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### The Securities Analyst as Agent: Rethinking the Regulation of Analysts

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# The Securities Analyst as Agent: Rethinking the Regulation of Analysts

Jill E. Fisch\*  
Hillary A. Sale\*\*

*ABSTRACT:* Recent press has highlighted shocking examples of bias, self-dealing, and inaccuracy in the behavior of the securities analyst. Critics have attributed the bubble and subsequent crash in the technology sector to analyst hype and posited that undue analyst optimism contributed to scandals such as Enron. After many years of minimal regulatory oversight, analysts are now the subject of extensive regulatory reform proposals, including a mandate in the Sarbanes-Oxley Act of 2002 requiring that the Securities and Exchange Commission adopt a variety of restrictions on analyst behavior.

Despite the media attention, there have been few attempts to conceptualize carefully the analyst's role. This Article offers such an analysis. First, the Article challenges the traditional conception of the analyst as independent gatekeeper. The Article draws upon empirical, legal, and anecdotal evidence to evaluate critically the existing behavior of securities analysts and the extent to which their activities increase market efficiency. As the Article demonstrates, analysts are subject to a variety of conflicts of interest that constrain their behavior. The resulting costs imposed by these conflicts are classic agency costs.

Accordingly, the Article develops a new conceptualization of the securities analyst as quasi-agent. Although analysts have not traditionally been treated as agents under standard agency law principles, from a broader economic perspective, analysts are properly understood to act in an agency capacity. Analysts act on behalf of multiple market participants, including their employers, issuers, and investors. These interests are in tension. Agency principles illuminate breakdowns in the analyst's role and provide guidance in identifying appropriate solutions. In particular, we argue that reform efforts should focus on the minimization of agency costs, through the application of a quasi-agency approach including a duty of reliability.

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*The Article focuses on the specific example of selective disclosure to demonstrate that the failure to conceptualize the quasi-agency status of the analyst's role led to an inappropriate tolerance of selective disclosure. Instead, the Article offers a new efficiency justification for the adoption of Regulation FD based on agency principles. The Article then discusses the implications of agency theory for recent proposals to address other types of analyst conflicts. The Article concludes by offering some suggestions for further debate.*

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*"From May 2000–February 2001, while the NASDAQ index declined by over one-third, analysts' . . . [sell]' recommendations held steady at . . . 0%"*<sup>1</sup>

#### INTRODUCTION

On April 8, 2002, New York Attorney General Eliot Spitzer announced shocking findings from an investigation of securities analysts at Merrill Lynch.<sup>2</sup> In papers filed with the court, Spitzer revealed that Merrill Lynch analysts consistently skewed their research reports and stock recommendations in an effort to generate investment banking business for the firm.<sup>3</sup> According to Spitzer, senior officials were aware that the research reports were tainted and often misleading, yet continued to assure public investors that the information was independent, objective, and unbiased.<sup>4</sup> Court papers detail repeated examples in which Merrill Lynch publicly recommended stocks to investors while disparaging those same stocks in internal e-mails as "dogs," or "junk," or warning that the company was "falling apart."<sup>5</sup> Indeed, as the market for Internet stocks plummeted in 2000, those papers reveal that Merrill maintained a rating of "accumulate" or above on all the companies it covered, never once advising investors to sell as stock prices plunged, sometimes "all the way to zero."<sup>6</sup>

Spitzer's investigation is merely one example in a series of recent developments highlighting the problematic role of the securities analyst. Both the media and the Securities and Exchange Commission (the "SEC") have warned of analyst bias, self-dealing, and other abuses. In addition, analysts have been criticized for their failure to spot problems at Enron. Finally, plaintiffs' lawyers continue to pursue novel liability theories in litigation against analysts. Amid all of this controversy, the SEC adopted Regulation FD in 2000 to prohibit issuers from selectively disclosing corporate information to analysts.<sup>7</sup> Belatedly, the SEC also announced an

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1. Barbara Moses, *Research Analysts Under Fire*, ALL-ABA Broker Dealer Regulation Course of Study (Jan. 10–11, 2002).

2. See Press Release, Office of New York Attorney General Eliot Spitzer, Merrill Lynch Stock Rating System Found Biased by Undisclosed Conflicts of Interests (April 8, 2002), available at [http://www.oag.state.ny.us/press/2002/apr/apr08b\\_02.html](http://www.oag.state.ny.us/press/2002/apr/apr08b_02.html) (last visited Mar. 25, 2003) (on file with the Iowa Law Review).

3. See *id.*

4. See *id.*

5. Petitioner's Affidavit in Support of Application for an Order Pursuant to General Business Law Section 354, at 10–13, *Spitzer v. Merrill Lynch & Co.*, No. 02-401522 (N.Y. Sup. Ct. Apr. 8, 2002), available at <http://www.oag.state.ny.us/investors/press/2002/apr/Merrill.pdf> (on file with the Iowa Law Review).

6. See *id.* at 9–10.

7. Selective Disclosure and Insider Trading, 65 Fed. Reg. 51716-91 (Aug. 24, 2000) (to be codified at 17 C.F.R. pts. 240, 243, and 249) (on file with the Iowa Law Review). The SEC has not, however, adopted any direct regulations of analyst behavior. In fact, the SEC's failure to take any action in the direction of regulating analysts was part of what prompted Attorney

inquiry into analyst conflicts of interest.<sup>8</sup> In spring 2002, the New York Stock Exchange (the "NYSE") and the National Association of Securities Dealers (the "NASD"), as self-regulatory organizations (the "SROs"), also adopted new standards for analyst disclosure and trading activity, which were subsequently approved by the SEC.<sup>9</sup> The latest development is a mandate under the new Sarbanes-Oxley Act that the SEC or the SROs promulgate rules to address analyst conflicts of interest.<sup>10</sup> The goal of these various measures was to implement a more thorough regulatory regime to alleviate the conflict of interest problems that have plagued analyst recommendations in recent years. Whether these steps will succeed, however, remains unclear, in part, because of the continued ambiguity in the conception of the analyst's role. To see why, consider how analysts are traditionally treated by courts, commentators, and regulators.

Historically, analysts have been relatively free from regulation. Indeed, in some respects, analysts have enjoyed preferred status under the federal securities laws. Courts carved out an analyst exception to the prohibition on the use of nonpublic information in securities trading, justifying this policy by a twofold claim. First, courts and commentators argued that selective disclosure to securities analysts is beneficial to the securities markets because it increases the dissemination and incorporation of information into stock price. Second, some commentators argued that analyst use of inside information does not pose risks analogous to those presented by traditional insider trading. Both justifications rely, in part, on the theory that analysts function as unbiased market gatekeepers. This "gatekeeping" theory is premised on the assumption that analysts act as conduits of information from company to shareholder and from shareholder to company. Because of the information flow provided by analysts, information is disseminated to the market, and the market becomes more efficient. Based on the conclusion that analysts actually perform this gatekeeping function, courts and regulators have left analysts largely unregulated so as to avoid interrupting the flow of information. Even in light of the analyst problems outlined above, these arguments are still used to defend a privileged role for securities analysts, including the claim that Regulation FD is both unnecessary and undesirable. Although this argument has recently been

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General Eliot Spitzer to launch his own investigation into the area. *See* Charles Gasparino, *Wall Street Has an Unlikely New Cop: Spitzer*, WALL ST. J., Apr. 25, 2002, at C3.

8. *See* Charles Gasparino & Scot J. Paltrow, *SEC Joins Pack, Opens Inquiry into Analysts*, WALL ST. J., Apr. 26, 2002, at A1.

9. *See* NASD and NYSE Rulemaking, Exchange Act Release No. 3445908 (May 10, 2002), available at <http://www.sec.gov/rules/htm> (last visited Mar. 25, 2003) (on file with the Iowa Law Review).

10. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 501, 116 Stat. 745, 791 (2002) (requiring SEC within one year to adopt rules "reasonably designed to address [analyst] conflicts of interest").

muted somewhat in the wake of revelations like those at Merrill Lynch, the actual role played by securities analysts remains open to debate.

This Article challenges the traditional view of analysts as independent gatekeepers. We question whether, given their jobs as employees, it is reasonable to assume analysts are actually “independent.” To explain why securities analysts are not “independent,” the Article draws upon empirical, legal, and anecdotal evidence to evaluate the existing behavior of securities analysts and the extent to which their activities increase market efficiency. Based on this examination, the Article demonstrates that analysts are not the independent information gatherers the courts and other academics have purported them to be but are, instead, subject to a variety of conflicts of interest that compromise their independence.

One possible response to this conflict of interest problem is simply to improve disclosure of these conflicts and to acknowledge that analysts are essentially salespeople, serving the interests of their firms’ investment banking clients. This response is unsatisfactory. Issuers, investors, and the markets themselves are heavily dependent upon the ability of the analyst to function as an information intermediary. In addition, the existing regulatory treatment of analysts has been premised on protecting this function, an objective that persists in the Sarbanes-Oxley Act.<sup>11</sup> Nonetheless, the substantial role that analysts play with respect to information flow and securities pricing is significantly undermined by conflicts of interest that create a variety of incentives for analysts to distort the information they present.

The resulting costs that these conflicts impose on the market are classic agency costs.<sup>12</sup> Analysts have not traditionally been treated as agents, at least for anyone other than their employer, and there are significant impediments to classifying them as agents under standard agency law. Nonetheless, because their intermediation effectively results in their acting on behalf of issuers, investors, and the markets, from a broader economic perspective, analysts are properly understood to act in an agency capacity. To capture this conceptualization while distinguishing analysts from traditional agents, this Article describes analysts as “quasi-agents.” We do not argue for the application of standard agency law principles, but we do propose that analyst regulation be viewed from an agency perspective. By utilizing this agency approach, it is possible to illuminate breakdowns in the analyst’s role and to provide guidance in identifying appropriate solutions. In light of this analysis, we argue that reform efforts should focus on the minimization of agency costs. Toward that end, we argue that analysts owe

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11. *See id.* (directing the SEC to adopt rules designed “to protect the objectivity and independence of securities analysts”).

12. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) (explaining nature and types of agency costs).

duties to the market—duties that we term “reliability duties”—and that those duties should be enforced.<sup>13</sup>

To provide a framework for analyzing these duties, the Article conceptualizes the security analyst’s role and outlines a quasi-agency model for understanding and regulating analyst behavior based on that conceptualization. This model serves three important purposes. First, it clarifies how conflicting duties inherent in the analyst’s role cause analysts to fail as gatekeepers. Second, the model provides a more coherent explanation for Regulation FD than that provided by the SEC’s focus on fairness. Finally, the model provides direction for further regulation.

The Article proceeds in the following manner. Part I formalizes the identity and role of the securities analyst. Part II identifies the conflicts of interest that securities analysts face, detailing empirical literature on their jobs and roles, and explains how these conflicts create incentives for analysts to use inside information in ways that are inconsistent with market efficiency. Part III briefly reviews the history of analyst regulation and describes key components of recent proposals for regulatory reform. Part IV expands on the deficiencies in reform proposals by demonstrating how the proposals fail to conceptualize the analyst’s role properly. Part V extends this analysis to develop a quasi-agency model of the analyst. The Part applies the model to create an analyst duty of reliability and to offer an efficiency-based justification for Regulation FD. The Article concludes with some reflections on the role of the SEC in regulating securities analysts.

## I. THE ROLE OF THE SECURITIES ANALYST

Securities analysts perform research and analysis on companies in order to evaluate securities and estimate their value as investments. In theory, they serve as information conduits, or intermediaries, between the companies they investigate and actual or potential investors in those companies.<sup>14</sup> Their work involves collecting and processing information from a variety of sources, both inside and outside of the company.<sup>15</sup> As a result of their research, analysts typically produce two products: a “report” and a “recommendation.” In the report, analysts offer facts and opinions about the subject company and its securities.<sup>16</sup> The recommendation, which is

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13. See Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55 (John W. Pratt & Richard J. Zeckhauser eds., 1985) (describing the role of fiduciary duties in reducing agency costs). For an argument that analysts’ fiduciary responsibilities should be limited to investors, see Peter H. Huang, *Legal Implications of Guilt and Pride for Securities Regulation*, 150 U. PA. L. REV. (forthcoming 2003).

14. TED TRAUTMANN & JAMES HAMILTON, INFORMAL CORPORATE DISCLOSURE UNDER FEDERAL SECURITIES LAW 108 (CCH 2000).

15. See AM. MGMT. ASS’N, A COMPANY GUIDE TO EFFECTIVE STOCKHOLDER RELATIONS 23, RES. REP. NO. 21 (1953).

16. Jason Michael Craft, *What’s All the Commotion?: An Examination of the Securities and Exchange Commission’s Regulation FD*, 14 DEPAUL BUS. L.J. 119, 125 (2001).

generally a selection from a series of rating categories, advises the investing public to buy, sell, or continue to hold the securities in question. When analysts act “independently and objectively, investors gain from the publication of their insights.”<sup>17</sup>

Analysts conduct their research for various types of investors. This Article, like most recent congressional and media attention, focuses on sell-side analysts.<sup>18</sup> Sell-side analysts, who comprise approximately 30% of the analyst industry,<sup>19</sup> are generally employed by brokerage firms and produce research for brokerage firm customers and other investors. Many of these brokerage firms also have an investment banking division. In addition to doing research for customer reports, analysts who work for those firms also may perform research for the underwriting of an issuer’s securities, participate in the road show (actually traveling to pitch securities), or help clinch the underwriting deal. The information produced by sell-side analysts is widely disseminated in the financial markets. Individual recommendations are announced to the marketplace, and services like Thomson Financial/First Call publish regular reports polling analyst predictions and recommendations. As a result, changes in analyst recommendations typically trigger substantial price movements.

Analysts generally tend to concentrate on a particular industry. In theory, they search for and analyze corporate information. Analysts read and digest company reports and other secondary sources, speak with company officers and employees, and, where appropriate, visit company sites to help them form an independent impression of the business. Analysts review company documents filed with the SEC and other regulators as well as material sent directly to shareholders. This information is available from the companies, the SEC, and secondary sources like Standard & Poor’s that compile, summarize, and republish it. Analysts also may review trade publications, including industry-specific magazines.<sup>20</sup>

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17. TRAUTMANN & HAMILTON, *supra* note 14, at 108.

18. The second large group of analysts is buy-side analysts. Buy-side analysts work for institutional investors, most commonly mutual funds. Their reports are not for the investing public, but for their employers. Their employers purchase securities for their own accounts and those of their clients. Approximately 60% of the analysts in today’s securities industry are buy-side analysts. See JEFFREY C. HOOKE, *SECURITY ANALYSIS ON WALL STREET: A COMPREHENSIVE GUIDE TO TODAY’S VALUATION METHODS* 19 (WILEY 1998). A small proportion of securities analysts are so-called independent analysts, who provide research without an underwriting or other relationship to the firms that they cover. Many independent analysts provide their reports on a subscription or other fee basis. Truly independent research can be expensive. See John Zielinski, Remarks at the SEC Roundtable Discussion on Financial Disclosure and Auditor Oversight (Apr. 4, 2002), available at <http://www.sec.gov/spotlight/roundtables/accountround040402.htm> (on file with the Iowa Law Review).

19. See HOOKE, *supra* note 18, at 19.

20. Buy-side and independent analysts also rely on the reports of sell-side analysts. See Rodney K. Rogers & Timothy J. Fogarty, *Critically Examining Sell-Side Analysts’ Reports: A*



Traditionally, analyst research also has included hands-on investigation.<sup>21</sup> Analysts may hold personal meetings with members of the company's management team. Those same managers may attend analysts' conferences to build relationships and share information. In the course of their discussions, analysts acquire information that they use to make their earnings estimates. They share those estimates with company officials who comment on and respond to them. Analysts may then refine the estimates in response to company reactions.<sup>22</sup>

The analyst generates his or her recommendation from the information collected. The analyst assesses the issuer's value based on that information and the issuer's place within its industry. Thus, processing the information on a particular company also requires analysts to process information on other companies within the industry, and it is common for analysts to specialize in a specific industry or sector. Typically, the analyst also will employ his or her financial skills to create and revise financial valuation models.

The end result of this research is a report that is distributed both orally and in written form. These reports not only describe the company and locate it within the industry, but also provide predictions. The most important of these predictions is the analyst's estimate of the company's future earnings. The securities markets have become highly sensitive to revisions of analyst estimates and to discrepancies between analyst predictions and issuer announcements of actual operating results, often responding to either with substantial price fluctuations. The report also contains a bottom-line recommendation based on the analyst's projections for the short, and sometimes the long, term. The exact terms used for the bottom-line recommendations vary across analysts, but the categories and purpose—translating the research into a one-word assessment, like buy, sell, or hold—is essentially the same.

The value of the report depends in large part on the extent to which the analyst's research and analysis are independent. The independence of analyst analysis has, however, increasingly become the exception rather than

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Theoretically Informed Content Analysis 4 (Oct. 2000) (unpublished manuscript, on file with the Iowa Law Review).

21. A recent *Wall Street Journal* article, for example, described the approach of one restaurant analyst as including the digestion of company reports and company food. Jeff D. Opydke, *Check, Please: Some Stock Analysts Get Back to Basics in Wake of Scrutiny*, WALL ST. J., Sept. 5, 2001, at A1. The analyst regularly eats in the restaurants she covers. She often visits several locations in a chain to determine whether the restaurant is busy, whether menu changes are popular, and whether the staff is pleasant and knowledgeable. If she finds a nasty staff, a dirty facility, or no waiting line at a previously oversubscribed restaurant, she combines that information with the financial reports and recent acquisitions into her research. *Id.*

22. See Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1026 (1990).

the rule.<sup>23</sup> Many analysts have come to rely on company insiders to share information about the company with them, creating a symbiotic and conflict-ridden relationship.<sup>24</sup> Rather than performing independent analysis, analysts have increasingly served as conduits for management to convey information to the securities markets. Moreover, as detailed in Part II below, analysts are subject to a variety of other conflicts that compromise their independence. As a result, the traditional hands-off approach to analyst regulation, which was premised on the theory that analysts functioned as independent gatekeepers, is no longer appropriate.<sup>25</sup>

## II. ANALYST CONFLICTS OF INTEREST

Contrary to the traditional judicial view,<sup>26</sup> securities analysts currently face a variety of conflicts of interest. These conflicts can be divided into three general categories. First, analysts and their firms may have an ownership interest in a company that is the subject of the analysts' report. Second, analysts may be subject to pressure because of the firms' business interests; investment banking relationships between brokerage firms and issuers have been particularly problematic. Third, analysts' reports may be affected by efforts to maintain superior access to corporate information, typically from company officials.

### A. OWNERSHIP INTERESTS

The first group of conflicts arises out of the investments made by analysts and their employers. Analysts consistently invest in the companies they cover. Their own self-regulatory organization rules require disclosure and monitoring of such investments, but disclosure requirements traditionally have been minimal, and monitoring has been virtually nonexistent. The NYSE requires disclosure of all financial positions held by a firm and its analysts in the securities of a recommended issuer, but permits the disclosure to be conditional.<sup>27</sup> Consequently, the NYSE requirements could be satisfied by including the boilerplate statement, "the firm or employees may own securities of a recommended issuer," in an analyst

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23. See Opdyke, *supra* note 21.

24. See Gretchen Morgenson, *See No Evil, Speak No Evil*, FORBES, Dec. 15, 1997, at 162, 164, available at 1997 WL 16177879 (quoting a money manager as saying that "[a]nalytists have become reporters for the company" and that "[i]f management says everything's okay, everything's okay") [hereinafter Morgenson, *See No Evil*].

25. See, e.g., *id.* (explaining that there is a "conspiracy among Wall Street analysts not to notice" that stock prices are about to fall). As early as 1953, the American Management Association exhorted managers to cultivate analysts: "It is important to cultivate this group, for its reports on your company, recommending the purchase or sale of your securities, may have very broad circulation and an important effect on the market action." AM. MGMT. ASS'N, *supra* note 15, at 23.

