

## FIDUCIARY DUTIES AND THE ANALYST SCANDALS

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### I. INTRODUCTION

I am delighted to be here and to deliver a lecture as part of the series honoring Daniel Meador. I am also honored to be part of the group of distinguished scholars who have delivered lectures in this series. I was invited to speak about fiduciaries and, in particular, whether research analysts should be regulated as fiduciaries. Regulators, legislators, and the self regulatory organizations—the New York Stock Exchange and the NASD—have been paying a lot of attention to analyst regulation. What put research analysts in the spotlight, however?

By way of background, analyst regulation goes back a few years to the stock market boom of the 1990s. Like most such booms, it eventually ended. In fact, it ended with the dramatic implosion of a large number of public companies including Enron, WorldCom, and others. Investigations of these companies revealed that there were widespread accounting problems, earnings manipulations, other kinds of corporate misconduct, abuses in executive compensation, and more. Indeed, only recently have we learned about the extent of option backdating that occurred during the 1990s.<sup>1</sup>

The analyst scandals compounded the problem. It appeared that research analysts fueled the flames of the technology bubble, the telecommunications boom, the hot IPO market, and so forth, by releasing overly optimistic and often baseless recommendations about scores of companies. Although many investors had long been aware that analyst research was biased, the extent of the scandal was far greater as revealed on April 8, 2002, when New York State Attorney General Eliot Spitzer announced the results of his investigation.<sup>2</sup> Spitzer revealed that research analysts had engaged in

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\* T.J. Maloney Professor of Business Law and Director, Corporate Law Center, Fordham Law School. Copyright 2006 Jill Fisch. This Essay is a modification of the Meador Lecture on Fiduciaries delivered at The University of Alabama School of Law on October 20, 2005. Portions of this Lecture have been developed more extensively in Jill E. Fisch, *Does Analyst Independence Sell Investors Short?*, 55 UCLA L. REV. (forthcoming 2007).

1. See, e.g., Damon Darlin & Eric Dash, *2 are Charged in Criminal Case on Stock Options*, N.Y. TIMES, July 21, 2006, at A1 (describing government filing of criminal and civil charges against the former chief executive and former human resources executive of Brocade Communications Systems).

2. See Press Release, Office of N.Y. State Attorney General, Merrill Lynch Stock Rating System Found Biased by Undisclosed Conflicts of Interests (Apr. 8, 2002) [hereinafter Spitzer Press Release], 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). The results of the investigation were detailed in the Eric R. Dinallo affidavit. Petitioner's Affidavit in Support of Application for an

a widespread practice of lies and misrepresentations in connection with their reports and recommendations to the investing public.<sup>3</sup> According to the announcement, analysts had been claiming that their investment advice was objective when it was tainted by conflicts of interest. Analysts had publicly touted securities despite negative internal information. Analyst ratings and recommendations were overwhelmingly skewed in favor of urging investors to buy and were seldom if ever adjusted, even when stock prices plunged and issuers collapsed.

A prominent figure in the analyst scandals was Salomon analyst Jack Grubman. Who was Jack Grubman? He was one of the best known and most influential analysts in the telecommunications industry. As such, his publicly announced opinions of telecommunications companies influenced market prices. When Jack Grubman told investors to buy AT&T, investors listened. The problem, according to the SEC, was that Jack Grubman did not recommend AT&T because he thought it was a good investment; he made the recommendation in order to get his children admitted to the prestigious 92nd Street Y nursery school.<sup>4</sup>

Then there was Henry Blodget. Henry Blodget specialized in Internet companies. During the 1990s, Internet companies were hot. Apparently, one could call virtually any company a “dot.com” and, simply by doing so, make it more attractive to investors. Similarly, investors appeared to view virtually any Internet based business strategy as credible.

