analysts may be encouraged to write "positive" reports because they "can trigger higher trading volumes, resulting in greater commissions".³⁵ The argument is that while the brokerage firm's sales force can approach any client with a "buy" recommendation and encourage a trade, many clients are reluctant or are unable to sell short. As a result, unless the client already owns the stock in his portfolio, a "sell" recommendation is less likely to generate a trading commission.

Michaely and Womack write that although an analyst's compensation may be somewhat affected by his influence on his firm's trading commissions, it is often difficult to assess his contribution to trading volume.³⁶ Institutional investors in particular try to minimize trading costs and, therefore, often make their decisions as to where to execute their trades independent of where they obtain the best research services.

Brokerage commissions, increasingly under pressure as a result of competition from discount brokers and electronic trading, now pale in comparison to corporate financing revenues and investment banking fees. Citing SIA statistics for 1999, *Institutional Investor* notes that total trading commissions at major firms and national brokerages was \$9.5 billion compared with about \$24.6 billion in investment banking fees.³⁷

A.2. Corporate financing business conflicts

Corporate financing activities typically include investment-banking services such as advising and assisting with initial public offerings (“IPOs”), seasoned equity offerings (“SEOs”), and mergers and acquisitions. In its October 2000 issue, *Institutional Investor* writes: “For years, investors have muttered about the increasing amount of time [sell-side] analysts spend hustling banking business – compromising the quality of research while dramatically boosting their annual pay packages. This year, with equity markets sagging and the M&A and underwriting businesses soaring, the muttering has become an outcry.”³⁸

Recently the SEC, particularly concerned about potential conflicts of interests faced by analysts from the investment banking side of the business, conducted interviews of brokerage firms, including eight of the top 12 underwriters in terms of the number of new issues underwritten in 2000. Acting Chairman Laura Unger reported some of the SEC’s preliminary results during the House Subcommittee hearings in July 2001. Firms told the SEC that research analysts were important participants in investment banking, “consulting on possible mergers, acquisitions and corporate finance deals, participating in road shows and initiating research coverage on prospective investment banking clients.” Investment banking largely determined the compensation pool for analysts at many of the firms the SEC interviewed, and “investment bankers at some firms are involved in evaluating the firm’s research analysts to determine their compensation”.³⁹

The SEC also reported “research analysts were significantly involved with start-up companies well before the companies had established an investment banking relationship with a broker-dealer”. Analyst activities “typically included establishing an initial relationship with the company, reviewing the company’s operations, and providing informal strategic advice”. The SEC found that often the companies permit analysts to invest in a private stake in the company before shares are available to the general public. The SEC found that “if the company went public and the analyst’s firm underwrote the IPO, the analyst always issued positive research on the company”.⁴⁰

Firms often assign research analysts to cover companies the firms have underwritten. The SEC found that for 308 of the 317 IPOs they analyzed during the study, the underwriting firm later provided research coverage.⁴¹

In order to prevent private equity holders from selling their stock soon after the IPO, potentially depressing the stock’s price, many underwriters negotiate lock-up agreements from these shareholders for a pre-agreed time after the IPO. The SEC examined lock-up agreements for 97 companies in which the underwriting firm or one of the firm’s analysts owned stock. The SEC found the firm’s sell-side analyst made a “buy” recommendation within a week prior to the lock-up expiration in 26 of these cases. The SEC noted that these types of reports (sometimes referred to as “booster shots”) “may generate buying interest in the stock and help increase the stock price while the firm, the firm’s clients, or the analysts sell their shares”.⁴²

When the SEC asked to what extent a firm’s investment banking group influences analysts’ research, “six firms stated that at times analysts provide investment bankers and client management with advance notice of pending change in the analyst’s recommendations”. The SEC noted, however, that the firms indicated investment bankers did not have the “authority to stop an analyst from downgrading a particular company’s rating”.⁴³

Academic researchers have documented several reasons why underwriter analysts may provide optimistic research. Krigman, Shaw, and Womack study 578 companies that went public between 1993 and 1995 and conducted an SEO within three years of their IPO.⁴⁴ The SEO business can be a lucrative

one for underwriters: Krigman *et al* estimate these companies paid about \$2 billion in fees to underwriters. Almost a third of the companies switch underwriters, however. Specifically, they select a lead underwriter for the SEO different from the lead underwriter of their IPO. Krigman *et al* conclude a key reason companies switch underwriters is to “buy additional and influential analyst coverage from the new lead underwriter”.⁴⁵

Krigman *et al* also survey the chief financial officers and chief executive officers of the companies who switch. More than half of the decision makers in their survey cite the quality and reputation of the underwriting firm’s research department and analysts as one of the top three reasons for selecting the lead underwriter for the IPO. This result suggests that companies expect their underwriters to provide positive analyst coverage following the IPO. These decision makers generally praise the service they received during the IPO process. They give “much lower marks”, however, to the service they received post-IPO, “especially research coverage by security analysts”.⁴⁶

Michaely and Womack find recommendations for companies the analyst’s firm underwrites are “biased and, in the long run, inferior to recommendations of non-underwriters”.⁴⁷ For example, they examine analyst recommendations issued in the month following the quiet period (i.e., after the initial period when no recommendations can be issued). They find underwriter analysts issue 50% more buy recommendations than other analysts do.