26. See generally *Dirks v. SEC*, 463 U.S. 646 (1983).

27. NYSE Rule 472.

report.<sup>28</sup> NASD Rule 2210 required member firms and their officers or partners to disclose ownership of option positions, but not of common shares.<sup>29</sup> The rule did not require the analyst who prepared a research report to disclose ownership of any financial position in a recommended issuer.<sup>30</sup>

Analysts' ability to invest in covered companies led to some egregious abuses. A recent investigation by the SEC discovered widespread instances of analysts trading contrary to their public recommendations.<sup>31</sup> Such trading is problematic because, at a minimum, it suggests a lack of faith by the analysts in the accuracy of their reports. Analyst trading that is consistent with a recommendation is also problematic, however, as the analyst may have an incentive to distort the information for personal gain. For example, Banc of America analyst Jerry Treppel was placed on administrative leave in May 2002 in light of questions about his trading recommendations in pharmaceutical stocks.<sup>32</sup> Treppel apparently reiterated a number of "buy recommendations" for a company in which he owned 21,000 shares and, at the same time, downgraded the stock of a major competitor.<sup>33</sup>

Similarly, the SROs have not enforced even the minimal existing disclosure requirements. The SEC recently completed a review of nine large brokerage firms and found that "compliance with the SRO rules that require firms to monitor the private equity investments of employees, including analysts, was poor."<sup>34</sup> Additionally, "nearly all of the firms examined were unable to identify all of their employees' investments in companies that the firm took public."<sup>35</sup> As a result, the firms could not determine the extent to which their analysts held conflicting interests in covered firms.

An SEC investigation revealed that nearly one-third of the analysts investigated owned securities in companies they covered and sometimes acquired their securities in private placements occurring prior to initial public offerings.<sup>36</sup> Pre-IPO purchases by analysts are particularly problematic because the analysts obtain their securities prior to the public offering for a fraction of the IPO price and have a stake in the effect of the reports they help to author.<sup>37</sup> Only one firm could accurately identify all pre-IPO

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28. *Id.*

29. NASD Rule 2210.

30. *Id.*

31. See Jessica Sommar, *Red-Faced SEC Targets Two-Faced Analysts*, N.Y. POST, May 24, 2002, at 41 (explaining that SEC task force will investigate analysts' conflicts of interest).

32. Christian Berthelsen, *BofA Tightens Rules for Analysts*, S.F. CHRON., June 21, 2002, at B1.

33. *Id.*

34. Rachel Witner McFague, *Unger Says Securities Firms Complied Poorly with Rules Relating to Analysts' Investments*, 33 SEC. REG. & LAW 1136, 1138 (Aug. 6, 2001).

35. *Id.*

36. *Id.*

37. *Id.*

investments by its analysts.<sup>38</sup> Another firm engaged in retroactive approval of pre-IPO purchases.<sup>39</sup> These factors suggest that analyst conflicts of interest are extensive and unmonitored.

### B. BUSINESS INTERESTS

Analysts also face pressure arising from the business interests of their employers. This pressure comes in two main forms, recommendations that are connected to brokerage commissions and recommendations that are tied to underwriting business. Significantly, brokerage firms are limited in the extent to which they can profit directly from the information produced by their research departments. Competition among brokerage firms, the extensive information available to investors at no charge through the media, the Web, and other sources, and the general public-good character of information limit the ability of brokers to charge for their research. As a result, in today's world, research departments do not earn revenue; other departments support them.

Some of this financial support is provided by the firm's brokerage business. Analysts provide information to investors. Through their transactions in securities, those investors generate commission revenues for the analysts' employers. Analyst recommendations that result in trades increase the commission revenue of their brokerages. Notably, because the potential universe of buyers is greater than that of sellers for any given security, buy recommendations are likely to have a greater effect on brokerage revenues than sell recommendations. A positive analyst report, therefore, is likely to generate more transactions in the securities covered, and those sales will generate a greater amount of commissions for the firm.<sup>40</sup> Positive reports also help the firms to attain and maintain clientele, thereby attracting additional sales and commissions. Thus, analysts face firm pressure to issue positive reports because those reports have greater potential to generate commission revenue for their companies.

A recent empirical study supports this conclusion. The study finds that analysts' recommendations are consistent with their employer's incentives but not those of the investing public.<sup>41</sup> Analysts tend to recommend growth and momentum stocks,<sup>42</sup> and they generally do not incorporate the predictive power of negative or "contrarian" indicators—indicators that,

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38. *Id.*

39. McTague, *supra* note 34, at 1138.

40. Amitabh Dugar & Siva Nathan, *The Effect of Investment Banking Relationships on Financial Analysts' Earnings Forecasts and Investment Recommendations*, 12 CONTEMP. ACCT. RES. 131, 137 (1995).

41. Narasimhan Jegadeesh et al., *Analyzing the Analysts: When Do Recommendations Add Value?* 3 (Nov. 6, 2001) (unpublished manuscript, on file with the Iowa Law Review).

42. *Id.*

according to the study's authors, actually account for future returns.<sup>43</sup> The study's authors posit that the focus on growth stocks is consistent with the incentives of sell-side analysts who work for firms with higher trading activity.<sup>44</sup>

A second and more problematic source of conflicts arises out of the employers' investment banking interests. Because of the elimination of fixed commissions and intense competition in commission levels, commission revenue currently reflects a relatively minor component of brokerage-firm revenue. For most major firms, investment banking revenue is far more significant. For example, in 1967, prior to the elimination of fixed commissions, commission revenue accounted for approximately 57% of Merrill Lynch's revenues, and investment banking accounted for less than a tenth of that sum.<sup>45</sup> In contrast, the Securities Industry Association reported in 1997 that commissions generated only 16% of industry revenues.<sup>46</sup> Industry investment banking revenues, however, have increased fifty-fold in the last twenty-five years.<sup>47</sup> This revenue imbalance is reflected in the makeup of investment firms' management, where the average ratio of top managers from corporate finance versus equity is seven to one.<sup>48</sup>

The implications of this development for analyst operations are substantial. Although at one time a firm and its brokers could generate profits on the basis of a strong research department and a reputation for integrity, today the big money comes from a firm's ability to attract investment banking business. This trend raises serious doubts about analysts' ability to remain independent. Because analyst research is an important element of a firm's investment banking operations, potential conflicts arise between the analyst's duty to provide accurate, honest reports and the analyst's duty to improve the firm's (and therefore the analyst's) financial standing. These conflicts arise because firms typically rely on their research departments, in part, to develop and maintain a strong client base, which enables the firms to sell securities in public offerings. Firms further involve their research analysts in the process of selling securities by enlisting their participation in roadshows and other marketing activities in which analysts

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43. *Id.*

44. *Id.*

45. BENJAMIN MARK COLE, *THE PIED PIPERS OF WALL STREET: HOW ANALYSTS SELL YOU DOWN THE RIVER* 50 (Bloomberg Press 2001). Moreover, Merrill was one of the firms with the largest investment banking departments; the disparity at other firms was even greater. *Id.*

46. *See id.* at 57 (quoting former Securities Industry Association senior vice president and director of research Jeffrey M. Schaefer).

47. *Id.*; *see also* Matthew L.A. Hayward & Warren Boeker, *Power and Conflicts of Interest in Professional Firms: Evidence from Investment Banking*, 43 ADMIN. SCI. Q. 1, 6 (1998); Paul J. Irvine, *Analysts' Forecasts and Brokerage Firm Volume* (May, 2001) (unpublished manuscript, on file with the Iowa Law Review); Rogers & Fogarty, *supra* note 20 (same).

48. Hayward & Boeker, *supra* note 47, at 6.

pitch securities to prospective purchasers.<sup>49</sup> A firm also enhances the attractiveness of its investment banking services if it can provide continued analyst coverage that will help to maintain the price of the securities subsequent to the offering. A firm's commitment to provide analyst coverage and the visibility of its analysts are key components of the firm's ability to attract investment banking business.<sup>50</sup>

In today's world, therefore, the analyst is the "star of the show" in a typical investment banking bake-off, or client competition.<sup>51</sup> The issuer wants coverage from the analyst because a "rousing endorsement from a highly ranked analyst" is believed to send the stock of a "fledging" company into "orbit."<sup>52</sup> The pressure that sell-side analysts face from their investment banking counterparts to cover particular clients has been widely exposed by the media in recent months.<sup>53</sup> Moreover, it is crucial that a firm interested in generating investment banking business maintain a reputation for promoting its investment banking clients.<sup>54</sup> The ultimate goal in investment banking is to sell securities, and a firm's investment banking business gives it a stake in the outcome of an issuer's offering. Positive reports and recommendations generate securities sales. The correlation between positive reports and increased securities sales is so strong, in fact, that some issuers have stated publicly that they avoid working with analysts who are critical of them and will choose underwriters based, in part, on whether the associated analysts' views are favorable.<sup>55</sup> This revelation shows that securities promotion is inherently in tension with securities evaluation. When analysts who evaluate certain companies are involved in the investment banking process of those same companies, an inherent conflict occurs.

The financial importance of investment banking to investment firms partially explains the consistent findings that analyst reports and recommendations are overly optimistic. Downgrades are rare.<sup>56</sup> According to the SEC, downgrades occurred only in 1% of the securities covered in 2000. Studies also reveal significant differences between positive and negative

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49. Analysts are often included on sales pitches precisely because they have knowledge about the industry—and because they write the reports that sell the stock. *See generally* Morgenson, *See No Evil*, *supra* note 24.

50. *See* Hayward & Boeker, *supra* note 47, at 5 (1998) (finding that analysts' presence and reports affect the finance department's ability to attract clients).

51. Jeffrey M. Laderman, *Wall Street's Spin Game*, *BUS. WK.*, Oct. 5, 1998, at 148.

52. *Id.*

53. *See* Michael Siconolfi, *A Rare Glimpse at How Street Covers Clients*, *WALL ST. J.*, July 14, 1995, at C1 (noting that analyst was asked by investment banking counterpart to initiate coverage on client whose stock was "reeling").

54. Hayward & Boeker, *supra* note 47, at 5.

55. *Id.*

56. *See generally* Maureen McNichols & Patricia C. O'Brien, *Self-Selection and Analyst Courage*, 35 *J. ACCT. RES.* 167 (1997).

rating rates.<sup>57</sup> Often analysts persist in adhering to positive recommendations despite negative opinions about future prospects for the stock.<sup>58</sup> Many analysts do not even downgrade companies that fail to meet their predications.<sup>59</sup> This bias is evident in sell-side analysts' performance as well. For example, one recent empirical study showed that the realized price growth in securities positively rated by sell-side analysts is one-sixth, while the realized price growth for securities receiving positive buy-side analyst ratings is one-third.<sup>60</sup> Similarly, other studies have revealed that analyst ratings are all overly optimistic and that sell-side reports are worse than the consensus.<sup>61</sup>

One might predict that the market would discount for this excessive analyst optimism; however, empirical studies suggest that, at least in the past, the market has failed to do so.<sup>62</sup> Spitzer's investigation, for example, revealed that Merrill's securities ratings consistently reflected a positive bias. Even though Merrill purported to classify securities according to a five-point scale, Merrill never used the lower two ratings, thus turning the scale into a de facto three-point system.<sup>63</sup> The investigation further revealed that downgrades and sell recommendations were virtually non-existent.<sup>64</sup> Although Merrill quietly terminated its coverage of a few stocks, rather than reducing its ratings, for the most part it simply maintained its positive ratings

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57. See generally Kent Womack, *Do Brokerage Analyst's Recommendations Have Investment Value?*, 51 J. FIN. 1 (Mar. 1996); R.E. Diefenbach, *How Good Is Institutional Brokerage Research?*, 28 FIN. ANALYSTS J., Jan.-Feb. 1972, at 54.

58. See generally Petitioner's Affidavit in Support of Application for an Order Pursuant to General Business Law Section 354, at 10, *Spitzer v. Merrill Lynch & Co.*, No. 02-401522 (N.Y. Sup. Ct. Apr. 8, 2002), available at <http://www.oag.state.ny.us/investors/press/2002/apr/MerrillL.pdf> (on file with the Iowa Law Review).

59. See Ron Kasznik & Maureen F. McNichols, *Does Meeting Expectations Matter? Evidence from Analyst Forecast Revisions and Share Prices* (Aug. 1999) (unpublished manuscript, on file with the Iowa Law Review). Yet downgrades are more accurate than upgrades. Womack, *supra* note 57, at 165. The extent of over-optimism that occurs in securities ratings decreases as the rating decreases. So, the buy rating is less accurate than the hold, and the hold rating is less accurate than the sell. Jennifer Francis & Donna Philbrick, *Analysts' Decisions as Products of a Multi-Task Environment*, 31 J. ACCT. RES. 216, 225 (1993).

60. See generally Patricia M. Dechow et al., *The Relation Between Analysts' Forecasts of Long-Term Growth and Stock Price Performance Following Equity Offerings* (June 1999) (unpublished manuscript, on file with the Iowa Law Review); Laurie Krigman et al., *Why Do Firms Switch Underwriters?* (2000) (unpublished manuscript, on file with the Iowa Law Review).

61. See Dechow et al., *supra* note 60; Krigman et al., *supra* note 60; see also Roni Michaely & Kent L. Womack, *Conflict of Interest and the Credibility of Underwrite Analyst Recommendations*, 12 REV. FIN. STUD. 653 (1999) (finding affiliated underwriters to have inflated estimates); Hsiou-Wei Lin & Maureen F. McNichols, *Underwriting Relationships, Analysts' Earnings Forecasts and Investment Recommendations*, 25 J. ACCT. & ECON. 101 (1998) (finding that affiliated analysts' buy recommendations perform worse than those of non-affiliated analysts).

62. Michaely & Womack, *supra* note 61, at 671-78.

63. Petitioner's Affidavit in Support of Application for an Order Pursuant to General Business Law Section 354, at 9, *Spitzer*, No. 02-401522.

64. *Id.*

even when stock prices collapsed.<sup>65</sup> Moreover, as the Internet market collapsed from spring 1999 to fall 2001, and Merrill analysts internally described covered stocks as “junk,” Merrill publicly continued to issue buy and strong buy ratings for these securities.<sup>66</sup>

Merrill’s story is hardly atypical. Benjamin Mark Cole has described how the four brokerage firms that led the Planet Hollywood IPO issued their highest ratings on the stock and continued to support those ratings with outlandish predictions about the company that were inconsistent even with the company’s own financial information.<sup>67</sup> Bear Stearns’ star analyst Joseph Buckley maintained his buy rating on the company as the stock sank from its post-IPO price of \$26 per share down to \$3 per share.<sup>68</sup> Buckley eventually downgraded the stock to neutral just months before the company filed for bankruptcy.<sup>69</sup>

In 1992, the *Wall Street Journal* published a copy of a memorandum from the managing director of corporate finance at Morgan Stanley making the firm’s expectations for its analysts explicit:

As we are all too aware, there have been too many instances where our Research Analysts have been the source of negative comments about clients of the Firm. . . . Our objective is . . . to adopt a policy, fully understood by the entire Firm, including the Research Department, that we do not make negative or controversial comments about our clients as a matter of sound business practice. . . . Would you please insure that these policy objectives are fully incorporated into the Research Compliance Manual we are currently preparing. Again, the philosophy and practical result needs to be “no negative comments about our clients.”<sup>70</sup>

Empirical evidence demonstrates that the investment banking conflicts of interest are directly correlated with analysts’ predictions. When analysts’ employers receive higher investment banking fees, the analysts generate more positive predictions.<sup>71</sup> The predictions suggest that the underwriters and their analysts are trying to boost the market for their clients’ securities.<sup>72</sup> Another study reported that analysts are more likely to upgrade stocks of underwriting clients than of non-underwriting clients.<sup>73</sup>

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65. *Id.* at 9–12.

66. *Id.*

67. COLE, *supra* note 45, at 104–11.

68. *Id.* at 104, 111.

69. *Id.* at 111.

70. *The Rohlbach Memo: “No Negative Comments.”* WALL ST. J., July 14, 1992, at A6.

71. Dechow et al., *supra* note 60, at 22.

72. Michaely & Womack, *supra* note 61, at 680.

73. Jennifer Conrad et al., How Do Analyst Recommendations Respond to Large Stock Price Movements? 4 (Mar. 2002) (unpublished manuscript, on file with the Iowa Law Review).



This pressure carries over to the firm's ability to deliver investors, an essential component of continued underwriting success. Investors want good buys and they want them to stay that way. Institutional investors, the key investors from the underwriting perspective, are unwilling to tolerate an analyst who downgrades a stock in which they hold a substantial position, leaving them to take the loss. As a result, analysts face pressure to support the stock price after the underwriting is complete. As Benjamin Mark Cole explained, "The best analysts, brokerages and mutual funds agree, are those who keep the buy signals on. At least until large clients have exited the stock."<sup>74</sup> Interestingly, those same institutional clients are also responsible for publicly rating analyst performance, thus limiting the potential effectiveness of reputation as a constraint on analyst optimism.<sup>75</sup>

The venture capital role played by investment banking firms is particularly problematic. The venture arms of many firms search out companies before they go public, assisting them in finding funding.<sup>76</sup> In return, the groups often take stock in their clients. The result of this process is that the venture capitalists end up with a significant stake in the successful sale and subsequent sustained stock price of the securities once the company has gone public.<sup>77</sup> Given this situation, the investment bank or its venture arm has a strong interest in what its analysts say about the stock following the offering—at least until the lock-up expires.<sup>78</sup>

The pressure on analysts continues after the offering in other ways. Underwriters support stock through market stabilization after the offering, which creates pressure for the analysts to continue to issue positive reports.<sup>79</sup> For offerings with lock-up agreements, the conflicts are even more layered. A lock-up agreement typically requires certain people not to sell their stock until a specified date (for example, six months after the offering date). Underwriters, however, have the right to release company officials from a lock-up agreement. Thus, the underwriter controls the date on which the lock-up ends. The underwriter also may own shares that are subject to the lock-up. The existence of a lock-up agreement may consequently lead to "booster shots," or positive reports issued by analysts that give the securities a price bump just prior to the expiration of the lock-up agreement.<sup>80</sup> These

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74. COLE, *supra* note 45, at 126.

75. *See infra* note 138.

76. *See* COLE, *supra* note 45, at 58–59.

77. *See id.*

78. *See* Mark Maremont, *Are Analysts Compromised When They Say "Buy" While the Bankers Sell?*, WALL ST. J., July 24, 2000, at A1 (discussing analysts' and investment bankers' interests).

79. *See* COLE, *supra* note 45, at 63.

80. Katrina Ellis et al., *When the Underwriter Is the Market Maker: An Examination of Trading in the IPO Aftermarket*, 55 J. FIN. 1039, 1056 (2000). Firms have created Chinese walls, or internal rules and procedures designed to diminish the conflicts of interest. In reality, those walls are rarely respected. They are "commonly, even flagrantly disregarded when they present obstacles to commercial objectives." Hayward, *supra* note 47, at 5–6.

booster shots benefit clients as well as underwriters and analysts who have stock in their clients.

Anecdotal evidence supports the conclusion that these conflicts influence analyst behavior. For example, at one point only one analyst at a major underwriting firm was covering Employee Solutions.<sup>81</sup> The underwriter, Merrill Lynch, was trying to win a secondary offering job.<sup>82</sup> In another case, a Piper Jaffray analyst “heaped praise” on a company while “lobbying” its CEO for underwriting business.<sup>83</sup> When that company chose other underwriters, the analyst wrote a “scathing” report on the company.<sup>84</sup> As the reporter telling the story observed, “[O]ne can only wonder what [the analyst] would say had he [instead] won a cut of the . . . IPO.”<sup>85</sup>

A 1997 *Forbes* magazine series provides further evidence on analyst independence—or the lack thereof. The *Forbes* reporter compared ratings of independent analysts to those attempting to obtain underwriting business. One example covered by the *Forbes* piece involved Steven Eisman, an analyst at Oppenheimer who thought that the prepayments on mortgage pools at GreenTree Financial seemed to be “distressingly speedy.”<sup>86</sup> Unable to obtain company numbers, he compiled the information on his own and expressed his concerns publicly.<sup>87</sup> Six weeks later, the company announced a pretax earnings charge of \$150 million, based on the prepayment problem Eisman had discovered.<sup>88</sup> Despite GreenTree’s statement, Eisman was the only analyst at a “major firm who [was] less than enthusiastic about the company.”<sup>89</sup> He also was the only analyst at a firm that had never underwritten one of GreenTree’s securitizations.<sup>90</sup>

Joseph Jolson, a second analyst covered, was, at the time of the story, an analyst at then Montgomery Securities.<sup>91</sup> He was one of four tracking Redwood Trust, Inc.<sup>92</sup> He was “bullish” on the company until an analyst at another firm—one that did “little investment banking”—gave the company a negative rating.<sup>93</sup> One day later, Jolson “slashed” his estimates, but

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81. Morgenson, *See No Evil*, *supra* note 24.