Blodget and his colleagues at Merrill Lynch publicly touted pets.com, infospace, etoys, mypoints.com, goto.com, and many other technology companies, urging investors to buy these supposedly wonderful stocks. At the same time, Blodget and his peers were privately describing the stocks as “dogs,” “powder keg[s],” and “piece[s] of junk.”<sup>5</sup>

Regulators were concerned that investment banking and other conflicts of interest had led to the analyst scandals. In some cases, an issuer’s stock plunged all the way to zero while analysts maintained their “buy” recommendations (although concededly at zero almost any company would be a good buy).<sup>6</sup> Regulators were concerned that analyst research was not reliable and was misleading the market and investors. And so, they responded.

The first out of the box was Eliot Spitzer. Spitzer’s investigation, which initially focused on Merrill Lynch, later extended to encompass the activities of the nation’s leading investment banks and revealed much of the misconduct described above—the conflicts of interest, the fact that analysts

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Order Pursuant to General Business Law Section 354, at 10-13, Spitzer v. Merrill Lynch & Co., Index No. 02/401522 (N.Y. Sup. Ct. Apr. 8, 2002) [hereinafter Dinallo Aff.], available at <http://www.oag.state.ny.us/press/2002/apr/MerrillL.pdf>.

3. Spitzer Press Release, *supra* note 2.

4. Complaint ¶¶ 89-99, SEC v. Grubman, 03-CV-2938 (S.D.N.Y. Apr. 28, 2003), available at <http://www.sec.gov/litigation/complaints/comp18111b.htm>.

5. Dinallo Aff., *supra* note 2, at 10-12 (quoting Henry Blodget, Managing Director, Internet Research Group, Merrill Lynch) (internal quotation marks omitted).

6. *Id.* at 9-10.

were participating in investment banking, the concern that investment banking objectives were skewing the information that analysts were releasing to the market place, and so forth. Spitzer, with the involvement of the SEC, the self-regulatory organizations, and other regulators, negotiated the Global Research Settlement. The Settlement embodied a variety of regulatory reforms designed to address analyst conflicts of interest.<sup>7</sup>

One of the highlights of the Global Research Settlement was the forced separation of investment banking operations from research. Analysts were not supposed to work for the investment banking people anymore. They were not supposed to help a firm in its investment banking business. They were not supposed to be compensated on the basis of how much they helped generate investment banking revenues. The separation of investment banking and research was designed to keep research pure and to free it from the taint of investment banking.

Congress got involved as well. The Sarbanes-Oxley Act of 2002<sup>8</sup> addressed analyst conflicts of interest, although it did so in the same way that Congress often regulates in the securities industry—not by enacting substantive regulation but by instructing other regulators to take action. In section 501 of Sarbanes-Oxley, Congress essentially told the SEC and the SROs, “Deal with conflicts of interest, we’ve got a problem here, adopt some rules, fix it.”<sup>9</sup> The SEC adopted two rules that were designed to address the reliability of analyst research: Regulation AC—Analyst Certification<sup>10</sup> and Regulation FD—Fair Disclosure.<sup>11</sup> The New York Stock Exchange and the NASD adopted rules on analyst conflicts of interest.<sup>12</sup> The core concept behind these regulations was that analyst conflicts of interest were to blame for the analyst scandals and that mandated independence was necessary to assure the reliability of analyst research and to restore the analyst’s position as gatekeeper or fiduciary for the investing public. It is that concept that I want to explore further here.

## II. RESEARCH ANALYSTS AND WHAT THEY DO

Let me go into a little more detail about the role of the research analyst. The concern of the recent regulations, and the focus of this Lecture, is the

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7. See SEC Fact Sheet on Global Analyst Research Settlements [hereinafter SEC Fact Sheet], available at <http://www.sec.gov/news/speech/factsheet.htm> (last visited Mar. 4, 2007) (describing terms of Global Research Settlement).

8. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 501, 116 Stat. 745, 791-93 (to be codified in scattered sections of 15 U.S.C.).

9. *Id.* (requiring SEC or SROs to promulgate rules addressing analyst conflicts of interest).