Michaely and Womack survey a small group of investment managers and investment bankers as to the optimism biases they find. Every one of the investment managers (26 of 26) and 77% (10 of 13) of the investment bankers believe the best explanation for the findings was the conflict of interest story rather than a more benign explanation.

A.3. Proprietary trading conflicts

In its OIEA Investor Alert “Analyzing Analyst Recommendations”, the SEC warns investors that the brokerage-dealer firm that employs the research analyst “may own significant positions in the companies an analyst covers”.⁴⁸ The firms may also have acquired shares by obtaining a stake in the company pre-

IPO. The SEC notes that the firms “may act against their own [analysts’] recommendations, selling stock in a company even as the analyst reiterates a ‘buy’ or other favorable rating and issues a positive report about the company’s prospects”.⁴⁹

B. Pressures from managements of companies covered

A critical aspect of the analyst’s job is the timely access to new information about the companies he covers. Sometimes the new information comes from company suppliers and customers. But often it comes from the companies themselves. As a result, analysts inevitably cooperate with firms to achieve superior access to company management. Those that do not cooperate are regularly frozen out of future communication opportunities with management.

In October 2000, the SEC implemented Regulation Fair Disclosure (“Reg FD”) in an attempt to create “parity of information” between individual investors and securities professionals.⁵⁰ Reg FD was aimed at eliminating *selective disclosure*, which is the practice of companies’ disclosure of material nonpublic information in conference calls or meetings open only to analysts and institutional investors. *Nonmaterial* information *may* be disclosed preferentially and is valuable to analysts and investors.

The SIA in its May 2001 report “Costs and Benefits of Regulation FD” notes that although many companies still conduct “one-on-ones” with analysts, companies’ representatives are now more likely to “stick to the script”.⁵¹ The SIA report suggests this may partly be a result of confusion on companies’ parts about what distinguishes material information from nonmaterial information and urges the SEC to clarify this distinction.

Analysts and directors of research at several brokerage firms told us in November 2001 that despite Regulation FD, access to management continues to be an important part of the information gathering process. In fact, with respect to their access to company executives, brokerage analysts appear to have a privileged position relative to *buy-side* professionals. The results of recent surveys of buy-side investment professionals indicate one of the services they value most from brokerage analysts is their ability to arrange meetings for them with company executives.⁵²

In her testimony to the House Subcommittee on July 31, 2001, Laura Unger, Acting Chairman of the SEC, warned of the pressures that analysts face from company managements: “The management of companies an analyst follows may pressure him/her to issue favorable reports and recommendations. Less than favorable recommendations may not be well received by management and issuers may threaten to cut off an analyst’s access to its management if the analyst issues a negative report on the company. This could cause the analyst to issue a more favorable report than his/her analysis would suggest.”⁵³ Such concerns are not new. Siconolfi reports that analysts who write negative reports or issue sell recommendations on a company’s stock risk losing their ability to collect information from the company’s management, indicating analysts may be “excluded from meetings, outings and conference calls with top company executives.”⁵⁴ Pressures from company management may have increased in recent years. Sargent writes, “Corporate managements, compensated in equity options for stock performance, have become more bold in punishing analysts who fail to toe the party line.”⁵⁵

Boni and Womack find that 69.3% of buy-side professionals believe pressure from corporate managements to provide positive research is usually or always an important motivation for brokerage analysts.⁵⁶

Lim notes “when companies have good news, managers have every incentive to push this news out to investors as quickly as possible.”⁵⁷ Lim tests whether the widely observed optimism bias in analysts’ earnings forecasts is consistent with the thesis that analysts, attempting to produce accurate forecasts, intentionally impart a positive bias in their forecasts in order to obtain more precise private information from company management in the long run. Using data for 1984 through 1996 for analysts from over 300 brokerage firms, Lim finds analysts impart a greater positive bias to companies for which less information about earnings prospects is publicly available. He reasons this finding is consistent with his thesis as analysts have a greater incentive to incur bias to obtain access to the management of these companies. He also finds that analysts at smaller brokerage firms (presumably with less resources) and analysts with less experience make more optimistic forecasts, consistent with the story that they have a greater need for

access to management. Hong, Lim, and Stein find stock price momentum effects are stronger and more persistent for poor performers: apparently bad news reaches investors more slowly than good news.⁵⁸

C. Pressures from institutional investor clients

In her testimony to the House Subcommittee on July 31, 2001, Laura Unger, Acting Chairman of the SEC, warned of the pressures that analysts face from their institutional investor clients: “Institutional investors, such as mutual funds, that are clients of the analyst’s firm may have a significant position in the security of a company covered by the analyst. An analyst may be inhibited from issuing a rating downgrade that would adversely affect the performance of an institutional client’s portfolio for fear that the client would take its brokerage business elsewhere. Moreover, many publications rate analysis based upon input from institutional investors.”⁵⁹

Sargent writes “there’s tremendous pressure from fund managers not to go negative on companies in which they have big positions”.⁶⁰ Sell-side analysts note that despite their public outcries for independent research, institutional investors sing a different tune when the stocks in question are those in their own portfolios. Stephen Hash, director of U.S. equity research for Lehman Brothers notes: “That’s the great irony of our business. Portfolio managers don’t want us to downgrade stocks.”⁶¹