82. *See id.*

83. Peter Burrows, *A Sudden Change of Heart at Piper*, *BUS. WK.*, Dec. 6, 1999, at 6, *available at* 1999 WL 27296551.

84. *Id.*

85. *Id.*

86. Gretchen Morgenson, *See No Evil, Speak No Evil: The Dog Ate Our Homework*, *FORBES*, Dec. 15, 1997, at 167, 167, *available at* 1997 WL 16177945.

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.*

91. Gretchen Morgenson, *See No Evil, Speak No Evil: Love for Sale*, *FORBES*, Dec. 15, 1997, at 166, *available at* 1997 WL 16177944.

92. *Id.*

93. *Id.*

continued to rate the stock a buy.<sup>94</sup> Redwood was a Montgomery underwriting client.<sup>95</sup>

The importance of investment banking also has a direct impact on analyst success and compensation. For example, an analyst at Morgan Stanley attended a meeting with a corporate finance colleague. She had assessed the proposed offering price of securities in an investment banking client to be approximately half of the amount on which the banking side of the firm had decided.<sup>96</sup> At the meeting her colleague “snapped open his briefcase and pulled out [a] recently released compensation memo.”<sup>97</sup> The memo proposed that analysts be graded from A to C on their ability and role in attracting investment banking clients and then compensated accordingly.<sup>98</sup> According to the *Wall Street Journal*, the analyst was “stunned.”<sup>99</sup> She felt that she was raising an “objectively quantifiable issue,” and her colleague was not “interested at all in the substance of [her] work.”<sup>100</sup> He wanted to know only whether she was “going to help him get the deal done.”<sup>101</sup> Once the deal is done, of course, the investment-bankers want continued coverage because without it they cannot build business. As a result, they pressure analysts not to drop coverage of clients as well.<sup>102</sup>

Media and academic studies continue to report that sell-side analysts are paid, in part, on the basis of finance business generated.<sup>103</sup> When they help land clients, their bonuses reflect it, either as a percentage of the contract landed or in absolute dollars.<sup>104</sup> For example, one analyst contract contained a formula that could have resulted in up to \$1 million in compensation over a two-year period based on landing underwriting business.<sup>105</sup> Interestingly, however, analyst salaries typically are not based on any direct attempt to measure the accuracy of analyst recommendations or reports.<sup>106</sup> Instead,

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94. *Id.*

95. *Id.*

96. Michael Siconolfi, *Under Pressure: At Morgan Stanley, Analysts Were Urged to Soften Harsh Views*, WALL ST. J., July 14, 1992, at A1.

97. *Id.*

98. *Id.*

99. *Id.*

100. *Id.*

101. Siconolfi, *supra* note 96.

102. *Id.*

103. Charles Gasparino, *Analysts' Contracts Link Pay to Deal Work*, WALL ST. J., May 6, 2002, at C1; Michael & Womack, *supra* note 61, at 659; Scott E. Stuckel, *Reputation and Performance Among Security Analysts*, 47 J. FIN. 1811, 1812 n.2 (1992).

104. *See* Gasparino, *supra* note 103.

105. *Id.*

106. *See generally* Dugar, *supra* note 40, at 152; Michael & Womack, *supra* note 61, at 659-60.

analyst salaries reflect their perceived “star quality,” which has more to do with their skill at public relations than at objective evaluation.<sup>107</sup>

Consider the case of Jack Grubman, a telecommunications industry analyst. Grubman was, for years, one of the highest paid analysts on Wall Street. In the 1990s, his annual compensation was reportedly in the range of \$20 million.<sup>108</sup> His recommendations, however, fared less well. In 2001, five telecommunications concerns all filed for bankruptcy.<sup>109</sup> Jack Grubman was in the middle of this group of industry failures. Grubman issued buy recommendations on thirty such companies in the two years preceding the bankruptcies.<sup>110</sup> Of course Grubman was, at the same time, helping his firm, Salomon Smith Barney, win security deals from the same companies.<sup>111</sup> According to the *New York Times*, from 1997 to 2001, Salomon cornered the telecom investment banking market, “tak[ing] in more in fees from telecom companies than any other firm on the street.”<sup>112</sup> During the years in which Grubman was hyping the stocks, Salomon collected \$809 million for underwriting stocks and bonds and \$178 million for strategic combination advice. Although investors who followed Mr. Grubman’s recommendations, and held on to securities in the firms he was hyping, “fared dismally,”<sup>113</sup> Grubman fared well. A portion of the underwriting fees went directly to Grubman. Incidentally, Grubman received *Institutional Investor*’s top ranking

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107. Although analyst salaries may incorporate the *Wall Street Journal* analyst rankings, which arguably reflect accuracy indirectly, analysts are known to visit management just prior to the *Journal*’s review, leading to potential bias in the *Journal*’s management survey. See Stickel, *supra* note 103, at 26. Similarly, the analyst rankings published by *Institutional Investor* magazine are reportedly based on surveys in which big money managers are asked to rank analysts based on factors that include industry knowledge, accessibility, and various other criteria. According to one empirical study, the resulting rankings are based more on reputation and recognition than on analyst performance and research efforts. See Xi Li, *Career Concerns of Analysts: Compensation, Termination, and Performance* (Apr. 8, 2002) (unpublished manuscript, on file with the Iowa Law Review).

108. See Charles Gasparino, *The Soaring '90s: Behind the Investing Giants and Stocks that Marked a Decade*, WALL ST. J., Dec. 13, 1999, at C1 (reporting Grubman’s annual compensation in 1999s to be “as much as \$25 million”); Paul Sweeney, *Sharing in the Bounty: Dot-Coms and Hyper Competition Have Raised Wall Street Compensation Levels to Unprecedented Heights, but Will It Last?*, INV. DEALERS DIGEST, June 12, 2000 (citing reports that Grubman was earning \$20 million annually).

109. See Gretchen Morgenson, *Telecom’s Pied Piper: Whose Side Was He On?*, N.Y. TIMES, Nov. 18, 2001, at 3.

110. See *id.*

111. Perhaps more troubling is the fact that Grubman solicited proxies in the control contest between WorldCom and British Telecommunications for MCI Communications at the same time that he was purporting to cover WorldCom as a research analyst. See Matthew Goldstein, *WorldCom Enlisted Grubman in MCI Take*, THE STREET.COM (July 11, 2002), at <http://www.thestreet.com/markets/mathewgoldstein/10031200.html> (on file with the Iowa Law Review).

112. *Id.*

113. *Id.*

in 1998,<sup>114</sup> despite his conspicuous absence from the magazine's performance-based lists such as best stock pickers or best earnings estimates.<sup>115</sup>

### C. ACCESS INTERESTS

A third type of analyst conflict is created by analysts' need to maintain access to issuers to obtain company information. These potential conflicts are perhaps the most dangerous from the perspective of the securities markets. As indicated above, securities analysts have become increasingly reliant on covered companies themselves as sources of research information. At the same time, corporate officials face substantial pressure to maintain the company's stock price. These corporate officials tend to view analyst skepticism or criticism with disfavor. As a result, analysts who issue negative reports or recommendations face harsh criticism<sup>116</sup> or worse from corporate officials.<sup>117</sup>

Indeed, analysts who exercise independent judgment are often frozen out of future access.<sup>118</sup> Corporate officials may refuse to take analysts' phone calls, prohibit employees from speaking with them, avoid their questions in conference calls, and refuse to attend analyst-organized conferences.<sup>119</sup> These stonewalling efforts by issuers interfere with analyst efforts to conduct research on the company. As a result, analysts question whether they can be honest and still do their job.<sup>120</sup> One analyst, who had repeatedly failed to rate a bank's securities as a "buy," for example, was denied an opportunity to meet with the bank's chief executive officer.<sup>121</sup> Instead, the company suggested that he meet with a lower-ranked management member who was not even located in the bank's headquarters.<sup>122</sup> Another analyst attempted to attend a Boston Chicken, Inc., research analyst conference, but was greeted with the following comment from the company's chief financial officer: "We don't want you here. We don't want you to confuse yourself with the

114. *See id.*

115. *See* COLE, *supra* note 45, at 125.

116. Dugar, *supra* note 40, at 135; *see* Susan Pulliam, *Analysts to Tell Congress that Skepticism Gets Them Abuse*, WALL ST. J., Mar. 19, 2002, at C1 (quoting two Morgan Stanley analysts who were "lambast[ed]" by the chief executive at Qwest Communications International, Inc. after they questioned the company's accounting practices, and noting that SEC is currently investigating Qwest's accounting practices).

117. *See* Stephen Barr, *What Chinese Wall?*, 16 CFO MAG., Mar. 1, 2000, at 63 (describing series of retaliations by issuers against analysts who issue negative reports).

118. *See* Pulliam, *supra* note 116 (discussing treatment of analysts by Wall Street firms).

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.*

facts.<sup>123</sup> The analyst had issued a sell recommendation on Boston Chicken's stock. Similarly, when independent analyst Anne Anderson issued a sell rating on Oxford, Inc., Oxford's response was to "disinvite" her from its analyst conference and refuse to return her calls.<sup>124</sup>

In extreme cases, analysts who issue accurate but unfavorable reports may even be fired.<sup>125</sup> In one of the most high-profile cases, star analyst Mike Mayo issued a controversial recommendation in spring 1999 that clients sell bank stocks.<sup>126</sup> Despite the fact that Mayo's prediction was strikingly accurate—bank stocks suffered their worst performance, relative to the market, in fifty-four years—he was subsequently fired.<sup>127</sup> After conducting interviews with dozens of securities professionals, *Fortune* magazine concluded that Mayo was fired for his honesty.<sup>128</sup>

A casino analyst at Janney Montgomery Scott, Marvin Roffman, was also fired after forecasting that Donald Trump would default on interest payments for his Taj Mahal casino in Atlantic City.<sup>129</sup> Roffman subsequently won an arbitration suit against Janney for \$750,000.<sup>130</sup> Incidentally, Trump did default on the interest payments as Roffman had predicted.

Similarly, Donaldson, Lufkin and Jenrette, Inc. ("DLJ") analyst Thomas K. Brown was "a Master of the Universe in bank stocks: fifteen years on Wall Street and in eight of the past nine years, the top-ranked analyst of regional banks on the prestigious Institutional Investor All-America Research Team."<sup>131</sup> After seven years at DLJ, however, Brown said he was fired because he had been too negative on DLJ clients.<sup>132</sup>

Analyst pressure may come in other forms as well. Analysts may face litigation from disgruntled issuers. Issuer Positive Response Television Inc. sued Painewebber analyst Stan Trilling, blaming its stock plunge on a critical article in *Forbes* magazine.<sup>133</sup> Likewise, another company "slapped" two

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123. Michael Siconolfi, *Incredible "Buys": Many Companies Press Analysts to Steer Clear of Negative Ratings*, July 19, 1995, WALL ST. J., at A1.

124. Morgenson, *See No Evil*, *supra* note 24.

125. *See, e.g.*, Deborah Lohse, *Analyst Feels Vindicated on Conseco*, WALL ST. J., May 14, 2000 at C1 (describing CEO of Conseco, Inc. as approaching stock analyst who issued negative report on company, threatening analyst, and calling analyst's superiors and noting that Conseco later reported earnings problems). For another story, ten years earlier, on the same analyst, see Jeffrey M. Laderman et al., *How Much Should You Trust Your Analyst?*, BUS. WK., July 23, 1990, at 54.

126. *See* David Rynecki, *The Price of Being Right*, FORTUNE, Feb. 5, 2001, at 126.

127. *Id.*

128. *Id.*

129. *Conseco Drops Merrill for Morgan After Downgrade*, BLOOMBERG NEWS, Oct. 13, 1994.

130. *Id.*

131. Jeffrey M. Laderman, *Wall Street's Spin Game*, BUS. WK., Oct. 5, 1998, at 148.

132. *Id.* DLJ claimed that the dismissal was based on "a longstanding and acrimonious conflict with colleagues in the institutional-equities division" of DLJ. *Id.*

133. William Power, *Company Sues Broker, Forbes for Share Fall*, WALL ST. J., Dec. 4, 1995, at C1.

analysts with defamation suits when they issued reports questioning its profit potential.<sup>134</sup>

The analyst-issuer relationship does not compromise just the analyst. The relationship can also distort the issuer's decision-making. For example, corporate officials are loath to report performance numbers that differ from analyst predictions. This apprehension has two effects. First, officials provide analysts with earnings "guidance" in an effort to insure that their predictions do not create unrealistic expectations on the part of the market.<sup>135</sup> Second, once the predictions have been released, officials face overwhelming pressure to meet those numbers, including the risk of litigation. As a result, officials may resort to "managing" their financial figures in order to meet analyst predictions.<sup>136</sup> Increased earnings management by corporate officials has recently led to widespread restatements.

In light of these multiple and significant conflicts, it is apparent that the reality of the analyst role is far different from the theoretical independent gatekeeper. Analysts and their employers own stock in covered companies. Analysts work for investment banking firms and are tied into the client-wooing process. Analysts are forced to give positive coverage to win clients, to keep clients, and to keep their jobs. Even nominally independent analysts face pressure to issue only positive coverage or risk being frozen out of access to corporate information. As Part III explains, courts and regulators have done little to dampen these conflicts and therefore have failed to protect investors adequately.

### III. REGULATION OF THE SECURITIES ANALYST

#### A. FEDERAL REGULATION—THE COURTS

In performing the roles described above, the securities analyst has been surprisingly free from regulatory oversight. Federal law does regulate SEC-registered investment advisers, albeit "lightly."<sup>137</sup> The federal securities laws

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134. Elizabeth MacDonald, *Libel Suits Pose a Risk for Analysts*, WALL ST. J., Dec. 29, 1999, at C1.

135. Indeed, a group of scholars found evidence that post-1992, analysts consistently "walk down" their earnings estimates to a level that the firm can beat by the end of the year. Scott A. Richardson et al., *The Walkdown to Beatable Analyst Forecasts: The Roles of Equity Issuance and Insider Trading Incentives* (Aug. 2001) (unpublished manuscript, on file with the Iowa Law Review), available at <http://mit.edu/wysokip/www/papers.htm>. The practice is most pronounced among firms that are either net issuers of equity or where managers sell stock following an earnings announcement. *Id.*

136. Joseph Fuller & Michael C. Jensen, *Just Say No to Wall Street* (Feb. 17, 2002) (unpublished manuscript, on file with the Iowa Law Review), available at <http://papers.ssrn.com/abstract=297156>.

137. Roberta S. Karmel, *The Challenge to Financial Regulators Posed by Social Security Privatization*, 64 BROOK. L. REV. 1043, 1063 (1998). Karmel describes the recordkeeping,

do not, however, set forth any requirements or prerequisites specific to the role of securities analysts, primarily because as long as analysts do not provide personalized investment advice or recommendations, they are not viewed as client fiduciaries.<sup>138</sup> Similarly, the analyst function does not usually involve handling customer money or securities.<sup>139</sup> Moreover, because sell-side analysts typically are employed by broker-dealers and are compensated indirectly through brokerage commissions rather than paid directly for investment advice, they are exempt from the Investment Advisers Act pursuant to section 202(a)(11).<sup>140</sup>

Significantly, existing law permits analysts to operate under a variety of conflicts of interests such as those discussed in Part II above. Until recently, in most cases, the law imposed little or no affirmative obligation to disclose even the existence of these conflicts apart from the largely theoretical risk that failure to disclose would constitute securities fraud. Furthermore, because of the narrow construction of the Investment Advisers Act, it is difficult to determine the precise scope of actionable fraud under it. Any such fraud would seem to require a direct personal relationship of advisor and client.<sup>141</sup>

Alternatively, an analyst could be liable under section 10(b) and Rule 10b-5 of the Securities and Exchange Act of 1934.<sup>142</sup> Traditionally, such suits

reporting, and disclosure requirements applicable to investment advisers and observes that "there are no qualifications for becoming an investment adviser." *Id.*

138. The Investment Advisers Act of 1940 regulates

any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.

Investment Act of 1940 § 80b-2(a)(11), 15 U.S.C. §§ 80b-1 to -21 (2000). Its focus, however, is on direct investment recommendations to clients. *See generally* *Lowe v. SEC*, 472 U.S. 181 (1985) (finding that Act was directed to business of providing personalized investment advice to specific clients). Commentators have observed that *Lowe's* analysis should similarly bring financial columnists, who are not making direct recommendations to specific clients, outside the scope of the Act. *See, e.g.*, David Levant, *Financial Columnists as Investment Advisers: After Lowe and Carpenter*, 74 CAL. L. REV. 2061, 2079 (1986).

139. Analysts who are employed by broker-dealers may be subject to securities regulations regarding financial security and recordkeeping. Thus, for example, analysts commonly are required to take the Series 7 exam because they are associated persons of registered broker-dealers. *See* 17 C.F.R. § 240.15c-7.1 (2002).

140. The Act excludes from the definition of investment adviser a broker or dealer whose investment advisory activities are solely incidental to its brokerage business and who does not receive any separate compensation for providing investment advice. 15 U.S.C. § 80b-2(a)(11) (2000).

141. *See* 15 U.S.C. §§ 80b-1 to -21.

142. 15 U.S.C. § 78j (2000); 17 C.F.R. § 240.10b-5 (1992).



have been rare.<sup>143</sup> Recently, however, investors have begun to bring claims against analysts based on false or misleading recommendations or predictions. For example, in May 2001, investors filed a NASD arbitration claim against Morgan Stanley and its controversial analyst Mary Meeker, alleging that they were misled by that firm's overly optimistic and inaccurate recommendations of technology stocks.<sup>144</sup> On August 1, 2001, another class of investors filed suit against six brokerage firms for issuing misleading favorable recommendations and research reports on a variety of Internet securities.<sup>145</sup> The extent to which these suits will be successful remains an open question. On one hand, in July 2001, Merrill Lynch paid \$400,000 to settle a case by a former client, alleging that he was duped by a Merrill Internet analyst.<sup>146</sup> On the other hand, a federal court quickly dismissed the suit against Morgan Stanley and Meeker.<sup>147</sup>

The most controversial regulatory area involving analysts has been the extent to which their use of nonpublic information creates the potential for insider trading liability. Historically, analysts have enjoyed superior access to corporate information. Issuers routinely shared information with a favored group of analysts before disclosing the information to the general public.<sup>148</sup> Issuers would hold invitation-only meetings and conference calls to release updated corporate information and answer analyst questions.<sup>149</sup> Moreover, issuers would respond privately to analyst inquiries and, in some cases, would review the analyst's work product and offer guidance as to its accuracy.<sup>150</sup>

During the 1970s, the SEC pursued analysts and their clients in several cases for using information selectively disclosed by corporate insiders. In *In re Investors Management*, for example, the SEC censured analysts at Merrill Lynch and their tippees for trading on the basis of non-public negative

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143. *But see In re Credit Suisse First Boston Corp. Sec. Litig.*, 97 Civ. 4760, 1998 U.S. Dist. LEXIS 16560, at \*36 (S.D.N.Y. Oct. 19, 1998) (denying motion to dismiss private suit by investors alleging that analyst made unduly pessimistic recommendations due to his firm's short positions in covered securities).

144. *Malvin v. Morgan Stanley Dean Witter & Co.*, 01 Civ. 7248, 2001 U.S. Dist. LEXIS 13373, at \*1 (S.D.N.Y. Aug. 23, 2001).