10. Regulation AC—Analyst Certification, 17 C.F.R. §§ 242.500-.505 (2006).

11. Selective Disclosure and Insider Trading, Securities Act Release No. 33-7881, Exchange Act Release No. 34-43154, Investment Company Act Release No. 24599, 65 Fed. Reg. 51,716 (Aug. 24, 2000).

12. See Order Approving Proposed Rule Changes by the NYSE and NASDAQ Relating to Research Analyst Conflicts of Interest, Exchange Act Release No. 34-48252, 68 Fed. Reg. 45,875 (Aug. 4, 2003); Order Approving Proposed Rule Changes by NASDAQ and NYSE Relating to Research Analyst Conflicts of Interest, Exchange Act Release No. 34-45908, 67 Fed. Reg. 34,968 (May 16, 2002).

sell-side analyst. Sell-side analysts work for big financial firms like Merrill Lynch and Goldman Sachs.<sup>13</sup> These firms engage in a variety of types of securities business—investment banking, operating as a broker-dealer, and proprietary trading. Sell-side analysts are contrasted with buy-side analysts who work for institutional investors, such as mutual funds.<sup>14</sup> There is also a third category of analysts, the so-called independent analysts. Independent analysts, at least in theory, just conduct research and sell it; they do not engage in other types of securities business.<sup>15</sup> Independent analysts are supposed to be the “saviors” for providing reliable information to the securities markets.<sup>16</sup> Although common wisdom places analysts in these three distinct categories, I am not convinced that the bright line categories really hold. In fact, I’m particularly wary of this line between sell-side analysts with big conflicts and independent analysts who are gate-keepers and whom we can trust because, as we’ll see in a moment, independent analysts have conflicts too.

What do analysts do? They provide research coverage, they provide a report, and they provide a recommendation on the companies that they choose to cover.<sup>17</sup> A substantial component of what the analyst does is cover a company. In many ways, it’s less what the analyst says than the fact that the analyst has chosen that particular company because there are thousands of publicly traded companies out there, and we as investors are boundedly rational. Investors cannot pay attention to all of those companies. The mere fact that an analyst has chosen a particular company and written something about it makes it salient, makes it accessible. To a degree, analyst coverage causes people to invest almost regardless of the nature of the underlying coverage.

At the same time, however, analysts have good reasons to avoid providing negative coverage of an issuer, for reasons that I’ll discuss further. Thus, the decision to cover is a positive signal.<sup>18</sup> In other words, analysts, by covering a company, essentially say to investors: “You should buy this stock.” Similarly, by terminating coverage, analysts send a subtle signal: “Sell this stock. This isn’t one you want to hold on to anymore.” This is a signal that institutional investors are particularly adept at reading.<sup>19</sup> So coverage is a big deal.

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13. See, e.g., Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1041 (2003) (describing analyst categories).

14. *Id.* at n.18.

15. *Id.*

16. Ann Davis & Susanne Craig, *Analyze This: Research Is Fuzzier Than Ever: ‘Independent’ Label Becomes a Mantra After the Crackdown, But Conflicts Have Emerged*, WALL ST. J., Apr. 26, 2004, at C1.

17. See Fisch & Sale, *supra* note 13, at 1040-43 (describing nature of analyst investigation and resulting products).

18. See, e.g., Somnath Das et al., *Analysts’ Selective Coverage and Subsequent Performance of Newly Public Firms*, 61 J. FIN. 1159, 1160 (2006) (explaining that analysts engage in “selective coverage,” choosing to provide coverage for firms about which they have positive expectations).