Institutional investors directly affect sell-side analyst compensation. *Institutional Investor* conducts an annual poll that asks investment managers to rank sell-side analysts by industry. First, second, and third place winners each year are named to the “All-America Research Team”. *Institutional Investor* also tallies up the winning analysts’ places to rank brokerage firms. Stickel notes that this poll is perhaps the most significant external influence driving analyst compensation.⁶²

D. The analyst’s personal investments

In his April 2001 article for *Institutional Investor*, “Should Analysts Own Stocks They Cover?”, Justin Schack argues “largely overlooked” in all of the complaints about analysts’ loss of objectivity “has been

perhaps the most fundamental conflict of interest of all Wall Street Analysts – owning the stock of companies they cover”.⁶³ Schack notes that although it is difficult to know how widespread the practice, analysts’ personal investments in companies they cover can be huge. One of the examples he describes is an analyst, who having invested in \$150,000 in pre-IPO venture capital rounds, initiated post-IPO coverage with a buy rating. Schack states the analyst’s shares at that point were worth about \$10 million.⁶⁴

Currently self-regulatory organization regulations do not prohibit the practice of analysts owning stocks in the companies they cover. Some firms prohibit or place limitations on the stocks their analysts can own. At some firms, analysts simply are forbidden from making personal trades that are opposite their recommendations.

Among the preliminary results of ongoing examinations of securities firms that Acting SEC Chairman Laura Unger reported to the House Subcommittee hearings in July 2001, she noted the following observations with respect to analysts’ personal investments:

- 1.) Analysts sometimes provided research coverage for companies in which they had made pre-IPO investments. Post-IPO, the analysts initiated research coverage with “buy” recommendations.
- 2.) Analysts sometimes traded contrary to their research recommendations. Analysts’ profits from selling shares while maintaining “buy” recommendations were between \$100,000 and \$3.5 million.⁶⁵

E. The analyst’s cognitive miscues such as “the inside view” or “overreaction to information shocks”

Various academic researchers have argued that analysts’ recommendations and earnings forecasts may suffer from cognitive biases rather than intentional optimistic pandering. For example, analysts may suffer from a behavioral tendency to overweight new information too heavily when updating their priors, forming posterior expectations that are too extreme as a result.⁶⁶

Michaely and Womack offer the possibility that the analysts of underwriting firms are optimistically biased post-IPO because they frame their analyses too narrowly, a cognitive failure described by Kahneman and Lovallo as “the inside view”.⁶⁷ Instead of analyzing a company just underwritten as just another of many post-IPO companies, many of which fail, because of their inside knowledge acquired as they helped the company come public, analysts view the company as unique with high potential (as parents do their children) and are unable to assess rationally the likelihood of failure or poor performance. Analysts unaffiliated with the underwriting firm are more able to take an “outside view” and frame the problem of how to value the post-IPO company more broadly and statistically.

F. The research opinions of other sell-side analysts

Analysts may also be influenced by the forecasts and recommendations of other analysts. Academic theoreticians have developed a variety of models of mutual imitation or herding.

Welch writes: “Herding in financial markets, in particular, is often presumed to be pervasive, even though the extant empirical evidence is sparse”.⁶⁸ Welch tests for herding in analysts’ recommendations.

Among his findings are:

- 1.) Analysts’ changes in recommendations are positively correlated with the previous two analysts’ changes in recommendations. The correlations are stronger when changes correctly predict short-run stock returns. He notes that he cannot determine whether multiple analysts are reacting to the same new information or whether analysts are simply imitating other analysts, however.
- 2.) Analysts’ changes in recommendations are positively correlated with the prevailing *consensus* of analysts’ recommendations. The correlations are *not* stronger when the consensus correctly predicts stock returns. He concludes that consensus herding, therefore, is not the result of analysts’ efficient aggregation of new information.

3.) Perhaps most interestingly, analysts' changes in recommendations are more strongly correlated with the consensus recommendation in bull markets than in bear markets. He suggests that this is consistent with analysts' doing a poorer job of independent news gathering and analysis in bull markets than in bear markets, "perhaps causing more fragility and thus a higher incidence of 'crashes' in up-markets than of 'frenzies' in down-markets".⁶⁹

Hong, Kubik, and Solomon test analysts' earnings forecasts for evidence consistent with the theoretical work of Scharfstein and Stein that suggests analysts herd to protect reputational concerns.⁷⁰ Specifically, analysts may herd because they perceive the cost of being the lone wrong voice as greater than that of being wrong with the herd. Hong *et al* find that older analysts are more likely to issue forecasts before younger analysts and these forecasts are likely to deviate more from the consensus. They conclude that the perceived benefit to an analyst from using herding strategies is greater earlier in the analyst's career when there is presumably more uncertainty about the analyst's abilities.

IV. Proposals That Address the Credibility Controversy

Several proposals have been made to address the sell-side credibility controversy, and some of them already have been put into practice. Generally they can be categorized as suggestions to 1) restrict analysts' personal trading and investments, 2) increase disclosure requirements, 3) reinforce "Chinese firewalls" that separate investment banking from research, 4) standardize ratings, 5) issue more "sell" recommendations, 6) educate investors, and 7) expand independent research services.