145. *Fadem Trust v. Credit Suisse First Boston Corp.*, 01-CV-7161 (S.D.N.Y. Aug. 1, 2001), available at <http://www.lovellstewart.com/homejump.html?page=caselist.html> (on file with the Iowa Law Review); *see also* *McNamara v. Bre-X Minerals Ltd.*, 2001 U.S. Dist. LEXIS 4571 (E.D. Tex. Mar. 30, 2001) (refusing to dismiss complaint against JP Morgan, issuer's investment adviser, for public statements made by Morgan analysts).

146. *NASD Backs Analyst-Conflict Disclosures, Members Say*, BLOOMBERG NEWS, Oct. 10, 2001.

147. *Neil Roland & Walter Hamilton, Keeping Tabs on the Investigations*, L.A. TIMES, Mar. 5, 2002, at C5.

148. *See supra* note 7.

149. *See id.*

150. *See id.*

information about Douglas Aircraft.<sup>151</sup> In *Bausch & Lomb*, the SEC sought injunctive relief after analysts covering Bausch & Lomb met with the company's chief executive officer and obtained non-public negative information regarding future earnings and business operations.<sup>152</sup> In another case, *Monarch Fund*, the SEC attempted to obtain disgorgement from an investment advisor and the funds he managed, which had traded on the basis of information obtained from a corporate director about the company's future funding.<sup>153</sup> In *SEC v. Lum's, Inc.*, the SEC pursued Lehman Brothers after its broker, who had obtained nonpublic information about a downturn in earnings at Lum's, communicated that information to an institutional client that then sold its stock.<sup>154</sup> Finally, in *Dirks v. SEC*, the SEC censured Raymond Dirks for communicating information about an undisclosed fraud at Equity Funding to his clients, who subsequently traded on the basis of the information.<sup>155</sup>

The SEC justified its efforts to target selective disclosure to analysts on fairness grounds.<sup>156</sup> Its position was that all investors should have equal information or, at least, equal access to information.<sup>157</sup> Accordingly, the SEC reasoned that when analysts or their clients traded on the basis of non-public, selectively disclosed information, they violated Rule 10b-5.<sup>158</sup> The *Lum's* court summarized this position, explaining that "selective disclosure . . . ultimately works unfairness in the markets: some people are better informed and thus can conduct better analyses, in reaching decisions to act, because of unfair advantages not enjoyed by others."<sup>159</sup>

Judicial reaction to analysts' liability based on their receipt and use of selectively disclosed corporate information was largely critical of the SEC's position. The criticism was of two types. First, the courts placed greater value than the SEC on the role of analysts in uncovering and disseminating corporate information.<sup>160</sup> Second, a number of courts questioned the scope of rule 10b-5 and reasoned that its application was limited to cases involving a breach of fiduciary duty.<sup>161</sup> The Supreme Court ultimately accepted both of these arguments. In *Chiarella*, the Court rejected the "information" theory

151. *In re Investors Management Co.*, 44 S.E.C. 633, 648 (1971). Merrill Lynch was acting as prospective managing underwriter for a new issue of Douglas Aircraft securities at the time of the selective disclosure. *Id.* at 634.

152. *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 9 (2d Cir. 1977).

153. *SEC v. Monarch Fund*, 608 F.2d 938, 939 (2d Cir. 1979).

154. *SEC v. Lum's Inc.*, 365 F. Supp. 1046, 1060 (S.D.N.Y. 1973).

155. *Dirks v. SEC*, 463 U.S. 646, 651 (1983).

156. *See In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961).

157. *See id.*

158. *See id.*

159. *Lum's*, 365 F. Supp. at 1058.

160. *See, e.g., Dirks*, 463 U.S. at 646.

161. *See, e.g., Chiarella v. United States*, 445 U.S. 222 (1980).

of liability in favor of the “fiduciary” theory.<sup>162</sup> Superior information alone, the Court concluded, did not give rise to a duty to the marketplace to disclose or abstain from trading.<sup>163</sup> Instead, corporate insiders violated federal law by trading on nonpublic information because such trading was in breach of their fiduciary duty to stockholders.<sup>164</sup> Because Chiarella lacked such a duty, he was not liable.<sup>165</sup>

In *Dirks*, the Court directly considered the implications of its fiduciary theory for securities analysts.<sup>166</sup> The *Dirks* Court treated the analyst Dirks as a tippee, and articulated a standard governing when analysts, as tippees, inherited a fiduciary duty from the corporate source of nonpublic information. The Court concluded that liability for the use of information selectively disclosed by corporate insiders required that the insider obtain a personal benefit from the disclosure.<sup>167</sup> The Court specifically concluded that application of a parity of information standard to analysts could inhibit the aggressive research that is necessary for an efficient securities market.<sup>168</sup> Significantly, the *Dirks* holding was premised on the “undisputed” proposition “that Dirks himself was a stranger to Equity Funding, with no pre-existing fiduciary duty to its shareholders.”<sup>169</sup> According to the Court, despite Dirks’ activities as an analyst, which included disseminating information to investors about Equity Funding, “[h]e took no action, directly or indirectly, that induced the shareholders or officers of Equity Funding to repose trust or confidence in him.”<sup>170</sup>

Despite *Dirks* and *Chiarella*, questions remain regarding the permissible scope of selective disclosure. First, it is unclear what type of personal benefit

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162. *See id.*

163. *See id.* at 234. The decision was motivated, in part, by a desire to protect the analyst community. *See* A.C. Pritchard, Justice Lewis F. Powell, Jr. and the Counter-Revolution in the Federal Securities Laws 61–67 (July 2002) (unpublished manuscript, on file with the Iowa Law Review). This Article questions the basis for that desire.

164. *Chiarella*, 445 U.S. at 227–29. The Court did not fully articulate its rationale for insider trading regulation in *Chiarella*, and that deficiency persists. One justification for regulation that is suggested, although not fully developed, by Zohar Goshen and Gideon Parchomovsky, is an agency rationale. *See* Zohar Goshen & Gideon Parchomovsky, *On Insider Trading, Markets, and “Negative” Property Rights in Information*, 87 VA. L. REV. 1229, 1259–61 (2001) (demonstrating that insider trading provides corporate managers with incentives that reduce their effectiveness as corporate agents).

165. The Court identified the possibility that insider trading could be premised on a fiduciary duty owed by the trader to someone other than the issuer or its stockholders, but did not address the issue. *Chiarella*, 445 U.S. at 232. Subsequently, the Court extended the scope of fiduciary obligations upon which insider trading liability could be premised in *United States v. O’Hagan*, 519 U.S. 1087 (1997).

166. *Dirks v. SEC*, 463 U.S. 646 (1983).

167. *See id.* at 662 (“[T]he test is whether the insider personally will benefit, directly or indirectly, from his disclosure.”).

168. *Id.* at 658.

169. *Id.* at 665.

170. *Id.*

is necessary after *Dirks*. Second, neither *Dirks* nor *Chiarella* addresses the extent to which an analyst may engage in personal trading on the basis of selectively disclosed information. Third, the cases do not consider the extent to which analyst insider trading liability may be premised on conflicts of interest. Nonetheless, after a 1991 action against CE● Stevens for selectively disclosing corporate information to analysts “in order to protect and enhance his reputation,” which was settled through a consent decree but widely criticized by commentators, the SEC stopped bringing selective disclosure actions based on section 10(b).<sup>171</sup>

## B. FEDERAL REGULATION—THE SEC AND REGULATIONS FD AND AC

### 1. Regulation FD

#### a. Background

As described above, the Supreme Court’s decisions in *Chiarella* and *Dirks* created a privileged status for analysts with respect to insider trading regulation. Analysts benefited from traditional insider trading regulation because they, unlike corporate insiders, were allowed to profit from the receipt of non-public corporate information. By prohibiting corporate insiders from using the information but granting the “property rights” to analysts, insider trading regulation placed analysts at the head of the line.<sup>172</sup> This preferred status is of particular importance because of the nature of information as a public good. The value of nonpublic information dissipates quickly. Those with the first access to the information can therefore reap the greatest value if they are permitted to use it.<sup>173</sup>

The practice of selectively disclosing significant corporate information generated complaints that small investors were being treated unfairly.<sup>174</sup> The

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171. Merritt B. Fox, *Regulation FD and Foreign Issuers: Globalization’s Strains and Opportunities*, 41 VA. J. INT’L L. 653, 662 (2001).

172. See Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 232 (1991) (noting that “[a]lthough they do not have the access of an insider, [investment professionals’] resources enable them to be ‘next in line’ in terms of quality of information”) (quoting Donald C. Langevoort, *Setting the Agenda for Legislative Reform: Some Fallacies, Anomalies, and Other Curiosities in the Prevailing Law of Insider Trading*, 39 ALA. L. REV. 399, 400 n.6 (1988)).

173. See *id.* at 227–28 (“It is the fact that an insider has obtained his informational advantage because of his position, and the fact that his position is attributable to the presence of other less-privileged transactors in the market, that makes the insider’s use of nonpublic information unfair.”).

174. See Susan Pulliam, *Abercrombie & Fitch Ignites Controversy Over Possible Leak of Sluggish Sales Data*, WALL ST. J., Oct. 14, 1999, at C1 (noting that small investors are often last to know about important company developments); Susan Pulliam & Gary McWilliams, *Compaq Is Criticized for How It Disclosed PC Troubles*, WALL ST. J., Mar. 2, 1999, at C1 (same); Randall Smith, *Conference Calls to Big Investors Often Leave Little Guys Hung Up*, WALL ST. J., June 21, 1995, at C1 (same).

problem took on increased urgency as market volatility increased in the late 1990s. The media reported various stories in which investors in possession of nonpublic information were able to earn large profits or avoid substantial losses.<sup>175</sup> Market followers indicated a concern that such incidents would cause investors to lose confidence in the markets. The problem was aggravated by the fact that the incidents did not appear to be isolated occurrences; a substantial number of issuers apparently made selective disclosure a regular practice.<sup>176</sup>

*b. Regulation FD*

On December 20, 1999, the SEC responded to concerns about selective disclosure by proposing Regulation FD.<sup>177</sup> From the outset, Regulation FD was a departure from the historical treatment of selective disclosure through antifraud regulation. The proposed regulation created an independent duty of disclosure to be enforced through SEC enforcement actions rather than private civil litigation.<sup>178</sup> In addition, Regulation FD dealt with selective disclosure by regulating issuers, not analysts.<sup>179</sup>

The SEC acknowledged that historically selective disclosure had been addressed as part of the regulation of securities fraud.<sup>180</sup> Nonetheless, it reasoned that new regulation was warranted for several reasons. In addition to the fundamental unfairness associated with unequal access, the SEC noted that by allowing corporate officials to use information as a commodity, selective disclosure created an incentive for them to delay public disclosure.<sup>181</sup> Delays in public disclosure enabled corporate officials to manage earnings and, indirectly, manipulate market expectations.<sup>182</sup> Selective disclosure also facilitated issuer use of disclosure practices to pressure analysts to generate favorable reports and recommendations by allowing issuers to create relationships that gave preferred analysts the first

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175. See Smith, *supra* note 174 (explaining how "big" investors with access to nonpublic information provided through conference calls impacted markets).

176. In addition, a study of corporate disclosure practices by the National Investor Relations Institute reported that 26% of responding companies stated that they engaged in some types of selective disclosure practices. NAT'L INVESTOR RELATIONS INST., A STUDY OF CORPORATE DISCLOSURE PRACTICES, SECOND MEASUREMENT 18 (1998), *cited in* Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, 72,592 n.11 (proposed Dec. 28, 1999) (to be codified at 17 C.F.R. pt. 243).

177. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,590.

178. See *id.* at 72,598.

179. See *id.* at 72,594.

180. Indeed, a number of commentators argued for the continuation of this approach. Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,718 (Aug. 24, 2000) (to be codified at 17 C.F.R. pt. 243).

181. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,592.

182. *Id.*

shot at internal company information.<sup>183</sup> Finally, the SEC noted that advances in information technology had reduced the importance of analysts as information intermediaries and made it easier and less costly for issuers to disseminate information directly to the public.<sup>184</sup>

In light of these conclusions, the SEC posited that its new regulation would provide a number of advantages. In addition to increasing investor confidence in market integrity, the SEC predicted that issuers would benefit from participating in more open disclosure practices.<sup>185</sup> Those open disclosure practices, the SEC argued, would have the effect of lowering the cost of capital.<sup>186</sup> In addition, the SEC reasoned that analysts would benefit from an “equal competitive footing.”<sup>187</sup> Absent issuer ability to play favorites in the release of corporate information, analysts could report with greater candor.<sup>188</sup> Moreover, analyst performance would reflect ability and effort rather than access to corporate insiders.<sup>189</sup> As a result, better information would be provided to the marketplace, either through direct company disclosure or improved analyst performance.<sup>190</sup>

The SEC adopted the final version of Regulation FD on Aug 24, 2000, with an effective date of October 23, 2000.<sup>191</sup> Consistent with its initial proposal, the SEC designed Regulation FD to be an issuer disclosure rule, not an antifraud rule. As modified, Regulation FD continues to prohibit issuers and those acting on their behalf from selectively disclosing material nonpublic information to securities industry professionals, institutional investors, and certain other persons.<sup>192</sup>

Regulation FD applies to issuers with “securities registered under Section 12 of the Securities Exchange Act” and those “required to file reports under Section 15(d).”<sup>193</sup> The regulation covers only communications by an issuer’s senior management, its investor-relations professionals, and

183. *Id.*

184. *Id.* at 72,593.

185. *Id.* at 72,605.

186. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,605.

187. *Id.*

188. *Id.* at 72,605–06.

189. *Id.* at 72,606.

190. *Id.* at 72,607. The proposal provoked immediate controversy. The SEC received almost 6000 comment letters, and although most individual investors supported the new regulation, issuer and analyst reaction was less favorable. See Kristy L. Covey, *Developments in the Substantive Law: Regulation FD Controversy*, TEX. LAW., Dec. 18, 2000, at 84 (describing rule as generating “significant opposition from Wall Street”). Many critics denounced the rule, arguing that its guidelines were ambiguous and that fear of liability would reduce information flow to the markets. See Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,718 (Aug. 24, 2000) (to be codified at 17 C.F.R. pt. 243). The outcry prompted the SEC to extend the initial comment period and to modify the proposed rule substantially. *Id.*

191. *Id.*

192. *Id.*

193. 17 C.F.R. § 243.101(b) (2002).

those who regularly communicate with market professionals and security holders.<sup>194</sup> It does not cover every low- or mid-level employee. Nor does the rule apply to all disclosures, but only those made to specific categories of recipients: brokers and dealers;<sup>195</sup> investment advisers and certain institutional investment managers;<sup>196</sup> investment companies and hedge funds;<sup>197</sup> and holders of the “issuer’s securities, under circumstances in which it is reasonably foreseeable that the holder will purchase or sell the issuer’s securities on the basis of the information.”<sup>198</sup> Thus analysts, institutional investors, and other market professionals are included under the rule.<sup>199</sup> In addition, the rule explicitly exempts disclosures to people owing “a duty of trust or confidence to the issuer” (such as professional advisers);<sup>200</sup> persons subject to an express confidentiality agreement;<sup>201</sup> and credit rating agencies.<sup>202</sup> The SEC has further stated that it does not believe the rule covers disclosures to the media or those involved in ordinary business communications with the issuer such as customers or suppliers.<sup>203</sup>

The rule covers disclosure of material nonpublic information other than communications made in connection with registered offerings.<sup>204</sup> The SEC did not clarify the definition of materiality, despite requests that it do so.<sup>205</sup> Nonetheless, in an effort to provide increased guidance about materiality, the SEC listed several categories for which “close scrutiny” is warranted, including disclosures relating to earnings, mergers and acquisitions, new products or discoveries, changes in control or management, changes in auditors, events regarding company securities, and bankruptcies or receiverships.<sup>206</sup> The SEC specifically singled out private, one-on-one discussions between companies and analysts regarding earnings estimates as an area raising special concern. Calling this an area involving “a high degree of risk,” the SEC noted that even indirect guidance such as “expressing comfort” could amount to selective disclosure.<sup>207</sup>

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194. *Id.*

195. *Id.* § 243.100(b)(1)(i).

196. *Id.* § 243.100(b)(1)(ii).

197. *Id.* § 243.100(b)(1)(iii).

198. 17 C.F.R. § 243.100(b)(1)(iv) (2002).

199. *Id.* § 243.100(b)(1)(i)–(iv).

200. *Id.* § 243.100(b)(2)(i).

201. *Id.* § 243.100(b)(2)(ii).

202. *Id.* § 243.100(b)(2)(iii).

203. Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,720 (Aug. 24, 2000) (to be codified at 17 C.F.R. pt. 243).

204. *Id.* at 51,721, 51,725.

205. *Id.*

206. *Id.*

207. *Id.*

Regulation FD divides selective disclosures into two categories: intentional and unintentional.<sup>208</sup> For selective disclosures that are intentional (or reckless), the issuer must simultaneously disclose the information to the public.<sup>209</sup> For selective disclosures that are unintentional, the issuer must disclose promptly, meaning within twenty-four hours or before the beginning of the next trading day, whichever is later.<sup>210</sup> Issuer options for effective disclosure include the following: filing the information through Item 5 of Form 8-K, furnishing the information through Item 9 of Form 8-K, or otherwise disseminating it in a manner “reasonably designed to provide broad non-exclusionary coverage.”<sup>211</sup> Methods that satisfy this third option include press releases distributed through widely circulated news or wire services and conferences with public notice and access.<sup>212</sup> The SEC explicitly warned that publication of the information on an issuer’s Web site does not constitute public disclosure.<sup>213</sup>

The SEC has stated repeatedly that Regulation FD is designed as an enforcement tool rather than an extension of private civil liability.<sup>214</sup> Responding to the concern that Regulation FD might chill issuer communications, the SEC clarified the final rule to provide that issuers would be liable only “when an issuer’s personnel knows or is reckless in not knowing that the information selectively disclosed is both material and nonpublic.”<sup>215</sup> In addition, the final rule explicitly states that the failure to make a public disclosure required by Regulation FD is not a violation of Rule 10b-5.<sup>216</sup> Thus, Regulation FD should not expand the scope of antifraud liability.<sup>217</sup> Nonetheless, the SEC can bring administrative or civil enforcement actions against violators and individual employees, and analysts may be liable for causing violations and for aiding and abetting as well.<sup>218</sup>

*c. The Impact of Regulation FD*

Industry reaction to Regulation FD was extremely negative. Both the comments in response to the SEC’s proposed release and the initial responses to the final regulation warned that the new rule would have the

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208. 17 C.F.R. § 243.100(a)(1)–(2) (2002).

209. *Id.* § 243.101 (a)(1).

210. *Id.* § 243.100 (a)(2), 243.101(d).

211. *Id.* § 243.101 (e)(1)–(2).

212. Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,724, 51,724–25 (Aug. 24, 2000) (to be codified at 17 C.F.R. pt. 243).

213. *Id.*

214. *Id.* at 51,726.

215. 17 C.F.R. § 243.101(a) (2002).

216. *Id.* § 243.102.

217. *Id.*

218. Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,726.



effect of substantially decreasing information flow to the marketplace.<sup>219</sup> Critics also predicted that the regulation would increase price volatility.<sup>220</sup>

Initial public discussions reflected these concerns. On April 24, 2001, the SEC held a roundtable discussion in New York City to consider the early experience of analysts, issuers, and investors with Regulation FD.<sup>221</sup> At that time, issuers related their efforts to provide equal informational access, but described their fear of liability exposure.<sup>222</sup> Analysts stated that the quality of corporate information had been reduced dramatically by the enactment of the rule.<sup>223</sup> In addition, multiple participants identified recent increases in price volatility and attributed those increases to the rule.<sup>224</sup>

Commissioner Laura S. Unger, the only Commissioner to vote against the rule, prepared a report shortly after the rule's adoption.<sup>225</sup> In this report, Commissioner Unger made several recommendations to make Regulation FD function more efficiently. First, she urged the SEC to provide more guidance on the definition of materiality.<sup>226</sup> This recommendation responds directly to a concern expressed by issuers, analysts, and lawyers—that without better guidance, companies may err on the side of not releasing information for fear of crossing the materiality line. Second, the report asserted that the Commission should explore adding disclosure mechanisms to its approved methods of distribution, including, for example, Web site postings.<sup>227</sup> Third, the report urged the Commission to study the chilling effect, if any, of Regulation FD on corporate communications.<sup>228</sup>

It is difficult empirically to assess the impact of Regulation FD due to its recent adoption. Nonetheless, initial research suggests that the purported negative effects of Regulation FD on information flow and volatility may be overstated. Several studies are particularly worthy of note. First, Philip Shane et al. investigated the effect of Regulation FD on the information environment.<sup>229</sup> Although the authors observed an initial reduction in information flow, they found that analysts are now gathering more

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219. *Id.* at 51,718.