19. See, e.g., Michael B. Mikhail et al., *When Security Analysts Talk Who Listens?* 3-4 (Apr. 6, 2006) (unpublished manuscript, available at <http://ssrn.com/abstract=709801>) (finding that institutions

Analysts also prepare a report. Analysts use their own research and publicly available information both about a particular company and about the industry to explain what the company does and what its prospects are. Analysts make predictions about the company's future, particularly about earnings, and analysts issue a recommendation. Typically, firms use from three to five terms to characterize their recommendations, and the terms vary from firm to firm.<sup>20</sup> UBS Warburg, for example, uses five categories, ranging from strong buy to sell.<sup>21</sup> Bear Stearns uses three: outperform, peer perform, and underperform.<sup>22</sup> The extent to which firms explain these categories varies, and it is somewhat difficult to compare ratings from one company to those of another, but the recommendation serves the basic function of telling investors what it is that they are supposed to do.

The information that analysts release is directed to their investor-clients and to the markets and the general public. In recent years, analysts have made particular efforts to reach out beyond their firm's own clients and customers. Analysts go on TV, analysts issue statements that are reported in the press, analysts release recommendations to Thomson First Call. As a result, analysts don't just speak to a select group of customers, they speak to the world.

How is analyst research funded? The interesting thing about analyst research is that it is remarkably difficult to fund.<sup>23</sup> One might think that the analyst's business model is relatively straightforward. The analyst does research and determines which companies are good investments. The analyst then sells that information to investors. Investors purchase the research and receive the benefit of the analyst's recommendations. But there is a problem with this business model. First, quality research is really expensive. So the analyst has to charge a lot of money for his or her product. Why is good research really expensive? There is an opportunity cost issue. If someone does a good job of identifying good investments, does it make more sense to sell that information or to simply purchase the stocks that have been identified? Hedge funds, for example, are competing with brokerage firms for the same information, and if they get it first, they will exploit the investment opportunity, limiting the analyst's ability to profit from the research.

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and retail investors respond differently to analysts).

20. See MarketWatch, Guide to Analyst Recommendations, <http://www.marketwatch.com/tools/guide.asp?siteid=mktw> (last visited Mar. 1, 2007) (identifying and describing recommendation terms used by various brokerage firms). A substantial number of firms revised their recommendations in 2002, moving from a five to a three point scale. See Ohad Kadan, Leonardo Madureira, Rong Wang & Tzachi Zach, Conflicts of Interest and Stock Recommendations—The Effects of the Global Settlement and Recent Regulations 13-14 (July 2005) (unpublished manuscript, available at <http://ssrn.com/abstract=568884>) (describing the change).

21. *Id.*

22. *Id.*

23. See generally Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269, 286-90 (2003) (describing difficulty of financing quality research).

The second problem is a public good problem.<sup>24</sup> As soon as the analyst releases his or her valuable research to an investor, the analyst's ability to sell the information to someone else is reduced because the value of the information dissipates very quickly. There are a limited number of purchasers before the information makes its way into the public domain, and its sales value disappears.

As a result of these funding problems, traditionally research has been subsidized through business relationships. One type of relationship—the relationship that Eliot Spitzer and the SEC have been focusing on—is investment banking services. Issuers that are trying to sell their stock into the marketplace hire investment banks to help them. From the issuer's perspective, it is attractive for the investment bank to have people on staff who provide information to the market about the issuer—and it is especially good if those people say favorable things about the issuer. Investment banking is one way that investment banks can subsidize analyst research because issuers pay substantial sums for investment banking services. What is the analyst's role? Analysts are marketing the issuer's sale of stock. And some would say that they are doing marketing under the guise of providing independent research. That is Eliot Spitzer's concern.

The analysts say, "Oh, Pets.com is a great company" because they are getting paid by Pets.com to sell Pets.com stock. You might say, "What's wrong with that?" The used car salesman says, "It's a great car, it's not a lemon," and we all know he doesn't fool anyone because he's being paid to sell this car. That is not a conflict of interest; that's his job. Well that's exactly the question I want to explore a bit further: are analysts more appropriately viewed as salesmen or fiduciaries, because their resulting obligations are very different depending on the answer.