A. Restrictions of analysts' personal trading and investments

As discussed earlier, some firms allow analysts to own stocks in the companies they cover while some do not.⁷¹ Some of those in favor of analyst ownership say that analysts are better or more careful or more diligent about valuing a company's stock when they own it. Those opposed to analyst ownership argue it creates an unfair opportunity for analysts to use their own research pronouncements to manipulate the

stock's price for personal gain. In November 2001, newly-appointed SEC Harvey Pitt Chairman said, "I don't think there is any inherent need for a prohibition against an analyst owning stock". Chairman Pitt said he is "more concerned with analysts' buying cheap stocks in companies before they go public" or "trading ahead of their investor recommendations".⁷²

Boni and Womack find that buy-side professionals' opinions are almost evenly split as to the ownership issue: 42% believe brokerage analysts should be allowed to own stocks of companies they cover while 48% believe they should not.⁷³ The investment professionals are in much stronger agreement as to *when* analysts should be allowed to trade stocks they cover: 96% believe analysts should not be allowed to trade a security while they are preparing research on it or within a reasonable period of time after issuing research on it. Most (79%) buy-side professionals believe the analyst's personal trading should be completely consistent with his investment recommendations. Almost all (94%) believe analysts should have to disclose ownership positions. Exactly half (50%) believe the analyst's ownership of a company's stock will *not* lead to more accurate research by that analyst.

Yet, there may be an even more subtle reason for encouraging or requiring analysts to refrain from ownership in the stocks they follow. The "inside view" expounded by Kahneman and Lovallo suggests that it is difficult for "insiders" (in this case, owners of stock) to think objectively and statistically about issues, people, or companies with which they are emotionally entangled.⁷⁴ When situations are thought of as unique, rather than as members of a class of probabilistic events, they are likely to think in terms of potentially achievable outcomes rather than most likely outcomes. Kahneman and Lovallo suggest that intelligent, rational decision making in probabilistic situations requires a standoffish "outside view". It is easy to see how the biased "inside view" is related to analyst decision making. This idea is not an ethical or legal dilemma but simply one that attempts to improve decision making under uncertainty.

B. Increased disclosure requirements

In her testimony to the House Subcommittee in July, Acting SEC Chairman Unger said, "The Commission plans to work with the SROs [self-regulatory organizations] to improve and more diligently

enforce existing rules governing the disclosure of conflicts of interest”.⁷⁵ NASD has requested comments on “Proposed Amendments to Rule 2210” that would increase firms’ disclosure requirements.⁷⁶ It would extend some disclosure requirements to analysts, requiring them to disclose personal financial interests in securities they recommend, for example.

Institutional investors appear to support increased disclosure requirements. Boni and Womack find that only 4% of professional money managers and buy-side analysts believe the current level of disclosure of brokerage firm reports is sufficient.⁷⁷ Most (87%) believe disclosure of investment banking activities and other potential conflicts should be more visible in recommendation reports (e.g., on the front page, in bold type, etc.). Even more (92%) believe brokerage reports should disclose exactly when the firm last acted as underwriter to the company covered. Almost as many (82%) believe the reports should disclose when the firm provided merger/acquisition advice to the company covered. Almost two-thirds (65%) believe the reports should disclose for how long the firm has acted as a market maker in the covered stock; 62% believe the reports should disclose the actual value of stock the brokerage firm is long or short.

Given the optimism bias of analysts whose brokerage firms have an investment banking relationship with the companies covered, full and clear disclosure of this relationship appears to be particularly important. Boni and Womack find that 86% of professional money managers and buy-side analysts say they discount the opinions and recommendations of analysts when there is an investment banking relationship between the analyst’s firm and the company being analyzed.⁷⁸ Michaely and Womack find that the market slightly discounts the post-IPO recommendations of analysts of underwriters relative to non-underwriters.⁷⁹ But underwriters’ analysts’ recommendations are not completely discounted as the evidence suggests they should be. The market reaction to recommendations of analysts who are not affiliated with the underwriting firms is stronger initially, but the difference between reactions to underwriters and non-underwriters’ recommendations is only marginally significant. Investors apparently recognize, at least to some extent, the potential bias and the self-interest in underwriters’ recommendations. Longer term (for a 12-month period), firms recommended by underwriter analysts

under-perform the non-underwriter analysts' recommendations by a wide margin (18.4%) and this result is quite significant. A strategy of buying stocks recommended by underwriters' analysts yields a negative abnormal return of 5.3%. Michaely and Womack conclude that underwriters' analysts' recommendations are positively biased and that the market does not understand the full extent of the bias. Since the market does not appear to fully discount the bias of underwriter recommendations and most professional money managers and institutional investors claim to understand this bias, the victims of the bias are most likely to be the less sophisticated individual ("retail") investors.

Economists might argue that full disclosure would encourage firms that have truly independent and objective research to distinguish themselves from firms that do not.⁸⁰ This holds, in theory, if the benefits firms receive from reputations for independent and objective research outweigh the costs. Brokerage firms provide research primarily to encourage clients' transactions of stocks and bonds, and, in the case of the largest brokerage firms, to facilitate underwriting. The largest brokerage firms often represent corporate financing clients, often as stock and bond issuers ("borrowers"), as well as investors ("lenders"). While investors would likely prefer independent and objective research ("truth telling"), issuers prefer brokerage research analysts to be optimistic ("credible marketers"). Can brokerage firms resolve this conflict?