220. *Id.* at 51,731.

221. *See, e.g.*, Jeff D. Opdyke, *Wall Street, SEC Discuss "Reg FD" at Roundtable*, WALL ST. J., Apr. 25, 2001, at C16.

222. *Id.*

223. *Id.*

224. *Id.*

225. LAURA S. UNGER, SPECIAL STUDY: REGULATION FAIR DISCLOSURE REVISITED (2001), available at <http://www.sec.gov/news/studies/regfdstudy.htm> (on file with the Iowa Law Review).

226. *Id.*

227. *Id.*

228. *Id.*

229. Philip Shane et al., *Earnings and Price Discovery in the Post-Reg. FD Information Environment: A Preliminary Analysis* (Nov. 15, 2001) (unpublished manuscript, on file with the Iowa Law Review).

information during the period between quarterly earnings announcements, with the result that, by the end of the period, analysts' forecasts, however debatable, are as accurate as those prior to Regulation FD.<sup>230</sup> Moreover, their study found that price discovery has improved in the post Regulation FD period and that recent price volatility has actually decreased, suggesting higher overall levels of market information.<sup>231</sup> The study concluded that "in the post-Reg. FD environment, firms have found effective alternative means of informing analysts and investors about forthcoming quarterly earnings."<sup>232</sup>

Second, a study by Brian J. Bushee et al. employed two pre-Regulation FD samples and compared them to each other in the post-Regulation FD environment.<sup>233</sup> The first set of firms included those that restricted access to conference calls before Regulation FD became effective.<sup>234</sup> The second set included firms that had unlimited access.<sup>235</sup> To examine the effect of Regulation FD, the study's authors considered the timing, use, and information content of conference calls.<sup>236</sup> The authors found that only those firms that were likely to benefit little from the calls discontinued them.<sup>237</sup> They also found that the amount of information released during conference calls has not decreased.<sup>238</sup> Further, they found that the amount of individual investor trading during conference calls has increased, and that price volatility has increased for firms in the group previously restricting access.<sup>239</sup> They concluded, therefore, that Regulation FD has improved access to company information for all investors, and, with the exception of the small amount of increased volatility for a small subset of firms, the criticisms of Regulation FD appear to lack merit.<sup>240</sup>

Third, a study by Frank Heflin et al. focused specifically on price volatility.<sup>241</sup> Although the study identified increased stock market volatility following the adoption of Regulation FD, the authors concluded that the Regulation was unlikely to be the cause.<sup>242</sup> Moreover, the study found that although volatility increased around earnings pre-announcements, it

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230. *Id.* at 18.

231. *Id.* at 19.

232. *Id.* at 20.

233. Brian J. Bushee et al., *Managerial and Investor Responses to Disclosure Regulation: The Case of Reg. FD and Conference Calls* (Apr. 2002) (unpublished manuscript, on file with the Iowa Law Review).

234. *Id.*

235. *Id.*

236. *Id.*

237. *Id.* at 13.

238. Bushee, *supra* note 233, at 18.

239. *Id.* at 21-22.

240. *Id.* at 26.

241. Frank Heflin et al., *Stock Return Volatility Before and After Regulation FD* (2002) (unpublished manuscript, on file with the Iowa Law Review).

242. *Id.* at 30.

decreased around announcements of actual earnings.<sup>243</sup> This finding suggests that an increase in the incorporation of earnings information by the market may be reducing the informational impact of actual earnings announcements.<sup>244</sup>

Fourth, a study by Shyam V. Sunder used bid-ask spreads as a proxy for the presence of selective disclosure and its effect.<sup>245</sup> Sunder found that prior to Regulation FD, bid-ask spreads were higher in firms employing selective disclosure policies than for those choosing not to do so.<sup>246</sup> Sunder further found a decrease in bid-ask spreads since the enactment of Regulation FD—arguably indicating that Regulation FD is decreasing informational asymmetries and the correlative informational advantages some investors garnered—but his work also revealed that despite the contentions of companies and analysts, Regulation FD has not caused firms to decrease information provided through voluntary disclosures.<sup>247</sup> Importantly, Sunder's study offers reason to question other academic defenses of selective disclosure, including Goshen and Parchomovsky's liquidity-based defense.<sup>248</sup>

## 2. Regulation AC

Ironically, the SEC's initial method for addressing analyst conflicts was to warn investors about the risk of relying on analyst recommendations. In summer 2002, the SEC posted a brochure, *Analyzing Analyst Recommendations*, on its Web site warning investors about potential analyst conflicts of interest that may undercut the integrity of their recommendations and advising investors about how to uncover various types of conflicts.<sup>249</sup> In light of the increased focus on and controversy over analyst conflicts, this approach was clearly inadequate. Subsequently, in February 2003, the SEC adopted

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243. *Id.* at 22.

244. *Id.* at 25.

245. Shyam V. Sunder, *Investor Access to Conference Call Disclosures: Impact of Regulation Fair Disclosure on Information Asymmetry* (Jan. 10, 2002) (unpublished manuscript, on file with the Iowa Law Review).

246. *Id.* at 29.

247. *Id.*

248. Another study, employing a different approach, also finds that Regulation FD has reduced selective disclosure of information. *See* Eric Zitzewitz, *Regulation Fair Disclosure and the Private Information of Analysts* (Apr. 2002) (unpublished manuscript, on file with the Iowa Law Review). In his study, Mr. Zitzewitz measured the number of analyst forecasts released individually (solo forecasts) and compared that number to those released on the same day as other analyst reports (multi-day forecasts). *Id.* at 4. He found that solo forecasts decreased after the enactment of Regulation FD and that multi-day forecasts increased. *Id.* Prior to Regulation FD, approximately 70% of forecasts were solo forecasts and those forecasts contained 65% new information. *Id.* After Regulation FD, approximately 50% of forecasts were solo forecasts, and the percent of new information to the market from them was down to 27%. *Id.*

249. U.S. SEC. AND EXCH. COMM'N, *ANALYZING ANALYST RECOMMENDATIONS* (2002), available at <http://www.sec.gov/investor/pubs/analysts.htm> (on file with the Iowa Law Review).

Regulation Analyst Certification, or Regulation AC.<sup>250</sup> Regulation AC mirrors the certification approach adopted by the SEC for corporate CEOs and CFOs.<sup>251</sup> The new Regulation requires all brokers, dealers, and certain other persons associated with brokers and dealers to add certifications to their research reports stating that the research analyst believes that the report accurately reflects his or her personal views and disclosing any compensation or other payments received in connection with the recommendations or views.<sup>252</sup> In addition, analysts will now have to provide periodic certifications to broker-dealers in connection with analysts' public appearances. The goal of Regulation AC is to "promote the integrity of research reports and investor confidence in the reports."<sup>253</sup> It is important to note that Regulation AC creates no private right of action.

### C. DEVELOPMENTS IN SELF REGULATION

#### 1. NASD/NYSE Regulations

Recent controversy over analyst activities also has led to the proposal and promulgation of additional regulations from the self-regulatory organizations. The SEC recently approved new SRO regulations targeted at decreasing conflicts of interest.<sup>254</sup> The rules make several changes to the current investment banking and analyst structure.

First, the rules attempt to regulate ties between research reports and client solicitation. For example, the rules prohibit analysts from tying favorable ratings to investment banking services.<sup>255</sup> The rules also establish

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250. Regulation Analyst Certification, 17 C.F.R. § 242 (2002), available at <http://www.sec.gov/rules/final/33-8193.htm> (on file with the Iowa Law Review).

251. Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934, File No. 4-460 (U.S. Sec. and Exch. Comm'n June 27, 2002), available at <http://www.sec.gov/rules/other/4-460.htm> (on file with the Iowa Law Review).

252. 17 C.F.R. § 242.

253. *Id.*

254. See Research Analyst Conflicts of Interest, 67 Fed. Reg. 34,968, 34,969 (May 10, 2002). At the time this Article went to press, additional SRO proposed rule changes were pending. See NASD and NYSE Rulemaking: Proposed Rule Changes Relating to Exchange Rules 344, 345A, 351, and 472 and the National Association of Securities Dealers, Inc., Exchange Act Release N. 34-47110 (proposed Dec. 31, 2002), available at <http://www.sec.gov/rules/sr/34-47110.htm> (on file with the Iowa Law Review). These rule changes are designed to address analyst conflicts of interest by restricting who can prepare and approve research reports; limiting who can be involved in compensation decisions; limiting trading activities; requiring additional disclosures of conflicts; requiring member organizations to document analyst compensation and to include that compensation in certain statements filed with the SEC; requiring registration of analysts under certain new categories and qualification examinations for analysts; and creating continuing education programs for analysts and supervisory analysts designed to provide information on rules, regulations, ethics, and other professional responsibility issues. *Id.* These proposed rule changes are not significantly different from many components of the Merrill Lynch Agreement. See *infra* Part III.C.2.

255. Research Analyst Conflicts of Interest, 67 Fed. Reg. at 34,969.

quiet periods during which firms acting as managers or co-managers of offerings are prohibited from issuing reports on IPOs and secondary offerings, but only for forty days after the offering, not for the entire lock-up period.<sup>256</sup>

Second, the rules attempt to restructure the nature of the relationship between a firm's investment banking and research departments. To do so, the rules prohibit investment banking departments from having supervisory relationships with research analysts.<sup>257</sup> Counsel must monitor any discussions between the two departments about research reports.<sup>258</sup> In addition, clients may review research department reports only for factual accuracy.<sup>259</sup> The rules also prohibit links between an analyst's compensation and specific investment banking transactions.<sup>260</sup> Noticeably, however, the rules do not bar any compensation that is connected to investment banking business in general. Instead, the rules require only that the link be disclosed.<sup>261</sup>

Third, the rules require disclosure of financial ties between investment banks and their analysts and the companies who hire them. Securities firms must disclose in their research reports if they had a managerial role in a public offering of securities or had any other investment banking role with that company during the prior twelve months.<sup>262</sup> Securities firms also must disclose information in a prospective manner.<sup>263</sup> If they own 1% or more of a company's shares or expect to receive, or intend to seek, compensation for investment banking services from a company during the next three months, they must disclose that fact.<sup>264</sup>

Fourth, the rules focus on analysts' personal trading policies. If the company is in the sector for which an analyst provides coverage, the rules restrict the analyst and members of his or her households from investing in securities of a company prior to its IPO.<sup>265</sup> Analysts are also prohibited from trading in securities of issuers they follow for thirty days before and five days after they issue reports about the company.<sup>266</sup> Analysts must disclose if they own shares of companies recommended.<sup>267</sup> The rules also require analysts who make public appearances to disclose conflicts of interest, including

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256. *Id.* at 34,974-75.

257. *Id.* at 34,972.

258. *Id.*

259. *Id.* at 34,969.

260. Research Analyst Conflicts of Interest, 67 Fed. Reg. at 34,973.

261. *Id.*

262. *Id.*

263. *Id.*

264. *Id.* at 34,973.

265. Research Analyst Conflicts of Interest, 67 Fed. Reg. at 34,976.

266. *Id.*

267. *Id.*

whether they or the firm for which they work own securities in a covered issuer or if the issuer is an investment banking client of the firm.<sup>268</sup>

Fifth, the rules seek to provide clarity on the meaning and purpose of securities' firms rating mechanisms. Firms have been criticized for using euphemisms for their stock ratings.<sup>269</sup> Now, firms must explain in their research reports the meaning of the terms they use, and they must use terms in a manner consistent with their plain meaning.<sup>270</sup> In addition, those firms must provide statistics on the percentage of ratings per term, relative to the number of investment banking clients in each category.<sup>271</sup> Other statistical information must be relayed in the form of a chart or graph.<sup>272</sup> Here, securities firms must depict historical price movements of a particular security, juxtaposed with their own ratings and changes in those ratings, as well as the firm's own price targets for the issuer.<sup>273</sup>

## 2. The Merrill Lynch Settlement

The settlement of the New York Attorney General's investigation into Merrill Lynch has created another form of regulation that is best classified as self-regulation. Pursuant to the settlement agreement (the "Merrill Agreement"), Merrill Lynch agreed to make certain reforms and disclosures.

268. *Id.* at 34,975.

269. *See* Siconolfi, *supra* note 123.

270. *See* Research Analysts Conflicts of Interest, 67 Fed. Reg. at 34,970.

271. *Id.* at 34,974.

272. *Id.*

273. *Id.* These rules address the recommendations of the Securities Industry Association, one of the earliest proponents for changes in analyst/issue/underwriter relations. Key components of the recommendations include (1) Research departments should not report to investment banking or any other business units that might compromise their independence; (2) analysts should be encouraged to indicate both when a stock should be bought and when it should be sold, and management should support the use of the full ratings spectrum; (3) analysts should not trade against their recommendations and should disclose their holdings in companies they cover; (4) analysts' pay should not be directly linked to investment banking transactions, sales, and trading revenues or asset management fees. *Id.*; *see also* SEC. INDUS. ASS'N, BEST PRACTICES: SOFT DOLLAR AND OTHER COMMISSION ARRANGEMENTS (1997), *available at* <http://www.sia.com/publications/pdf/bpdollar.pdf> (on file with the Iowa Law Review).

In January 2002, John Ramsay, senior regulatory counsel at The Bond Market Association and former deputy general counsel at NASDR, reported that a joint regulatory effort was underway between the SEC, the NASD and the NYSE to make the SIA's best practices mandatory. *See* S.J.T., *Regulators to Formalize Best Practices for Analysts*, COMPLIANCE REP., Jan. 27, 2002, *available at* <http://www.compliancereporter.com/news/regulators+to+formalize+best+practices.asp> (on file with the Iowa Law Review).

In Canada, the Securities Industry Committee on Analyst Standards, known as the Crawford Committee after its leader, Purdy Crawford, made similar recommendations, primarily for disclosure of analyst conflicts of interest, in an effort to protect retail investors. Interestingly, the Crawford Report also urged a degree of institutional investor activism, recommending that institutions measure the value added by analyst research and, where possible, allocate their trading business to reflect that value.

Because the investigation was not limited to Merrill Lynch, the terms of the Merrill Agreement are expected to spread to other firms as well.

In addition to paying \$100 million in penalties, Merrill Lynch agreed to change the way it compensates its stock analysts.<sup>274</sup> Now, investment bankers will have no role in determining how much analysts are paid.<sup>275</sup> The bankers are not allowed to evaluate analysts,<sup>276</sup> communicate with analysts about their salaries, or communicate with anyone else responsible for determining salaries.<sup>277</sup> Merrill Lynch also agreed to prohibit people involved in determining analyst compensation from soliciting or using information about investment banking revenues received from covered companies.<sup>278</sup> Finally, anyone involved in determining analyst compensation is prohibited from considering any information about analysts received from investment bankers.<sup>279</sup> Analyst compensation is to be determined only by the research department managers.<sup>280</sup>

The Merrill Agreement specifies the appropriate factors to be considered in compensation decisions, stating that analyst salaries are to be “based primarily upon”<sup>281</sup> the quality of the research and performance of recommendations;<sup>282</sup> competitive compensation factors;<sup>283</sup> input from investor clients;<sup>284</sup> and input from other, non-investment banking divisions at Merrill.<sup>285</sup> Pay is to be based solely on services intended to benefit Merrill’s investor clients.<sup>286</sup> These services include the formulation of research and reports;<sup>287</sup> communication of investment information to investor clients;<sup>288</sup> “cooperation, accessibility and responsiveness consistent with serving investor clients”;<sup>289</sup> and participation in identification of investment opportunities.<sup>290</sup>

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274. Patrick McGeehan, *\$100 Million Fine for Merrill Lynch*, N.Y. TIMES, May 22, 2002; *see also* Agreement Between the Attorney General of the State of New York and Merrill Lynch, Pierce, Fenner & Smith, Inc. ¶ 7–11 (May 21, 2002), available at [http://news.corporate.findlaw.com/legalnews/documents/archive\\_m.html](http://news.corporate.findlaw.com/legalnews/documents/archive_m.html) (on file with the Iowa Law Review) [hereinafter Merrill Agreement] (settlement agreement detailing changes in analyst compensation).

275. *See* McGeehan, *supra* note 274.

276. Merrill Agreement, *supra* note 274, ¶ 9(b).

277. *Id.* ¶ 9(c).

278. *Id.* ¶ 9(a).

279. *Id.* ¶ 9(d).

280. *Id.* ¶ 10.

281. Merrill Agreement, *supra* note 274, ¶ 10.

282. *Id.* ¶ 10(a).

283. *Id.* ¶ 10(b).

284. *Id.* ¶ 10(c).

285. *Id.* ¶ 10(d).

286. Merrill Agreement, *supra* note 274, ¶ 8.

287. *Id.* ¶ 8(a).

288. *Id.* ¶ 8(b).

289. *Id.* ¶ 8(c).

290. *Id.* ¶ 8(d).

In addition, the Merrill Agreement requires Merrill Lynch to set up a new Research Recommendations Committee (the “RRC”). The role of the RRC is to monitor and supervise research recommendations for “objectivity, integrity, and . . . rigorous analy[sis].”<sup>291</sup> RRC membership will include both sales and research people.<sup>292</sup> The RRC will have the power to approve any initiation of or change in research recommendations.<sup>293</sup> Analysts requesting the power to make such changes will be required to provide information as to their conflicts with the covered companies.<sup>294</sup>

The Merrill Agreement also regulates the role of analysts in the solicitation of investment banking business. The Merrill Agreement makes clear that analysts will continue to participate in the solicitation of business.<sup>295</sup> Management of their division, however, must approve any such participation in advance.<sup>296</sup> Analysts will be required to inform the RRC of any such participation.<sup>297</sup> Further, the Merrill Agreement states that Merrill has agreed to prohibit analysts “from promising, implying, offering, or communicating in any way that a specific recommendation or change of an existing recommendation will be made in exchange for the awarding of an investment banking transaction.”<sup>298</sup> Analysts also are prohibited from lowering ratings in retribution for loss of business.<sup>299</sup>

The Merrill Agreement also requires Merrill to disclose, in its research reports, any compensation “it has received or is entitled to receive” from companies covered in those reports.<sup>300</sup> Merrill must include a standard statement on all such reports telling investors that they should assume that Merrill has sought and will continue to seek investment banking business with covered companies.<sup>301</sup> Merrill’s research reports will include specific disclosures, on a percentage basis, of rating categories used by Merrill for other stocks in that company’s industry, stocks for which Merrill provided

291. Merrill Agreement, *supra* note 274, ¶ 12.

292. *Id.* ¶ 12(a).

293. *Id.* ¶ 12(b).

294. *See id.* ¶ 12(c) (“[T]he relevant research analyst shall disclose to the RRC any participation by the analyst with investment bankers in an investment banking transaction for the subject company within in the last 12 months.”).

295. *See id.* ¶ 14 (setting forth procedure to be followed in solicitation of investment banking business).

296. *See* Merrill Agreement, *supra* note 274, ¶ 14(a) (requiring Research Management to approve solicitations for investment banking transactions).

297. *See id.* ¶ 14(b) (demanding research analysts to disclose “intended participation” in solicitation).

298. *Id.* ¶ 14(d).

299. *See id.* ¶ 14(e) (prohibiting “analysts from changing any research recommendation”).

300. *Id.* ¶ 5(b).