Another way of funding analyst research is through brokerage commissions. Prior to 1975, before commissions were deregulated, every broker had to charge the same amount for executing a trade.<sup>25</sup> Brokers did not compete on execution quality, website quality, or things like that, and they didn't compete on price because commission rates were fixed. Instead, they competed with research. Investors chose a broker because of the quality of information they received from that broker. At the same time, investors had no reason to place their trades through anyone else because no other broker could offer them a lower commission. If Merrill Lynch gave you good information, you traded through Merrill Lynch. The fixed commissions were artificially high—much higher than the brokers' trading costs. And the difference paid for the brokerage firm's research.

Well the SEC did away with this form of subsidy when it eliminated fixed commissions.<sup>26</sup> So now, if Merrill Lynch gives you great information

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24. See *id.* at 285-86 (explaining the public good problem).

25. See *id.* at 286-87 (describing brokerage firm use of research to attract trading customers prior to elimination of fixed commissions).

26. Fixing of Rates of Commission, Exchange Act Release No. 34-11203, 40 Fed. Reg. 7,394 (Feb.

but you place your trade through Charles Schwab, you are very happy but you are not funding Merrill Lynch's research anymore. Commissions still subsidize analysts' research, but the commissions that subsidize analysts' research are not retail investor commissions. They are commissions paid by institutional investors, commonly referred to as "soft dollars."<sup>27</sup> Soft dollars are commissions that exceed what the institutions would pay in a truly competitive market for the cost of executing the trades.<sup>28</sup> Institutions perhaps should pay three cents a share for a trade. Instead, they pay six cents a share, and the difference is for the bundle of services that the brokerage firm provides, which includes research.<sup>29</sup>

Why do they bundle it this way? There are several reasons and, in fact, the payment of soft dollars has come under a fair amount of scrutiny.<sup>30</sup> My personal view is that institutions use soft dollars to lower their reported expenses. The cost of research purchased with soft dollars is reflected in commissions, and commissions are paid with fund assets. If, on the other hand, the investment adviser buys the research directly, it comes out of the investment adviser's pocket. Either the investment adviser charges the fund for that research in the form of higher fund expenses—which are disclosed to potential investors—or the research costs lower the adviser's profits.

That's one possible reason for using soft dollars; there are others, and the debate about soft dollars is too extensive to detail here. One important aspect of soft dollars, however, is the fact that soft dollars are used to subsidize so-called independent research. In fact, industry representatives say that the funding for independent research would almost entirely disappear if soft dollars were eliminated.<sup>31</sup>

Finally, analysts' research is subsidized through trading. Trading can occur at the firm level in the form of proprietary trading, by the firm's affiliated mutual funds—Sanford Bernstein's well-known independent research firm is owned by Alliance Capital, which manages a group of mutual funds, and by the analyst herself. Indeed, one of the other elements in the analyst scandals was the revelation that analysts were not just engaging in widespread personal trading but in trading that was contrary to their public

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20, 1975) (abolishing the ability of an exchange to require its members to charge a fixed rate for commission as compensation for the use of the exchange's facilities).

27. See Letter from Matthew P. Fink, President, Inv. Co. Inst., to William H. Donaldson, Chairman, SEC (Dec. 16, 2003), available at <http://www.sec.gov/rules/petitions/petn4-492.htm> (explaining that soft dollars are the use of brokerage commissions to pay for research products and services).

28. See Jill E. Fisch, *Does Analyst Independence Sell Investors Short?*, 55 UCLA L. REV. (forthcoming 2007) (explaining use of soft dollars).

29. See Charles Gasparino, *Mutual-Fund Investors Risk Bite From 'Soft-Dollar' Deals*, WALL ST. J., Sept. 16, 1998, at C1 (quoting financial adviser Robert Levitt as stating that money managers typically pay around six cents per share for soft dollar commissions and three cents per share for commissions that do not include soft dollars).