Addressing the investing clients' interests, the preamble to the SIA's 2001 "Best Practices for Research" monograph states: "At the heart of these and other best practices adopted by SIA is the core principle that the investors' interests must come first. This principle is the source of the trust and confidence that the securities industry has earned from the public. To abide by the highest professional standards is the responsibility we incurred when we chose to manage other peoples' money. Anything less would be inconsistent with the trust our clients have in us and a betrayal of our professional obligation."⁸¹ This statement suggests that brokerage firms believe that in order to continue to attract and maintain investors' business in the long run, they must credibly signal that they are looking out for the best interests of these clients. Yet, few if any investors are willing to pay hard dollars for brokerage research reports or recommendations. That is, brokerage research usually is not sold directly, but instead

is a product bundled with transactions services. As long as research and recommendations are accounted for as a cost rather than a direct source of revenues and profits, it may be difficult for brokerage firms to assess the benefits of reputations for independence and objectivity versus the benefits of using research, at least to some extent, to boost profits through selling stock and encouraging trading.

C. Reinforcement of “Chinese firewalls”

In her testimony to Congress, Acting SEC Chairman Unger notes: “there may be benefits from research analysts working with investment bankers. For example, an investment banker underwriting a company’s offering will sometimes employ its firm’s research analysts to help it conduct its due diligence investigation into the company it is underwriting. The due diligence investigation helps ensure that the prospectus contains all material information required to be disclosed. In these cases, research analysts play an important role in facilitating the due diligence process, especially in expedited offerings.”⁸²

The SIA “Best Practices for Research” recommends a number of guidelines that would attempt to reinforce the separation (“Chinese firewall”) between investment banking and research within brokerage firms. These recommendations include:

- 1) Research analysts should not report to investment banking.
- 2) A research’s analyst’s pay should not be directly linked to *specific* investment banking transactions, sales and trading revenues, or asset management fees.
- 3) An analyst should not submit research to investment banking or to corporate managements for approval.⁸³

Institutional investors clearly do not believe that firewalls exist at this time. Boni and Womack find that 87% believe an analyst’s desire to retain and attract investment-banking clients for the firm is an important motivation.⁸⁴ Perhaps more interestingly, many institutional investors doubt that guidelines to reinforce Chinese walls could be enforced: 91% believe research should not report to investment banking but only 48% of these respondents believe this guideline can be credibly enforced. Most (89%) believe analyst pay should not be linked to specific investment banking transactions but only 36% of these

respondents believe this guideline can be credibly enforced. Finally, 90% believe analysts should not submit research to investment banking or corporate managements but 44% of these respondents doubt this guideline can be credibly enforced.

D. Standardization of ratings

As discussed earlier, ratings categories vary across brokerage firms. For example, Prudential's analysts give a stock one of three possible ratings: "buy", "hold" or "sell". In contrast, as of November 13, 2001, Merrill Lynch maintained 11 rating levels: "near-term buy", "long-term buy", "near-term accumulate", "long-term accumulate", "near-term neutral", "long-term neutral", "near-term reduce", "long-term reduce", "near-term sell", "long-term sell", and "no opinion".⁸⁵ Some regulators have suggested ratings terminology may confuse investors.⁸⁶ Andy Melnick, Director of Global Securities Research & Economics at Merrill Lynch, argues that different investors have different needs and objectives. For example, younger investors may prefer investments with higher expected return and higher expected risk than those close to retirement. The multi-tiered ratings system allows Merrill Lynch's research analysts to communicate the necessary risk/return profiles of research recommendations to its brokers and clients. As of October 2001, the SIA Ad Hoc Committee on Analyst Integrity had discussed possible standardization of ratings categories across firms without coming to a consensus.

Findings of Boni and Womack suggest firms' time would be better spent working to continue to clarify ratings rather than attempting to agree on a standardization of ratings.⁸⁷ Although 56% of professional money managers and buy-side analysts agree that standardization of ratings would be helpful, 89% believe each firm should clearly define its formal ratings system and publish this information in every report or make it otherwise available. Their responses also suggest there is an unwritten "code language" among analysts: 79% say they interpret "hold" recommendations as "sell" recommendations. In June 2001, Prudential said it was "encouraging its analysts to call a stock a "sell" instead of hiding behind euphemisms such as 'neutral' or 'market perform'".⁸⁸

E. More “sell” recommendations

Given the widely-documented positive bias in analyst recommendations (i.e., many more recommendations to buy than sell), some institutional investors have long argued analysts need to increase the number of sell recommendations they make.⁸⁹ Several of the brokerage research directors with whom we spoke said this is an important step toward restoring investor confidence. Boni and Womack find that most of professional money managers and buy-side analysts (85%) believe analysts should issue more sell recommendations.⁹⁰

F. Investor education

In issuing its 2001 Investor Alert, the SEC indicated that it believes individual investors are at a disadvantage unless they fully appreciate the conflicts of interest that brokerage analysts face. Clearly, full disclosure would have to go hand in hand with the education of retail investors. For example, as discussed in the increased disclosure section above, it is important for investors to be able to observe when analysts’ firms have underwriting relationships with the companies about which they write and recommend. But disclosure alone would be ineffective for those who did not also understand the bias in research that the relationship portends on average.