301. *See* Merrill Agreement, *supra* note 274, ¶ 5(c) (including legend that investors should assume Merrill Lynch is seeking other business).



investment banking services, and other stocks covered by Merrill in general.<sup>302</sup>

The Merrill Agreement requires the disclosures in solicitation documents to be changed.<sup>303</sup> Under the settlement, those documents must now state that Merrill prohibits its employees from offering pricing or recommendations as part of the solicitation process.<sup>304</sup> The documents also must state that analysts are prohibited from being compensated in connection with the investment banking business except if their work is intended to benefit investor clients.<sup>305</sup>

The Merrill Agreement further requires Merrill to provide disclosures whenever it terminates coverage of an issuer.<sup>306</sup> The disclosures must state the rationale for the decision<sup>307</sup> and that the last recommendation should not be relied upon in the future.<sup>308</sup> To ensure compliance with these provisions, Merrill must appoint a one-year compliance monitor.<sup>309</sup> That person's job will be to ensure that the provisions are enacted and to serve as an ombudsperson for Merrill staff.<sup>310</sup>

### 3. The Impact of Regulation on the Conflicts

As discussed in Part II of this Article, the role of security analyst is rife with potential conflicts of interest. Both the newly adopted NASD regulations and the Merrill Agreement purport to revise the ways analysts do business in order to eliminate these conflicts. Regulation FD similarly attempts to reduce conflicts indirectly by regulating issuer conduct. Regulation AC regulates analysts directly, but focuses primarily on disclosure rather than elimination of conflicts. Together, the rules remain fraught with loopholes. As described above, one source of analyst conflicts is the analysts' personal trading in covered securities. Regulation FD does not purport to speak to this issue. The Merrill Agreement does not address it either. By requiring certification of analysts' belief in their recommendations, Regulation AC arguably addresses this issue, but in an indirect fashion and only through disclosure. The power of disclosure-based remedies to fix the problem, however, is open to considerable debate.

The NASD regulations do restrict ownership in two ways. First, analysts may not hold pre-IPO shares, but only in the sector for which the analyst

302. *Id.* ¶ 5(d)(i)-(iv).

303. *See id.* ¶ 15 (setting forth disclosure requirements during solicitation of public equity underwriting).

304. *Id.* ¶ 15(a).

305. *Id.* ¶ 15(b).

306. Merrill Agreement, *supra* note 274, ¶ 16.

307. *Id.* ¶ 16(a).

308. *Id.* ¶ 16(b).

309. *Id.* ¶ 17.

310. *Id.* ¶ 17.

provides coverage. For example, a bank analyst cannot own bank securities pre-IPO, but she can own securities in an Internet firm. Therefore, analysts can help each other or buy venture securities in firms in which their employers do venture investing and can still benefit from each other's positive ratings and investment banking work. Thus, the rules do not address the basic venture conflict that exists when investment-bankers hold shares in companies they take public. Second, even though analysts can still hold post-IPO shares in companies they cover, their ability to trade securities of those companies is limited under the NASD regulations. This limitation prohibits analysts from trading these shares for thirty days prior to releasing reports and for five days after. This restriction limits the potential severity of the conflict but does not eliminate it.

Similarly, both the NASD and the Merrill Agreement attempt to address business conflicts by drawing lines between investment banking and research departments. Neither does so successfully. Although both seek to eliminate the supervisory role of investment bankers over analysts, neither prevents analysts from participating in the investment banking side of the business so long as the analyst's participation is monitored—either by counsel or by a special committee and enhanced disclosure. The NASD rules also prohibit ties between specific investment banking work and analyst compensation, but not general investment banking work. Again, this significant potential loophole makes clear that analysts are still expected to work in investment banking and to participate in client meetings. Under both sets of rules, analysts can still solicit business, but they cannot promise ratings in exchange for business or punish companies when they lose business. In addition, the links between the investment bankers and covered companies must be disclosed.

The NASD rules also restrict research reports post-IPO in an attempt to prohibit the highly criticized “booster shots.” Unfortunately, the rules provide only a forty-day quiet period, not a quiet period tied to the length of the lock-up. Thus, if the lock-up agreement is for 180 days, the investment bank's research department cannot release a report during the first forty days after the IPO, but is free to do so thereafter. At that point in time, the analyst can hold shares in the company, so the ownership conflict still exists. Finally, the NASD rules prevent clients from commenting on research reports, except to confirm their accuracy. The value of this restriction appears limited—to the extent that the client's comment is material, Regulation FD arguably prohibits it anyway.

Although the new rules improve analyst regulation, they fail to eliminate existing conflicts. Analysts are still permitted simultaneously to sell securities and to provide evaluations of those same securities. Analysts are still allowed to trade in some securities for which their fellow employees provide coverage. In addition, under the new regulatory regime, analysts

must still attempt to maintain conflicting duties to their employers, the market, their issuer clients, and the investors.

Finally, and most important, the existing regulatory reforms are purely reactive. They identify conflicts of interest that have been problematic and attempt to prohibit the relationships that give rise to those conflicts. This approach is fundamentally flawed. Freedom from investment banking ties, even in the strictest sense, does not guarantee analyst independence. Rather, as the history of analyst funding demonstrates, analyst research traditionally has been subsidized through other business activities. There is every reason to believe that this practice of cross-subsidization will continue. As one of this Article's authors has argued elsewhere, because of its public goods quality, analyst research cannot be sustained without additional financing support.<sup>311</sup> If investment banking revenues subsidized analyst research before, some other source of funding will have to take their place. Investment banking conflicts are likely to be replaced by other—perhaps less transparent—business relationships. Indeed, many research firms that qualify as independent under the most recent reforms have business relationships that could jeopardize the reliability of their reports.<sup>312</sup>

#### D. THE SARBANES-OXLEY ACT OF 2002

On July 30, 2002, President Bush signed the Sarbanes-Oxley Act of 2002 (the "Act").<sup>313</sup> The Act addresses a broad range of issues relating to corporate governance, disclosure, and fraud. Included among the many provisions is section 501, which focuses on analyst conflicts of interest.<sup>314</sup> Section 501 amends the Securities Exchange Act of 1934 by adding a new section, 15D. Section 15D imposes a mandatory rulemaking obligation on the SEC. Within one year, the SEC is required to adopt or authorize an SRO to adopt rules "reasonably designed to address [analyst] conflicts of interest."<sup>315</sup> The Act identifies the objectives of "foster[ing] greater public confidence in securities research" and "protect[ing] the objectivity and independence of securities analysts."<sup>316</sup> Congress explicitly identified a variety of structural safeguards to establish more effective Chinese walls to insulate analysts from investment banking influence in order to accomplish

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

312. See, e.g., Susanne Craig, *Will Investors Benefit from Wall Street's Split?*, WALL ST. J., Dec. 23, 2002, at C1 (observing that Sanford C. Bernstein & Co. and Prudential Financial Co., two firms commonly cited as independent research houses, are part of larger entities with substantial mutual fund operations which raise "at least the potential for conflict").

313. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 501, 116 Stat. 745 (2002).

314. *Id.*

315. *Id.* § 501, 116 Stat. at 791.

316. *Id.*

these objectives.<sup>317</sup> In addition, the Act mandates rulemaking to increase disclosure of analyst conflicts of interest, including the extent of an analyst's investments in securities of a covered issuer; business relationships between covered issuers and brokerage firms; compensation received from the issuer by the analyst or the brokerage firm; and any other material conflicts.<sup>318</sup>

#### E. SEC-SPITZER AGREEMENT TO REFORM INVESTMENT PRACTICES

On December 20, 2002, the SEC and New York Attorney General Eliot Spitzer announced that they had reached an agreement in principle with the various SROs and state regulatory authorities to reform investment practices.<sup>319</sup> The agreement is designed to operate as a global settlement of Spitzer's investigation into allegations of analyst misconduct at ten major Wall Street firms. As of March 2003, the agreement had not been finalized. The substantive terms of the agreement include severing links between analysts and investment banking, including any compensatory links and the standard practice of including analysts in road shows and other pitches; banning spinning to corporate executives and directors; requiring the covered brokerage firms to contract with independent research firms to provide research to that firm's customers, with regulators involved in the process; and disclosing publicly analyst recommendations, ratings, and price targets.<sup>320</sup> In addition, the settlement calls for investment banking firms to pay a total payment of \$1.4 billion in fines, penalties and restitution, with a portion of the money designated for investor education.<sup>321</sup> When finalized, the agreement will require full Commission approval. The most significant portions of this settlement are arguably the ban on spinning and the provisions for independent research. Because the actual language of the agreement has not been agreed upon—and was apparently still the subject of debate at the time this article went to press<sup>322</sup>—it is not possible to offer a critique of the provisions.<sup>323</sup>

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317. *Id.*

318. Sarbanes-Oxley Act § 501.

319. Press Release, U.S. Securities and Exchange Commission, 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/new/press/2002-179.htm> (on file with the Iowa Law Review).

320. *Id.*

321. The amount of this settlement is quite small relative to investment banking revenues and much of it will be tax deductible. Hillary A. Sale, *Gatekeepers, Disclosure, and Issuer Choice*, 82 WASH. U. L.Q. (forthcoming 2003).

322. See, e.g., Charles Gasparino, *Analyst Pact Is Held up by Words*, WALL ST. J., Jan. 16, 2003, at C1 (describing fight over language of settlement).

323. Cf. Choi & Fisch, *supra* note 311 (criticizing provision obligating firms to provide independent research and proposing alternative method of subsidizing independent research through voucher dollars).

## IV. SUMMARY OF DEFICIENCIES IN EXISTING REGULATION

Existing attempts to regulate securities analysts, including the Sarbanes-Oxley Act, are flawed. The flaw is the failure to conceptualize the analyst's role properly. Of course, securities analysts might be viewed simply as salespeople. If we accept the fact that analysts are, by and large, employees of investment banks that generate most of their revenue selling securities in public offerings, the analysts' ties to the investment banking business are not conflicts of interest. Similarly, it is not inappropriate to compensate salespeople with a share of the revenues generated by their efforts; salespeople are routinely paid on commission. Even personal trading does not present a problem if it is fully disclosed because salespeople owe no conflicting duties to potential buyers other than the obligation to refrain from fraud. Viewed in this light, existing regulatory efforts are unwarranted.

The Sarbanes-Oxley Act, however, is simply the most recent indication that courts, regulators, and commentators do not believe that analysts should be treated as traditional salespeople. Despite evidence raising troubling questions about the effectiveness of analysts in conveying information to the marketplace, these decisionmakers apparently believe that analysts serve a valuable role in doing so. Moreover, because of analysts' ability to obtain, evaluate, and disseminate information, policymakers view analysts as gatekeepers, enabling the market to discipline management through pricing. In *Dirks*, the Supreme Court based its decision to afford favorable regulatory treatment to analysts on the analysts' theoretical role in improving market efficiency. Existing favorable regulatory treatment stems from the belief that analysts "are crucial players in the mechanisms of marketplace efficiency that lead to optimal allocations of capital resources."<sup>324</sup> Similarly, recent calls for increased analyst independence are premised on the theory that, by serving as gatekeepers, analysts can reduce the incidence of fraud and other wrongdoing by corporate management.

Motivating this approach is the recognition that analyst reports and recommendations remain influential and can have a substantial effect on the price and volume of securities transactions. Simply put, analyst reports affect market prices.<sup>325</sup> Although investors may be aware that analysts have a variety of incentives to recommend stocks inappropriately, there are uncountable cases in which analyst hype alone seems to have resulted in significant stock price movements.<sup>326</sup> Interestingly, stock downgrades, which occur considerably less frequently, result in even more dramatic market reactions than do positive reports.<sup>327</sup>

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324. Langevoort, *supra* note 22, at 1024.

325. Rogers & Fogarty, *supra* note 20, at 4.

326. See COLE, *supra* note 45, at 97-119 (citing examples).

327. See generally Scott E. Stickel, *The Anatomy of the Performance of Buy and Sell Recommendations*, 51 FIN. ANAL. J. 25 (1995).

This market response leads to the concern that, if analyst information is sufficiently affected by the conflicts and incentives described above, it leads to distorted stock prices and reduced market efficiency. Accordingly, in addition to misleading investors who trade on the basis of inaccurate recommendations, conflicted analysts disrupt the operation of the securities markets. The resulting inefficiency interferes with appropriate allocations of capital. Hyped IPOs generate large sums of capital for companies that have no realistic prospects of success and which subsequently become insolvent, leaving investors holding the bag. At the same time, viable companies with reasonable prospects find it difficult to attract the necessary analyst attention to obtain financing. For established companies, reports that are based on the incentives created by personal trading and the prospect of investment banking revenue fail accurately to convey corporate information to the marketplace. Further, in an effort to meet analyst expectations or curry favor with high profile analysts, issuers may make inappropriate corporate decisions. In particular, analyst demands for high-paced growth may lead companies to adopt unrealistic business plans. When these plans fail to meet their goals, corporate officials may resort to outright fraud. Joseph Fuller and Michael Jensen posit, based on this reasoning, that analyst pressure was responsible, at least in part, for the demise of Enron.<sup>328</sup>

As a practical matter, analysts play a dual role, seeking to further the business of the firms that employ them, including brokerage and investment banking operations, while at the same time conveying sufficiently reliable information to influence market prices. These two components of the analyst role are not readily separated. The analyst's relationship to his firm and the firm's other business activities provides financial support for the analyst's research. Society cannot reasonably expect analysts to engage in costly research and then disseminate the results of that research to the market for free, absent some other source of financing. Furthermore, analysts can only imperfectly recover the costs of their research through market transactions, and, absent subsidization, the high cost of quality research is likely to impede its full dissemination into the marketplace. The analyst's so-called conflicts also may be the source of useful information and valuable synergies if, for example, the firm productively deploys the research that informs analyst recommendations in the context of IPO pricing.

Moreover, the access afforded by the analyst's business relationships lends credibility to the analyst's report. Investors rely on analyst research, in part, because they believe that analysts have both superior information and an incentive to convey that information to the marketplace accurately. The analyst role in increasing market efficiency depends crucially on the analyst's ability to influence pricing and trading decisions. Regulators do not want the public to view analysts merely as salespeople. Such a view, even if

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328. Fuller & Jensen, *supra* note 136, at 43-44.

accurate, would undercut the analyst's ability to affect market pricing. Yet, only if investors are willing to trust analysts, will the analyst's gatekeeping role be possible.

## V. A BETTER SOLUTION—THE QUASI-AGENCY MODEL

### A. DEVELOPMENT OF THE QUASI-AGENCY MODEL

Existing regulatory efforts cannot adequately address the conflict problems identified earlier because they fail to capture the dual aspects of the analyst's role. Accordingly, this Part proposes an alternative framework for examining security analyst behavior: the quasi-agency model. The motivation for this model is threefold. First, existing efforts to regulate analysts have paid insufficient attention to the need to fund analyst research. Second, although recent scandals have led to the promulgation of prohibitions on existing analyst conflicts, they are piecemeal solutions that do little to address the more general problem of analyst incentives. Third, even if it can be obtained, independence alone is insufficient to engender analyst reliability as a source of market information.

Based on these conclusions, logic suggests that regulation should impose two primary constraints on analyst behavior. First, analyst behavior should not be compromised by the analyst's business objectives. Second, analysts should be required to provide certain assurances about the information that they disseminate to the market. Both of these constraints are related closely to the fiduciary principles applicable to a traditional agency relationship. In light of this similarity, therefore, a quasi-agency model is better tailored to the problems relating to analyst reliability than a "gatekeeper" model.

The quasi-agency model starts from the premise that analysts are economic agents in the sense that they act for the benefit of others.<sup>329</sup> The interaction between these economic agents and their principals creates certain costs that Jensen and Meckling identify as "agency" costs. These agency costs consist of monitoring expenditures by the principal, bonding expenditures by the agent, and residual losses not prevented by either monitoring or bonding.<sup>330</sup> These costs can occur even where there is no legal or formal agency relationship.<sup>331</sup> Ultimately, agency costs are the result of two things: (1) the difference between the goals of the agent and those of the principal and (2) informational asymmetries between agent and

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329. Jensen & Meckling, *supra* note 12, at 305.

330. *See id.* at 308; *see also* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 304 (1983) (defining agency costs as "the costs of structuring, monitoring, and bonding a set of contracts among agents with conflicting interests").

331. As Jensen and Meckling observed: "Agency costs arise in any situation involving cooperative effort . . . by two or more people even though there is no clear cut principal-agent relationship." Jensen & Meckling, *supra* note 12, at 309.

principal.<sup>332</sup> Economic agency theory therefore focuses on addressing these two problems.<sup>333</sup>

Analyst conflicts of interest increase agency costs due to the difference between the analyst's goals and those of the principal. Yet, the effort to reduce these costs by eliminating analyst conflicts is flawed. Even within the gatekeeper model, analysts will be subject to conflicting objectives because they act as economic agents for several distinct principals. Analysts act on behalf of their employers, whose interests are often, but not always, aligned with those of the issuer client. Analysts also act on behalf of issuers through their receipt of market-sensitive corporate information and dissemination of that information into the capital markets. This function furthers various corporate purposes, including increasing public awareness of the issuer and its operations to facilitate capital formation, increasing securities sales in a public offering, and increasing the extent to which market prices accurately reflect the corporation's present and future operating results. Finally, analysts act on behalf of investors and the markets generally when providing reliable information intended to influence market prices.

The fact that analysts act for the benefit of several different groups—and that the law and regulations presume that they do—creates an unavoidable conflict. Independent of any self-interested behavior, analysts face conflicting incentives to the extent that one group's interests differ from those of another group. The multiple conflicts faced by the securities analyst are not unique. Agents commonly face the constraint that the interests of one principal limit the analyst's discretionary behavior on behalf of another. For example, partners in a law firm are agents of both their firm and the firm's clients; indeed, they owe fiduciary duties to both. The firm has an interest in maximizing its revenue from client representation; the client has an interest in obtaining the best quality service possible for the lowest fee. Although these interests are in tension, we do not conclude that the conflict is impermissible. Instead, the attorney's discretion to maximize firm revenues is constrained by the attorney's fiduciary duty to the client, which precludes the attorney from charging more than a reasonable fee.

As in the attorney example, fiduciary principles offer one mechanism for limiting the extent to which an agent's objectives may diverge from those of the principal. In trust law and corporate law, the duty of loyalty requires the agent to give primacy to the interests of the principal. In a customer-supplier relationship, the duty of loyalty does not apply, but the contract doctrine of good faith provides an analogous constraint. The quasi-agency model suggested here utilizes a duty similar to these. Thus, instead of barring analyst business relationships as other proposals suggest, we propose

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332. Kathleen M. Eisenhardt, *Agency Theory: An Assessment and Review*, 14 *ACAD. MGMT. REV.* 57, 58 (1989).

333. *Id.*



that such relationships should be constrained by a "duty of reliability." With respect to conflicts, an analyst would breach this duty of reliability if he issued a report or recommendation that would not have been issued by a reasonable person, similarly situated, who lacked the conflicting relationship. As with the attorney's fee discussed above, standard market practices would provide a benchmark for the legal standard.

By framing the analyst's obligation in terms of a duty of reliability, the analyst is given greater freedom to cross-subsidize research by providing services to other business operations than under the recent regulatory reforms. At the same time, the analyst would be precluded from allowing those services to influence the nature or quality of his research or the resulting recommendations. The standard also would reach other potentially conflicting interests, including those that regulators have not yet identified. Thus, the duty of reliability would provide the same type of gap-filling and flexibility that are valuable components of traditional fiduciary duties.

The analyst's duty of reliability would reduce agency costs in two ways. First, it would decrease the need for investors to investigate and evaluate potential analyst conflicts. In comparison to increased disclosure requirements, a duty of reliability would place the burden on the analyst to avoid being influenced by competing business considerations. Second, the duty would reduce monitoring costs. Investors would not face the need to keep tabs on the analyst's related business activities to ascertain potential motives for analyst statements.

Another concern about analyst behavior is that an analyst's report or recommendation may falsely imply that the analyst has engaged in an appropriate amount of research and possesses a suitable factual basis for the conclusions therein. The problem faced by the market in evaluating analyst research in this case involves an informational asymmetry. It is impossible for investors to verify whether the analyst has engaged in sufficient research to justify his conclusions. At the same time, under current law, the analyst is under no obligation to disclose factors that may undercut the reliability of the conclusions unless those factors rise to the level of a disabling conflict. Imposing a duty of reliability also can alleviate this concern. Accordingly, we propose that the duty of reliability incorporate the treatment of analyst recommendations as implied factual statements, in which the analyst is held accountable both for his or her belief in the statements and for having a reasonable basis for making them. This component of the duty of reliability finds support in the Supreme Court's analysis in *Virginia Bankshares, Inc. v. Sandberg*.<sup>334</sup> *Virginia Bankshares* involved an effort by an issuer's directors to avoid liability for securities fraud on the basis that the statements that they made in proxy materials that characterized a proposed merger as "fair" were

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334. 501 U.S. 1083 (1991).

merely opinions rather than fact. The Court recognized that statements of belief or opinion “are factual in two senses: as statements that the directors do act for the reasons given or hold the belief stated and as statements about the subject matter of the reason or belief expressed.”<sup>335</sup>

It is unlikely that, under current law, courts would hold analysts to the standard of disclosure articulated in *Virginia Bankshares*. First, the statements in *Virginia Bankshares* were misleading, in part, because they failed to disclose all the relevant information that the directors possessed about the value of the firm.<sup>336</sup> The Supreme Court has stated repeatedly that omissions are actionable under the federal securities laws only when the speaker has a duty to disclose.<sup>337</sup> Although corporate insiders are often charged with such a duty, based on their fiduciary obligations under state corporate law,<sup>338</sup> analysts do not possess an analogous obligation. Second, the *Virginia Bankshares* Court expressly premised its holding on the fact that the defendants were corporate directors, reasoning that stockholders would view directors’ statements as reliable both because of the directors’ expertise and knowledge and because of the directors’ state law fiduciary obligations.<sup>339</sup>

Nonetheless, the Court’s reasoning applies with equal force to analyst recommendations. Investors believe that analysts have superior information and expertise, and that knowledge is what gives analysts the power to affect market prices. Moreover, for analysts to act as effective gatekeepers, it is not only desirable but also necessary that investors rely on them in the manner described in *Virginia Bankshares*. Finally, the informational disparity between investors and analysts is best addressed by a rule that treats analyst recommendations as factual statements and holds analysts accountable if they do not actually believe those statements or if they lack a reasonable basis for making a particular recommendation.<sup>340</sup> Such an “implied fact” rule, implemented as the second component of the analyst’s duty of reliability, gives analysts an incentive to reduce agency costs by disclosing to investors all relevant information about the basis for their recommendation, including any limitations on their research, conflicting evidence, and so

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335. *Id.* at 1092.

336. *See id.* at 1094 (describing how statements failed to disclose evidence of the thinness of the market and about the going concern value of the firm).

337. *See Chiarella v. United States*, 445 U.S. 222, 230 (1980) (noting that silence may be fraudulent but only when there is a duty to disclose).

338. *See Dirks v. SEC*, 463 U.S. 646, 654 (1983) (identifying “independent fiduciary duties” owed by corporate insiders to the corporation and its shareholders).

339. *Virginia Bankshares*, 501 U.S. at 1091 (“Shareholders know that directors usually have knowledge and expertness far exceeding the normal investor’s resources, and the directors’ perceived superiority is magnified even further by the common knowledge that state law customarily obliges them to exercise their judgment in the shareholders’ interest.”).

340. *See Vulcan Metals Co. v. Simmons Mfg. Co.*, 248 F. 853, 856 (2d Cir. 1918) (“An opinion is a fact . . . . When the parties are so situated that the buyer may reasonably rely upon the expression of the seller’s opinion, it is no excuse to give a false one.”).

forth. Regulation AC provides part of the mechanism for creating such a duty—requiring analysts to certify their belief in what they say—but is limited to the subjective component of the duty of reliability proposed here. Moreover, Regulation AC does not create a private right of action and, absent significant new provisions for liability, is arguably ineffective in creating a functioning duty of reliability.

A quasi-agency approach to analyst regulation is also justified by the legal and regulatory roles imposed on analysts as gatekeepers who have the capacity to harm issuers, shareholders, and the market generally. Under state law, corporate insiders owe fiduciary duties to the issuer and its shareholders because of this capacity to do harm. In defending traditional insider trading liability, for example, Goshen and Parchomovsky focus on agency principles, demonstrating that much of the harm from insider trading stems from the fact that it generates incentives and conflicts that are inconsistent with the corporate official's fiduciary obligations to the corporation. At a minimum, insider trading may distract corporate insiders from focusing on corporate operations. More important, the ability to exploit corporate information for personal profit creates a conflict between the insider's interests and those of the corporation and its shareholders.<sup>341</sup>

This agency analysis can be extended to analyst regulation. Although the Supreme Court has distinguished between analysts and traditional corporate agents,<sup>342</sup> its argument is based on false assumptions.<sup>343</sup> Securities analysts are not standard corporate agents in the legal sense.<sup>344</sup> Nonetheless,

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341. For example, insiders may hoard corporate information for their private trading benefit, reducing the overall quality and quantity of corporate disclosure. They face greater incentives to distort corporate disclosure in order to enhance their trading profits. To achieve this goal, insiders may manipulate the timing and even the substance of corporate decisions.

342. *Dirks v. S.E.C.*, 463 U.S. 646, 658–59 (1983).

343. Similarly, Goshen and Parchomovsky argue that because analysts are not corporate decisionmakers, their use of nonpublic information does not create comparable agency costs. Goshen & Parchomovsky, *supra* note 164, at 1261; *see also id.* at 1259–60 (reasoning that, unlike traditional insiders, analysts cannot influence firm decision-making for their personal benefit, nor can they control scope or timing of corporate disclosure).

344. The classic elements of legal agency—consent, benefit and control—are present in the analyst's relationship with his employer, the issuer, and the investing public. *See, e.g.*, *Hanson v. Kynast*, 494 N.E.2d 1091, 1094–96 (Ohio 1986) (setting forth basic elements of agency). The analyst's role is clearly consensual from the perspective of all participants, including the analyst's employer, the issuer that voluntarily uses analysts both to disseminate information and to control that information and the manner in which it is disseminated, and investors who rely on analyst reports and pay, directly and indirectly, for analyst services.

With respect to control, analysts are subject to the control of their employers. Analysts are also accountable to, and hence under the control of, investment banking clients. Issuers exercise substantial control over analysts even though they are not the analysts' direct employers, as demonstrated by the evidence in Part II of this Article. Finally, in preparing research and reports that are directed to the investing marketplace, analysts are under the indirect control of investors.

agency conflicts create an analogous risk that analysts will use their influence over market information and firm decision-making to benefit themselves or competing business interests.

The gatekeeping model of the securities analyst is premised on the idea that the analyst's interests will be aligned with those of the issuer and the marketplace. Analysts traditionally have received market-sensitive corporate information that they are supposed to use for corporate purposes. These purposes may include increasing public awareness of the issuer and its operations to facilitate capital formation, increasing securities sales in a public offering, or increasing the extent to which market prices accurately reflect the corporation's present and projected operating results. Analysts control the degree to which this information actually benefits the corporation by varying the extent to which they release it in a timely and accurate fashion. Conflicts of interest induce analysts to distort this information flow. The ownership interests of analysts and their personal trading of covered securities create an incentive for them to distort or hoard information and to manipulate the timing of disclosures in order to create and exploit trading opportunities. Likewise, business interests, such as the desire to promote investment banking business, create an incentive for analysts to generate unduly optimistic reports and recommendations. The result of these conflicts is a tension between the business interest and the gatekeeping role. The access and information interests may create further analyst bias by interfering with analysts' ability to monitor management effectively.

Like corporate insiders, analysts can affirmatively harm corporate operations. The timing of operational decisions may be motivated by the timing of financial disclosures, such as a pending 10Q release, rather than by business factors. Analysts' ownership and business interests can combine to create an emphasis on short-term results, which may affect their own portfolios and those of their clients, but may cause management to underinvest in research and development and other long-term projects, thereby sacrificing long-term growth. Analysts also can cause stock price movements that interfere with mergers or other operational decisions. Most important, by demanding rapid growth and releasing unrealistic projections, analysts can pressure corporate officials to invest in excessively risky projects, to "manage" earnings and other financial data, and even to engage in fraud.

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Last, analysts provide a variety of benefits for issuers, investors, and the marketplace. If their information is accurate, issuers benefit from a more effective and reliable disclosure method, investors benefit by receiving valuable securities information as well as monitoring, and the markets benefit from greater efficiency. Even when the information is distorted through the conflicts described above, analysts are working primarily for the benefit of others, including issuers who benefit from analysts' services that facilitate their public offerings and institutional investors who can use preferential information to create trading opportunities.

There is no evidence to show that these harms are outweighed by the efficient market benefits that were emphasized by the *Dirks* Court.<sup>345</sup> Indeed, existing empirical evidence leads to the opposite conclusion. Although truly independent research and analysis might serve a valuable market function, analyst distortions currently are more likely to decrease market efficiency than increase it. As Donald Langevoort has explained, recent empirical research supports the view that analysts are contributing to mispricing, rather than accurate pricing.<sup>346</sup>

In sum, the reality of the analyst position reveals that if analysts are to operate as gatekeepers—with a role in monitoring management, conveying information to increase market efficiency, and advising investors on capital allocation—the regulations should treat analysts as quasi-agents and vest them with agency-like duties. Specifically, analysts should be bound by a duty of reliability. Analyst conflicts are likely to result in agency costs similar to those imposed by the self-dealing of traditional corporate insiders. Incorporating an agency perspective will help to decrease the conflicts created by the analyst role.

#### B. THE QUASI-AGENCY MODEL APPLIED TO REGULATION FD

The empirical and anecdotal evidence reviewed in this Article demonstrates that the traditional hands-off approach to analyst regulation is inappropriate. The theory of analyst regulation articulated in this Article, however, is not premised on fairness considerations or the presence of an unerodable trading advantage. Thus, we reject as insufficient the SEC's focus on fairness as the basis for its theory of analyst regulation. Instead, the quasi-agency model incorporates an efficiency rationale. Specifically, we argue that Regulation FD is justified as a mechanism for reducing agency costs.

As Jensen and Meckling explained, agency costs constitute the sum of monitoring expenditures by the principal, bonding expenditures by the agent, and residual losses not prevented by either monitoring or bonding.<sup>347</sup> These costs can be reduced in a variety of ways. In particular, it is possible to reduce agency costs through obligations that are imposed on third parties,

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345. *Dirks*, 463 U.S. at 658–59 (1983). Similar arguments have been made by other scholars. See, e.g., Goshen & Parchomovsky, *supra* note 164, at 1258 (noting lack of analyst influence on corporate decision-making); Craft, *supra* note 16, at 127–28 (arguing that analysts' expertise enables them to digest complex corporate information). See generally Peter L. Cholakis, *Company Disclosure of Earnings Projections: Should Individual Investors Be Allowed into the "Ballpark"?*, 39 SANTA CLARA L. REV. 819 (1999) (arguing that analysts vet information through their disclosure, providing a type of disinterested seal of approval).

346. Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 166–70 (2002). Langevoort suggests that a variety of behavioral biases exacerbate the incentives created by analyst conflicts and business relationships. *Id.*

347. Jensen & Meckling, *supra* note 12, at 308.

rather than directly upon the agents. The SROs, for example, are charged with monitoring analysts and their employers. The purpose of this monitoring is to decrease agency costs to investors.

The SEC's promulgation of Regulation FD can be rationalized as another method of reducing agency costs by restricting the conduct of a third party. In the case of Regulation FD, the restriction is imposed on the issuer. Regulation FD does not regulate analyst behavior directly. As described in Part II C above, selective disclosure can interfere with analysts' ability to perform their roles as agents to their employers, the issuers, the investors, and the marketplace. Regulation FD reduces analysts' incentives to distort their reporting in order to gain better access to corporate information, thereby reducing the informational asymmetry between investors and analysts. In addition, Regulation FD prevents selective disclosure from interfering with the company's obligations to its shareholders. Like traditional insider trading regulation, therefore, Regulation FD prevents management from using selective disclosure to manipulate analyst behavior by increasing the ability of analysts to function as effective gatekeepers and enhancing the value of the analyst to the issuer. Considering Regulation FD under the quasi-agency model, it becomes evident that by barring selective disclosure, Regulation FD reduces the ability of management to subject the analyst to a conflict of interest by conditioning the analyst's receipt of corporate information on the analyst's willingness to issue reports consistent with management's instructions. Regulation FD also increases the reliability of the analyst's product by preventing the product from being the subject of such management influence.

Several commentators have sought to justify selective disclosure based on presumed efficiency enhancements that analysts provide. For example, Stephen Choi argues that some corporate information may be too sensitive to permit public disclosure.<sup>348</sup> Widespread release may reduce firm value by providing information to competitors or may expose the company to securities fraud litigation.<sup>349</sup> Choi argues that selective disclosure allows management to release the information to a small group and thereby reduces the risks associated with the disclosure.<sup>350</sup> The evidence demonstrates, however, that management can use selective disclosure as a tool to manipulate and often block critical evaluations, thus undermining the capacity of market information to monitor management behavior.<sup>351</sup>

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348. See Stephen J. Choi, *Selective Disclosures in the Public Capital Markets*, 35 U.C. DAVIS L. REV. 533, 541-42 (2002).

349. *Id.* at 542.

350. *Id.*

351. Moreover, selective disclosure of the type advocated by Choi is most likely to occur in the context of due diligence, a context not addressed by Regulation FD.

Goshen and Parchomovksy argue that firms also can use information access to induce analyst coverage that they would otherwise be unable to obtain.<sup>352</sup> Although in theory this mechanism should benefit investors, in practice issuers can use selective disclosure to “buy” more than mere coverage, they also can buy analyst hype. Small capitalization companies are particularly vulnerable to the risk that this hype will be used to raise excessive capital to or allow insiders to exit at inflated prices. And the buying of such coverage interferes with analysts’ role as efficiency enhancers.

Finally, Choi and Talley argue that selective disclosure to large blockholders may subsidize valuable monitoring activity, thereby improving firm value for all shareholders.<sup>353</sup> This argument fails to recognize that the financial pressures faced by money managers and their need to maintain sufficient liquidity generate a greater need for institutions to demand protection from the price effect of analyst downgrades than to demand governance changes from corporate management. Institutional resistance to downgrades may partially explain the optimistic bias of analyst recommendations. Moreover, the pattern of institutional trading reveals that, when a company is in trouble, institutions consistently prefer exit to voice.

Selective disclosure compromises the analyst role in other ways as well. It allows corporate officials to purchase analyst complaisance and even cooperation with the currency of an informational advantage. This complaisance sacrifices independent information-collecting efforts. The very existence of selective disclosure makes it easier for analysts to rely on company-provided information, rather than engaging in independent research. Analysts grow increasingly dependent on company insiders for information, further decreasing independent efforts at collecting information. Selective disclosure thus enables management to buy analyst optimism and to silence critics of management decisions with the threat of curtailing information flow.<sup>354</sup> As a result, the ability of analysts to act as gatekeepers and independently check management decision-making decreases, and the added value analysts theoretically provide to the market is eliminated.

As the incentives for independence fade, so does the quality of analysts’ information. Analysts who depend on selective disclosures of company

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352. Goshen & Parchomovsky, *supra* note 164, at 1268–69.

353. Stephen J. Choi & Eric L. Talley, *Playing Favorites with Shareholders*, 75 S. CAL. L. REV. 271, 294–95 (2002). Although Choi and Talley recognize that such selective disclosure allows large investors to obtain special trading profits, they reason that these profits operate as a subsidy for the risks associated with a large ownership position, including reduced liquidity. *Id.* The argument does not address the question of whether investors are willing to pay blockholders for such monitoring.

354. See Langevoort, *supra* note 22, at 1040–43 (examining “issuer-analyst behavior” under a system of selective disclosure).

information are co-opted. As dependence, not independence, becomes the norm, fewer analysts search for information in the old-fashioned, dig-up-the-numbers or pound-the-pavement fashion. The analysts fail to challenge the information given them, simply incorporating it into forecasts, and the result is inaccurate, and, arguably, meaningless information. The forecasts are about currying management favor or investment banking business, or both, rather than providing the allegedly non-biased, cleansed review of management that courts and commentators have used to justify analysts' privileged information access.

As analysts increase their reliance on company-provided information, the threat of being cut off in response to negative reports becomes more potent. Analysts who depend on company sources for information cannot afford to anger their sources with negative reports. Analysts who depend on company sources cannot afford to be frozen out of company meetings. Analysts who depend on company sources have to worry when those sources threaten to have them fired. In short, analysts who depend on company sources for their information cannot afford to criticize or upset those sources.

Further, when analysts rely, some would say excessively, on selectively disclosed information without doing their own investigative research and fact checking, the information is subject to bias or outright manipulation. The information then shared with the marketplace actually does not promote accurate stock pricing or improved information flow. Instead, it compounds the effect of company hype without providing a check on that hype. The information to the market is distorted by the company's own lens. The analysts become only company conduits, not independent value-adders, and fail to fulfill the theoretical gatekeeping role for which they were accorded privileged status.

Selective disclosure also can hurt corporate performance. Over time, as the symbiotic relationship between corporate officials and analysts develops and increases, corporate officials may begin to manage earnings and other financial information in order to conform to analyst forecasts. The process becomes circular with both actors manipulating predictions, but with only one side knowing the truth. The existence of selective disclosure can thereby create incentives for corporate decision-making focused on analyst projections, rather than company goals.

Recent analyses suggest that this argument has merit—analyst pressure can directly affect corporate decision-making. There is reason to believe that the recent corporate focus on earnings announcements and short-term stock prices is, in part, a response to analyst demands. The market places extreme importance on these criteria due, in part, to the “contribution” of analysts. That reliance supports the proposition of Fuller and Jensen that management efforts to respond to analyst pressure on earnings estimates



was an important factor in the demise of Enron and Nortel.<sup>355</sup> Pressure to meet unrealistic analyst predictions spurred management to reach for unattainable earnings growth, leading to an unsustainable cycle of ever-increasing earnings announcements and share prices.<sup>356</sup> The market reacts strongly to any divergence between operating results and analyst predictions.<sup>357</sup> Analyst activity increases pressure for officials to manage earnings in order to meet expectations.<sup>358</sup> Analyst focus on predictions, short-term numbers, and earnings data thus influences managerial decisions.<sup>359</sup> Fuller and Jensen's view is that this misplaced management focus may impact operational decisions and, ultimately, sacrifice long-term corporate profitability.<sup>360</sup> In this scenario, the analysts have assumed a role in corporate decision-making.

Selective disclosure also can align analysts with management's personal interests in a manner inconsistent with other corporate or shareholder interests. For example, managers who are paid largely in options, as were those of the Internet era, cannot afford to miss their analysts' earnings expectations.<sup>361</sup> As long as favorable analyst reports keep stock prices high, managerial compensation tied to company performance will increase. Favorable analyst coverage also may improve managers' reputations and facilitate their future employment opportunities. Managers then have an incentive, at best, to harness analyst optimism, and, at worst, to manipulate information to increase their private gains. As the relationship builds, the power of accurate stock-market prices to discipline management and its decision-making through the takeover market erodes. Selective disclosure, then, can lead to a relationship in which the analyst is promoting management's interests, rather than those of the shareholders.

Selective disclosure enables management to buy institutional investors' complaisance with the currency of superior trading opportunities. Contrary to the position taken by Choi and Talley, selective disclosure reduces rather than increases the potential for productive monitoring by large stakeholders. Selective disclosure enables institutions to profit at the expense of other traders, even with investments in suboptimal management. Because of their opportunity to exit before negative information hits the marketplace, institutions receive protection against downside risk. Further, the negative reactions by institutional investors to any downgrades of the stocks they own adds to the analysts' incentive to maintain positive ratings.

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355. Fuller & Jensen, *supra* note 136.