G. Expansion of independent research services.

Economists might argue that if independent research has value, there should be a market for analysts and firms that provide research independent from brokerage firms. There are in fact independent research firms and firms that do little or no investment banking business. Although many of the largest institutional investors maintain their own research staffs, some investment managers pay for independent research. Boni and Womack report 46% of the professional money managers and buy-side analysts surveyed pay for independent research and indicate that they believe the existing companies that offer it

are sufficient.⁹¹ About half (51%) say that the independent research they buy is typically more useful than the sell-side research they receive. About two-thirds (65%) say they anticipate that the demand for and usage of independent services will increase in the future and 54% say their firms would be willing to pay more for independent research but that more or better quality services are needed. Only 23% say they are unwilling to pay for independent research because they are able to de-bias and use sell-side research at a lower cost.

In an October 2001 poll of investment managers, *Institutional Investor* found about 74% of respondents said “they would be to pay more for research deemed independent from corporate finance”.⁹² *Institutional Investor* also notes that some securities firms “are skeptical about the prospects for independent research firms”.⁹³ Alfred Jackson, head of global research for Credit Suisse First Boston, said, “I don’t know how that kind of independent research is going to be paid for. Institutions haven’t paid for it in 28 years, and I don’t know how that they are going to start now”.⁹⁴ The managing director of global investment research at one investment bank told us that independent research firms will never be able to retain or compete for the best analysts: they will never be able to offer the compensation packages that investment banking firms can.

V. Conclusions

In this paper, we have examined the Wall Street controversy, its underpinnings, and proposed fixes. We have argued that analysts’ employers, the companies researched, and perhaps even the institutional money managers themselves, provide analysts with incentives that are “misaligned” from the perspective of many individual investors. As a result, we conclude that the proposed fixes, for the most part, are unlikely to truly restore Wall Street research credibility.

It is worth emphasizing three points we believe are the most critical to understanding the controversy. First, consider the question: Why do brokerage firms employ analysts to provide investment research? Primarily, we believe, it is to encourage clients’ transactions in stocks and bonds, and, in the case of the

largest brokerage firms, to facilitate underwriting. In a theoretical sense, brokerage firms should perhaps be thought of as financial intermediaries, making possible intertemporal cash flow and risk shifting among agents. But in a more basic sense, they are marketers, earning commissions and fees the more transactions that they facilitate between buyers and sellers. It is thus not surprising that these firms face internal conflicts as to how best to serve both investor and issuer clients. While investors would probably prefer research analysts to be “truth tellers”, issuers would prefer research analysts to be marketers. When few investors are willing to pay directly for research and when underwriting fees dwarf brokerage commissions, how can brokerage firms credibly convince investors that their interests will not be dominated by the interests of borrowers?

A number of securities firms *have* announced changes in their policies regarding analysts’ ownership of stocks they cover. Securities firms may be reluctant to change policies to address other perceived conflicts of interest, however, due to concerns over their impact on pending or potential legal action. The settlement amounts that could result from such investor actions could be enormous. For example, in March 2001, one investor, Debases Kanjilal, filed an arbitration claim against Merrill Lynch and one of its analysts, Henry Blodget. Kanjilal claimed that because Merrill Lynch and Blodget stood to gain from future financial dealings with InfoSpace Inc., Blodget maintained unrealistic buy recommendations and price targets. He also argued that Blodget did not disclose the conflict of interest presented by Merrill Lynch’s corporate finance dealings with InfoSpace or that his compensation was partly determined by whether he brought corporate financing deals to Merrill Lynch. In July, Merrill Lynch settled the case for \$400,000 “to avoid the expense and distraction of protracted litigation”.⁹⁵

Also critical to understanding the research credibility problem is the important role of the corporations, the targets of analysts’ reports and recommendations, which control access to vital information analysts need. They reportedly permit unfettered access only to those analysts that stay close to the company’s party line. It is easy to blame analysts for not being objective. But one of the real problems lies with the corporations if they strategically dole out the most valuable information only to those who “cooperate” with managements’ optimistic forecasts. Regulation FD limits the release of

material information, but other technically *non*material information, such as strategic or long-term plans, is also valued highly by investors and hence analysts. While the largest institutional investors often develop their own direct links to corporate executives, sell-side analysts are awarded (if they cooperate) the privileged status of information intermediaries between corporations and their small and medium-sized investors. So, while sell-side research may be biased, to many investors, it may also be the *only* available information except for regulated reporting requirements.

Third, we conclude professional money managers understand the pressures and incentives that analysts face and the resulting optimism biases. Although they currently act to filter and de-bias analysts' information, they indicate strong preferences for increased disclosure. We conclude small investors, on the other hand, which the SEC wants to protect and assist, have less appreciation for the subtleties of these pressures, incentives, and resulting biases. Without adequate education, they will continue to be disadvantaged when they do not understand that "buy" may not mean "buy" and "hold" definitely means "sell".

Finally, we ask: Is there a market failure inherent in this credibility problem? There is little ostensible evidence from investment banks or professional investors to suggest so. It is unlikely that fewer securities are issued to those investors willing to pay. There is also little evidence that professional investors punish investment banks by taking their business elsewhere because of biased research. While it may be hard to argue that securities issuance is sub-optimally allocated, however, it would be hard to argue that the burden of biased research is therefore not costly to some market participants. It is quite unlikely that individual investors understand and are able to de-bias analysts' information without increased awareness and education.

Although many professional money managers say they understand analysts' conflicts of interests and adjust accordingly, the largest maintain their own in-house research staffs and some purchase independent research. If, as a result of the Wall Street credibility controversy, the demand for independent research increases, the supply of independent services will likely grow to meet it. Thus, while an economic solution again exists for institutional investors, it is a dubious fix for the uneducated individual investor.

Perhaps the single largest reason that few changes are likely to result from the research credibility debate is simply the timing of the debate. Ironically, during July 2001, when we asked one research director of a large investment bank whether he believed the research credibility controversy would “blow over”, he indicated this was unlikely unless either the stock market rallied or a major crisis provided a distraction. In fact, since the terrorist attacks of September 11 and the resulting focus on preparedness for future attacks, the debate over analyst independence appears to have “lost much of its steam”.^{96, 97}

Since the September terrorist attacks, new SEC Chairman Harvey Pitt has stated that rather than having the SEC put forth new regulations, he would prefer that the securities industry determine its own rules for dealing with analysts’ conflicts. As recently as December 2001, a spokesman for Representative Richard Baker, subcommittee chairman of last summer’s Congressional hearings on analyst independence, stated: “We’re getting close to picking this reform effort back up.”⁹⁸ But he also noted, “The best way to describe it is that we’re still waiting to hear back from Wall Street about serious efforts to cure themselves.”⁹⁹ Perhaps the strongest inquiry into analyst independence will be that by the New York state attorney general’s office, which has undertaken a “general probe of analysts’ conflicts”.¹⁰⁰ In the past, the New York attorney general’s office has pursued cases of criminal and civil securities fraud under a New York state law known as the Martin Act.¹⁰¹

In sum, we believe the proposals and actions to date from brokerage firms, the SIA, Congress, the SEC, NASD, and AIMR are “sticks” and not “carrots”: they address a few specific and most egregious issues, such as preventing analysts from benefiting by trading in stocks they recommend. But will the proposals recommended by the SIA, AIMR and the brokerage firms meaningfully restore research credibility? An affirmative answer to that question is unlikely. Brokerage firms and their agents, these much maligned security analysts, are like all other economic agents: they respond to incentives. None of the proposals changes the incentives of brokerage firms to let corporate financing clients’ interests dominate investors’ interests. Nor do they change the incentives of corporate managements to manipulate and promote their own optimistic stories by forcing analysts to cooperate or be shut out from access to management’s most recent and valuable information.

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Endnotes

¹The term *buy-side analysts* refers to analysts typically employed by institutional money management firms, such as pension funds, mutual funds, and insurance companies.

² *Financial Times* (2001); Gasparino (2001a); Elkind (2001).

³ Schack (2001, page 71).

⁴ Schack (2001, page 63).

⁵ *The Guardian* (2001, page 23).

⁶ See Gasparino and Opdyke (2001) and Craig (2001a, 2001b).

⁷ www.house.gov/financialservices/061401tc.htm.

⁸ www.house.gov/financialservices/061401tc.htm.

⁹ Unger (2001b, page 3).

¹⁰ www.sec.gov/investor/pubs/analysts.htm.

¹¹ SIA (2001b, introductory page.)

¹² SIA (2001b, page 1.)

¹³ NASD (2001, “Background” section).

¹⁴ AIMR (2001, page 1).

¹⁵ See AIMR “Invitation to Comment: Proposed Issues Paper on Analyst Independence,” July 10, 2001 (www.aimr.org/pdf/standards/ai_comment.pdf).

¹⁶ Jegadeesh, Kim, Krische, and Lee (2001). Jegadeesh *et al* cite www.bulldogresearch.com (now defunct) as their source and exclude “Associates” and other junior analysts.

¹⁷ Fernandez (2001, page 3). The Securities Industry Association (SIA) is an association “that brings together the shared interests of nearly 700 securities firms to accomplish common goals” [www.sia.com]. SIA member firms include brokerage firms, investment banks, and mutual fund companies. The SIA activities include research, education, and lobbying efforts.

¹⁸ Fernandez (2001, page 4).

¹⁹ Fernandez (2001, page 4).

²⁰ Michaely and Womack (1999).

²¹ Michaely and Womack (1999, page 659).

²² OIEA (2001, page 1).

²³ Womack (1996).

²⁴ OIEA (2001, page 1).

²⁵ Fernandez (2001, page 4).

²⁶ Fernandez (2001, page 4).

²⁷ Womack (1996).

²⁸ Stickel (1995).

²⁹ Barber, Lehavy, McNichols, and Trueman (2001a).

³⁰ Barber *et al* (2001a) note that *change* in recommendation, not just the *level* of recommendation, is important (page 533, for example). Using quarterly data and a different methodology, Jegadeesh *et al* (2001) conclude that changes in recommendations, *not* levels of recommendations, are useful criteria for investment decisions.

³¹ Barber, Lehavy, McNichols, and Trueman (2001b).

³² Numerous researchers have also documented an optimism bias in analysts' forecasts of company earnings. For example, Brown, Foster, and Noreen (1985), Stickel (1990), Dreman and Berry (1995), and Chopra (1998) are among those who document that analysts' earnings forecasts tend to exceed actual earnings forecasts.

³³ Barber, Lehavy, McNichols, and Trueman (2001b).

³⁴ See Barber, Lehavy, McNichols, and Trueman (2001a) for 1986 through 1995 and Barber, Lehavy, McNichols, and Trueman (2001b) for 1996 through 2000.