356. *Id.* at 43-44.

357. *Id.* at 43.

358. *Id.* at 42.

359. *Id.*

360. Fuller & Jensen, *supra* note 136, at 42.

361. Hillary A. Sale, *Judging Heuristics*, 35 U.C. DAVIS L. REV. 903, 933 n.133 (2002).

Selective disclosure thus contributes to the agency costs inherent in the conflicted analyst role this Article describes. Regulation FD recognizes these agency costs and responds by prohibiting the selective disclosure that aggravates the quasi-agent status of agents. The resulting reduction of agency costs provides an efficiency-based justification for Regulation FD's prohibition on selective disclosure. Significantly, Regulation FD reduces analyst agency costs without directly imposing state law agency principles such as fiduciary duties. By decreasing agency costs, Regulation FD increases the reliability of analyst research and reports.

Importantly, this argument is fundamentally different from attempts to justify Regulation FD in terms of fairness or equal access to information.<sup>362</sup> The agency argument provides a substantial departure from the SEC's stated reason for promulgating the rule.<sup>363</sup> As with traditional insider trading regulation, efforts to justify the prohibition in fairness terms are only partially convincing. For example, it is difficult to identify the investors who are disadvantaged by selective disclosure. Similarly, the presence of systematic informational disparities in the marketplace undercuts claims about investor expectations and frustrates attempts at principled line drawing.<sup>364</sup> Regulation FD can instead be justified as reducing agency costs and thereby improving market efficiency.<sup>365</sup>

Regulation FD is a valuable supplement to existing law. It fills the gap in current regulation of insider trading. Moreover, because Regulation FD is not a fraud-based approach to regulation, it cannot be avoided through disclosure. The Supreme Court's analysis of insider trading regulation is premised upon the idea that insider trading is deceptive. Accordingly, liability under section 10(b) can, in theory, be avoided through appropriate disclosure. If selective disclosure to analysts were regulated through insider trading law, it would be possible to argue that, by disclosing their potential conflicts of interest, such as personal trading or investment banking relationships, analysts would eliminate any possible deception and thereby avoid liability.

As the SEC has perhaps inadvertently recognized in promulgating Regulation FD, disclosure of analyst conflicts is unlikely to reduce

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362. See, e.g., John C. Coates IV, *Private v. Political Choices of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT'L L. 531, 557 (2001) (criticizing Regulation FD as "effort to compel 'equal access' to information"); William J. Carney, *Jurisdictional Choice in Securities Regulation*, 41 VA. J. INT'L L. 717, 727 (2001) (citing Fox, *supra* note 171, as demonstrating that fairness argument "is both misguided and trivial").

363. See, e.g., Fox, *supra* note 171, at 664 (describing fairness as SEC's main justification for Regulation FD); William K.S. Wang, *Selective Disclosure by Issuers, Its Legality and Ex Ante Harm: Some Observations in Response to Professor Fox*, 42 VA. J. INT'L L. 869, 871 (2002) (noting fairness considerations in rationale for Regulation FD).

364. See Fox, *supra* note 171, at 669-70 (disputing efficacy of fairness rationale for Regulation FD).

365. See *id.* at 692 (explaining Regulation FD's improvements to market efficiency).

substantially the agency costs generated by these conflicts. First, as the preceding discussion demonstrates, analyst conflicts are varied and often subtle. An analyst may, for example, have no existing investment banking relationship with an issuer, but will be looking at potential clients. A requirement that the analyst disclose existing investment banking relationships does not eliminate this conflict. Second, although disclosure might prevent investors from unduly relying on analyst recommendations, it would play no role in reducing the pressure that analyst behavior imposes on corporate decision-making. Disclosure would not stop the collusion between analysts and corporate management over the manipulation of earnings estimates. Finally, a key premise of *Dirks* is that securities analysts play a role in collecting and disseminating information to the securities markets.<sup>366</sup> Disclosure of analyst conflicts may prevent investors from claiming they have been misled, but it is inconsistent with maintaining their important gatekeeping role.<sup>367</sup>

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366. See *Dirks v. SEC*, 463 U.S. 646, 658–59 (1983) (discussing analysts' beneficial contribution to healthy securities markets).

367. The agency analysis suggests that some modifications to Regulation FD may be appropriate. For example, the SEC has restrictively interpreted the degree of disclosure necessary to meet the rule's requirements. Given its selective disclosure target, issuers should be able to employ any manner of dissemination sufficient to alleviate the selectivity problem and prevent favoritism. As a result, disclosure methods assuring broad dissemination, including webcasts, are arguably sufficient. Similarly, the Regulation should not preclude an issuer from selectively disclosing information to investors during a shareholder meeting that is not open to the general public. See, e.g., SEC, DIV. OF CORP. FINANCE, MANUAL OF PUBLICLY AVAILABLE TELEPHONE INTERPRETATIONS (4th Supp. Oct. 2000), available at <http://www.sec.gov/interp/telephone/phonesupplement4.htm> (on file with the Iowa Law Review) (advising that such disclosure would be inconsistent with Regulation FD's public disclosure requirement).

Regulation FD also may be underinclusive in eliminating opportunities for issuers to offer analysts selective informational benefits. The SEC telephone interpretation manual suggests that an issuer may properly disclose material information to a favored group of analysts, if the issuer makes simultaneous disclosure of the information through an EDGAR filing. See *id.* (stating that, under Interpretation 6, "[p]rior to making disclosure to a select audience, the issuer need only confirm that the filing or furnished report has received a filing date (as determined in accordance with Rules 12 and 13 of Regulation S-T) that is no later than the date of the selective disclosure"). This practice allows selected analysts an informational advantage over the rest of the marketplace. SEC endorsement of it facilitates favored groups of analysts with whom issuers maintain special relationships, further generating conflicts inconsistent with the analyst's agency role and the objectives of the Regulation.

Finally, Regulation FD could be modified to remove it further from the fraud-based jurisprudence from which it arose, by adopting a different standard for materiality. As currently interpreted, Regulation FD prohibits the selective disclosure of all material information. Issuers have complained that the materiality standard is unworkable generally and that its application to this area places a heavy burden on corporations to make nuanced legal determinations in the context of fast paced disclosure decisions. When viewed as a regulation designed to eliminate quasi-agent conflicts, like the use of access to information as currency, a narrower definition of materiality may be warranted. The American Law Institute's Federal Securities Code concept of a "fact of special significance" provides a potential source. The Code relies on this concept for

C. FURTHER APPLICATIONS OF THE QUASI-AGENCY MODEL

A complete resolution of the industry's problems is beyond the scope of any single article. As the previous section reveals, the quasi-agency model provides an alternative efficiency-based justification for Regulation FD. Similarly, the model can provide a starting point for addressing other analyst conflicts.

For example, Part II described conflicts created when analysts invest in the securities of covered companies. These investments create the potential for analysts to obtain collateral profits from the analysts' evaluation and dissemination of information to the investing public. Classic agency law principles prohibit agents from obtaining this type of benefit at the expense of the principal—any personal profits obtained by agents in the course of the agency relationship belong to the employer, whether or not the agent obtained the profit through wrongdoing.<sup>368</sup> The agency law rationale for this rule, which was derived from the law of trusts, is that the potential for personal profit creates an inherent conflict for agents and undermines their ability to privilege the rights of the principal.<sup>369</sup> Yet, with respect to trading in covered securities, analysts and principals were both profiting from the situation. Moreover, analysts' trading was taking place with either the express or implied consent of their employers.

Under current law, investors are expected to police this conflict. Yet, as detailed above, they do not—and neither does the market. Presumably, investors and the market fail to monitor adequately because of information costs, the same costs that led to the development of a rule of forfeiture in

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the scope of insider trading liability, defining such a fact more narrowly than materiality in general:

INSIDERS' DUTY TO DISCLOSE WHEN TRADING

SEC. 1603. (a) GENERAL.—It is unlawful for an insider to sell or buy a security of the issuer, if he knows a fact of special significance with respect to the issuer or the security that is not generally available, unless (1) the insider reasonably believes that the fact is generally available, or (2) the identity of the other party to the transaction (or his agent) is known to the insider and (A) the insider reasonably believes that that party (or his agent) knows the fact, or (B) that party (or his agent) knows the fact from the insider or otherwise.

FED. SEC. CODE § 1603 (1980). The Code also states the following:

A fact is 'of special significance' if (A) in addition to being material it would be likely on being made generally available to affect the market price of a security to a significant extent, or (B) a reasonable person would consider it especially important under the circumstances in determining his course of action in the light of such factors as the degree of its specificity, the extent of its difference from information generally available previously, and its nature and reliability.

*Id.* § 202(56).

368. See, e.g., *Tamowski v. Resop*, 51 N.W.2d 801 (Minn. 1952).

369. See *id.* at 804–05.

trust law.<sup>370</sup> Moreover, although disclosure may reveal the existence of a conflict, it does not convey the extent to which the analyst's objectivity has been compromised. Other principals, such as institutional investors or venture funds, may fail to object because they benefit from the alignment of interests that occurs when an analyst owns covered securities.

If the potential for personal profit when analysts trade for their own accounts undermines agent fidelity, a more appropriate regulatory response would limit the potential for analysts to engage in abusive trading. Here, the securities laws already provide a model. Section 16(b) of the Securities Exchange Act imposes limitations on personal trading by officers, directors, and large shareholders.<sup>371</sup> The statute does not make such trading illegal; it simply provides that, under specified circumstances, profits generated by the trades are forfeited to the corporation.<sup>372</sup> In particular, the statute requires forfeiture of profits generated through short swing trading—a sale and subsequent purchase, or the reverse, within a six month period.<sup>373</sup>

The law takes the position that short swing trades by insiders are particularly subject to abuse. The abuse is of the duty of loyalty type, consistent with an agency rationale for insider trading liability. Importantly, although the federal securities laws also require disclosure when corporate officials trade in their company's securities,<sup>374</sup> the law seemingly recognizes that disclosure is not a sufficient mechanism for preventing abuse. Section 16(b) is an agency-type remedy aimed at reducing the costs of the manager-shareholder agency relationship.<sup>375</sup> Given that the quasi-agency relationship between analysts, the issuer, and its shareholders creates analogous agency costs, a similar remedy seems appropriate.

The investment banking conflicts, or business interests, offer the greatest challenge from a regulatory perspective. Recent regulatory and media attention has focused on these conflicts, and the Merrill Agreement and NASD regulations are modest efforts to address the issue through greater separation and increased disclosure. The agency model demonstrates, however, that the magnitude of these conflicts and the lack of a single defined principal may be too substantial for the scope of the proposed remedies. In the investment banking context, the interests of the

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370. See *In re Gleeson's Will*, 124 N.E.2d 624 (Ill. App. Ct. 1955) (requiring that trustee forfeit personal profit to trust despite absence of demonstrated unfairness).

371. 15 U.S.C. § 78p (2000).

372. *Id.*

373. *Id.*

374. Insiders are required to disclose the timing and amount of their trading. See *id.* § 78p(a) (2000). Similar disclosure of specific analyst trades also might be appropriate, rather than the currently permitted boilerplate proviso that analysts may hold positions in covered securities.

375. See Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 HASTINGS L.J. 393, 393 (1991) (explaining that section 16 can best be defended in terms of reducing agency costs of management-shareholder relationship).

selling firm and the investing public, for whom the analyst is supposed to function as a gatekeeper, may be in direct conflict. As a result, agency principles suggest that the pressures imposed by investment banking operations may overwhelm the analysts' efforts to adhere to their gatekeeping role.

The most attractive solution to this problem may appear to be a complete separation of investment banking from analyst services, based on the proposition that a person cannot serve two competing masters. Indeed, commentators have advocated a similar separation, for analogous reasons, between the provision of consulting services and auditing services by accounting firms.<sup>376</sup> The history of the brokerage firm, however, suggests that attempting to remedy the conflict through a complete separation of functions may prove problematic. Investment banking has been linked to analyst services not merely because of the natural synergy between the two, but because the information dissemination and evaluation functions performed by analysts may not be independently viable absent the subsidy provided through investment banking revenues.

For some time, the industry has touted its Chinese walls as the answer to the problem. The existence of these walls is, first, proof that the problem exists and, second, an appealing but ineffective answer. In theory, these walls provide an attractive short-term fix for the improprieties plaguing the financial services industry. In reality, the walls are porous. Moreover, efforts to eradicate completely the influence of investment banking may result in the elimination of analyst activity altogether.<sup>377</sup> As pointed out in Part II above, without their role in investment banking, analysts are not directly profitable to the firm. Thus, resolution of these problems requires increased sensitivity to the role of analysts as quasi-agents, including the appropriateness of leaving this question to the SROs.

One possible alternative to SRO supervision is private civil remedies. Historically, courts have been wary of extending liability to analysts for misleading reports or recommendations. Private suits by investors, in particular, are barred by a variety of doctrinal limitations, most stemming from the legal conclusion that analysts owe no fiduciary duty to investors or the marketplace.<sup>378</sup> The quasi-agency model supports a broader recognition of analyst duties. At a minimum, the model suggests that, consistent with the

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376. See, e.g., Robert A. Prentice, *The SEC and MDP: Implications of the Self-Serving Bias for Independent Auditing*, 61 OHIO ST. L.J. 1597 (2000).

377. This problem could be redressed through the provision of an alternative source of funding for independent analysis. For a proposal advocating independent funding through a voucher mechanism see generally Choi & Fisch, *supra* note 311.

378. See, e.g., *Moss v. Morgan Stanley Inc.*, 719 F.2d 5 (2d Cir. 1983) (dismissing investor's securities fraud suit against analysts because plaintiff failed to demonstrate that analysts owed him a duty of disclosure).

gatekeeper role, when analysts disseminate information into the market, they should be held to a duty of reliability.<sup>379</sup>

Consideration of the agency model would not be complete without a few reflections concerning the appropriate regulatory authority. Historically, the SEC has taken a hands-off approach to analyst regulation, preferring to leave the matter to the SROs.<sup>380</sup> Regulation AC reflects the SEC's current willingness to address one concern of the quasi-agent status, the truthfulness of analyst reports. The potential effectiveness of Regulation AC is reduced, however, by its limited enforcement mechanisms. Importantly, although the Sarbanes-Oxley Act reflects a congressional concern for increased analyst regulation, it permits the SEC to delegate analyst regulation to the SROs.<sup>381</sup>

Such continued delegation is problematic. The SROs have proved themselves to be unable or unwilling to impose and enforce meaningful restrictions on analyst conflicts and self-dealing. The NYSE and the NASD are run by, and primarily are accountable to, their members, the brokerage firms. Given the importance of investment banking business for member firms, it is unrealistic to expect the SROs actively to curtail a structure that promotes these operations. As Part II explains, the current role of analysts is ideal from the perspective of the brokerage firms. Analysts function as de facto salespeople who play a valuable role in the firms' most profitable corporate finance business. In addition, brokerage firms often benefit more directly from analysts' work through proprietary trading in covered securities. It is not surprising, then, that the scope of the regulatory response by the SROs has been limited and that the SROs have failed effectively to enforce even the monitoring functions that they self-prescribed.<sup>382</sup> The SROs have little reason to disturb the status quo.

Most recently, state regulators have taken an interest in analyst behavior. New York Attorney General Eliot Spitzer led the highly publicized effort described above to impose greater controls on analyst behavior through state law litigation. After Spitzer successfully negotiated a set of standards of conduct in his litigation against Merrill Lynch, New York

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379. As the court's reasoning in *In re Credit Suisse First Boston Corp. Securities Litigation*, 97 Civ. 4760, 1998 U.S. Dist. LEXIS 16560 (S.D.N.Y. 1998), demonstrates, this obligation need not be premised on the finding of a legal agency relationship between analysts and investors.

380. Notably, the Sarbanes-Oxley Act resolves any potential ambiguity about the SEC's statutory power to regulate analysts.

381. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-24, § 501, 116 Stat. 745 (2002).

382. SRO rules required them to keep track of analyst investments and they did not do so. Their spotty history on monitoring their own brokers indicates that they are neglectful in other areas as well. See, e.g., Susanne Craig, *Critics Lash Out at Wall Street over Broker Acts*, WALL ST. J., May 24, 2002, at C1 (describing failure to catch broker who cheated clients out of \$125 million, despite multiple red flags, including mailing of statements diverted to post-office boxes, churning, and use of personal laptop at desk even though company prohibited such use). There is no reason to believe that they will be better regulators now. See generally Sale, *supra* note 321 (detailing other non-analyst conflicts of interest in investment banks and urging reform).

Comptroller Carl McCall announced that the state pension funds would refuse to do business with any brokerage firm that fails to comply with the Merrill Lynch standards voluntarily.<sup>383</sup> A number of other state pension funds have announced similar plans.<sup>384</sup>

Although state regulators have recently shown themselves to be less conflicted than the SROs, the desirability of addressing the analyst role through state regulatory and enforcement efforts remains questionable. First, there is no obligation on the part of the states to coordinate their activities. As a result, extensive state activism could subject analysts to conflicting or inconsistent regulations. Second, securities analysts play a significant role in the national securities markets. State regulators long have been restricted from regulating these markets, and there are reasons to question whether they have sufficient expertise to do so effectively. Concerns of potential bias and provincialism also counsel against local efforts to regulate national markets. Third, regulation of analysts is properly coordinated within the existing regulatory structure of the securities markets, which is provided by the federal securities laws and supervised by the SEC.

Given the existence of an administrative agency that has long presided over the markets, there is little justification for regulating analysts through a separate body. The SEC has sufficient expertise to regulate securities analysts as well as to consider and coordinate the interests of brokerage firms and those who benefit from the analysts' role in the marketplace. Accordingly, Congress' direction to the SEC in the Sarbanes-Oxley Act is appropriate, and the SEC should accept the responsibility. The principles set forth in this Article should help in fashioning the resulting regulation.

#### CONCLUSION

The foregoing analysis has several implications. In light of the ownership, business, and access conflicts described in Part II, many of the justifications for the analysts' privileged regulatory status are unfounded. Instead, this Article's analysis demonstrates that increased analyst regulation is appropriate because of the inability of private contractual solutions to address these problems. Analysts, who face multiple duties, are in the untenable position of trying to adhere to conflicting loyalties. As quasi-agents, analysts are not capable of fulfilling their multiple roles.

There are three main reasons why regulation is necessary. First, as with many agency costs, the nature of the conflicts and the scope of their impact are difficult to ascertain. Second, although we argue that analysts are quasi-agents, there are no direct contractual relationships between analysts and

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383. David Feldheim & Charles Gasparino, *Pension-Plan Officials Unveil Move to Protect Public Funds*, WALL ST. J., July 2, 2002, at C3.

384. *See id.* (including California and North Carolina).



the issuers they cover, the investors, or the securities markets. Third, analyst activities are financed indirectly. Although investors and issuers bear the costs of analyst malfeasance, they are poorly positioned to discipline such malfeasance through market transactions.<sup>385</sup>

Recognition of analysts' quasi-agency status allows for a coherent, efficiency-based justification for prohibiting selective disclosure to securities analysts. As demonstrated above, analyst receipt and use of material nonpublic information present analogous risks to the use of such information by traditional insiders. Selective disclosure compromises analyst independence, which undermines the analyst's role as information intermediary. Analyst pressure also may influence management objectives, inappropriate corporate decision-making. Further, selective disclosure is unlikely to increase market efficiency.

Finally, as this Article points out, Regulation FD is only one application of the quasi-agency model. Given that the assumptions undergirding the privileged regulatory status of analysts and investment banks are not warranted, this Article proposes that analyst regulation be reformulated from an agency perspective. An understanding of the analyst as quasi-agent suggests that the regulatory challenge may require greater innovation than the structural restrictions and disclosure provisions mandated by the Sarbanes-Oxley Act. In particular, the Article proposes that analysts be bound by a duty of reliability to the market and investors. Similarly, the quasi-agency model offers new ways to reconcile the conflicts exposed in this Article while retaining the analyst's role as information intermediary.

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385. See Choi & Fisch, *supra* note 311, at 1 (explaining how public goods problems and information asymmetries interfere with the market's ability to discipline analysts effectively).