³⁵ Unger (2001b, page 3).

³⁶ Michaely and Womack (1999).

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- ³⁷ Sargent (2000).
- ³⁸ Sargent (2000, page 58).
- ³⁹ Unger (2001b, pages 4-5).
- ⁴⁰ Unger (2001b, page 5).
- ⁴¹ Unger (2001b, page 5).
- ⁴² Unger (2001b, page 8).
- ⁴³ Unger (2001b, pages 5-6).
- ⁴⁴ Krigman, Shaw, and Womack (2001).
- ⁴⁵ Krigman, Shaw, and Womack (2001, page 245).
- ⁴⁶ Krigman, Shaw, and Womack (2001, page 249).
- ⁴⁷ Michaely and Womack (1999, page 680). Lin and McNichols (1998) find analysts of the lead underwriting firms are more likely to issue positively biased recommendations than analysts of non-underwriting firms, but they are not more likely to issue biased earnings forecasts. Dechow, Hutton, and Sloan (1998) conclude earnings forecasts of underwriters' analysts are more positively biased.
- ⁴⁸ OIEA (2001, page 3).
- ⁴⁹ OIEA (2001, page 3).
- ⁵⁰ Unger (2001a, page 3).
- ⁵¹ SIA (2001a, Attachment #1, page 2).
- ⁵² See Boni and Womack (2001) and Dini (2001).
- ⁵³ Unger (2001b, page 13).
- ⁵⁴ Siconolfi (1995, page A1).
- ⁵⁵ Sargent (2000, page 74).
- ⁵⁶ Boni and Womack (2001).
- ⁵⁷ Lim (2000, pages 377-378).
- ⁵⁸ Hong, Lim, and Stein (2000).

⁵⁹ Unger (2001b, pages 12-13).

⁶⁰ Sargent (2000, page 74).

⁶¹ Sargent (2000, page 74).

⁶² Stickel (1992).

⁶³ Schack (2001, pages 60-61).

⁶⁴ For additional and more recent information for on this example, see Thurm (2001).

⁶⁵ Unger (2001b).

⁶⁶ See, for example De Bondt and Thaler (1990).

⁶⁷ Michaely and Womack (1999); Kahneman and Lovallo (1993).

⁶⁸ Welch (2000, page 370).

⁶⁹ Welch (2000, page 394).

⁷⁰ Hong, Kubik, and Solomon (2000); Scharfstein and Stein (1990).

⁷¹ Schack (2001) provides a summary of the policies of analysts' stock ownership for the following eight investment banks as of April 2001: Credit Suisse First Boston, Deutsche Bank Alex. Brown, Goldman Sachs, Lehman Brothers, Merrill Lynch, J.P. Morgan, Robertson Stephens, and Salomon Smith Barney. Merrill Lynch, Credit Suisse, and Edward D. Jones announced they would prohibit or limit analysts' ownership of stocks of companies they cover in summer 2001.

⁷² Craig (2001c, page C8).

⁷³ Boni and Womack (2001).

⁷⁴ Kahneman and Lovallo (1993).

⁷⁵ Unger (2001b, page 11).

⁷⁶ NASD (2001).

⁷⁷ Boni and Womack (2001).

⁷⁸ Boni and Womack (2001).

⁷⁹ Michaely and Womack (1999).

⁸⁰ For example, Hutton (2001) writes: “the SIA should require that analysts’ research reports disclose the basis of analyst compensation and the performance of their previous recommendations. Such disclosures would greatly enhance retail investors’ ability to assess the potential bias in analysts’ research reports, thereby addressing regulators’ concerns, and permit securities firms with superior independent research groups to distinguish themselves” (page 1). Hutton also recommends that the SIA “create and accreditation process to demonstrate compliance with the best practices” (page 1).

⁸¹ SIA (2001b, introductory page).

⁸² Unger (2001b, page 12, footnote 15).

⁸³ SIA (2001b).

⁸⁴ Boni and Womack (2001).

⁸⁵ Source: www.briefing.com.

⁸⁶ See, for example, Unger (2001b, page 8).

⁸⁷ Boni and Womack (2001).

⁸⁸ See Gasparino and Opdyke (2001, page C1).

⁸⁹ See, for example, Sargent (2000).

⁹⁰ Boni and Womack (2001).

⁹¹ Boni and Womack (2001). Of the 92 portfolio managers and buy-side analysts who responded to the study, 43% work for firms that manage assets in excess of \$ 100 billion.

⁹² Dini (2001, pages 119-123).

⁹³ Dini (2001, pages 119-123).

⁹⁴ Dini (2001, pages 119-123).

⁹⁵ See Gasparino (2001b, page C2).

⁹⁶ See Gasparino (2001b, page C2).

⁹⁷ The terrorist attacks may also have shed light on an additional consideration in the research credibility debate. The *Wall Street Journal* reports that in the week following the September 11, 2001, terrorist

attacks, brokerage research analysts were told *not* to downgrade stocks, reportedly part of a concerted effort by the Fed, Congress, and the White House to maintain confidence in U.S. markets. See Raghavan, Pulliam, and Opdyke (2001).

⁹⁸ See Gasparino (2001b, page C2).

⁹⁹ See Gasparino (2001b, page C2).

¹⁰⁰ See Gasparino (2001b, page C1).

¹⁰¹ See Gasparino (2001b).