30. See Fisch, *supra* note 28 (describing regulatory controversy over use of soft dollars).

31. See, e.g., Judith Burns, *Independent Research Hits Snags: Business Isn't Bustling As SEC May Move to Curb Soft-Dollar Arrangements*, WALL ST. J., Sept. 20, 2004, at C15 (describing 2004 survey of independent research firms by Investorside Research Association reporting that "70% said they would consider quitting the business if the SEC bans soft-dollar transactions").

recommendations.<sup>32</sup> Analysts were saying, “Buy the stock,” but they were selling the stocks or selling stocks short. And the SEC didn’t think that was such a good idea.

The point of detailing the different funding mechanisms for analyst research is to demonstrate that neither retail brokerage customers nor the investing public really pay for the research. This is an important consideration in evaluating whether we should characterize research analysts as fiduciaries with fiduciary responsibilities to retail investors. The investing public may see an analyst appear on Wall Street Week, but the public investor isn’t paying for that research beyond paying his or her cable bill.

Similarly, retail brokerage customers, even though they might seem to be funding analyst research, really are not. Although it may appear that customers who pay the commissions of the full-service broker such as Merrill Lynch are paying for research, the true answer is that the retail customer does not buy information with commission dollars. We see this, in part, in the way that brokerage firms treat their retail customers. The retail investor doesn’t receive the same report as the institutional investor, and the retail investor doesn’t receive information in a sufficiently timely fashion to trade profitably on the information. Retail investors may pay for a variety of services—things like check writing, bill paying, consolidated accounts, ATM fee rebates—but the retail investor’s commission is not payment for quality information. This result is logical; after all, the retail investor could always obtain information from a full-service broker and trade elsewhere, at discounted rates, limiting the broker’s ability to sell information profitably. Investors do purchase investment advice, but they do so through investment advisers and advised investing accounts, not through trading commissions.

### III. CONFLICTS OF INTEREST AND THE ANALYST AS FIDUCIARY

The problem with the various funding sources that I’ve outlined above—the business relationships that subsidize analyst research—is that those relationships create incentives, incentives that are commonly described as conflicts of interest. For example, the analyst who subsidizes research through investment banking business has an incentive to be optimistic—to say that the company is great—in order to sell the issuer’s securities. Similarly, an analyst that recommends stock to institutional clients and hopes to obtain future trading commissions from those clients has an incentive to maintain his or her initial optimism on securities that have been the subject of a previous recommendation. If an institution buys a lot of stock in reliance on an analyst’s recommendation and the analyst then downgrades the stock, the institution will be left holding the bag when the stock price declines. An institution that has purchased on the basis of that

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32. See, e.g., Jessica Sommar, *Red-Faced SEC Targets Two-Faced Analysts*, N.Y. POST, May 24, 2002, at 41 (reporting that an SEC investigation found widespread personal trading by analysts contrary to their public recommendations).

analyst's recommendations is going to be reluctant to rely on that analyst in the future.

So these funding sources create incentives, and the result of these incentives are proportionately too many buy recommendations, a reluctance of analysts to downgrade, and biases in terms of their coverage as well as biases in their decision to cover a company.<sup>33</sup> This is not to say that analysts have an incentive to provide misinformation. The same business relationships create incentives for analyst accuracy. Why? Because an analyst's value to institutional clients, to issuer clients, and to a firm's proprietary trading desk or mutual fund affiliate is based on his or her ability to move prices by influencing trading behavior.<sup>34</sup> An analyst comes home from work and reports to her spouse: "Honey, I had a good day; I released a report and stock prices moved by 1%." That's an influential analyst. That is an analyst who is doing a good job. That is the analyst who is going to attract clients of these various types for his or her firm.

Empirical evidence confirms both that analysts are overly optimistic and that they are accurate.<sup>35</sup> Analyst sell recommendations at the height of the technology boom were virtually nonexistent—and keep in mind that this was when prices were at their peak.<sup>36</sup> The theory is that investors should buy low and sell high, right? So prices were really high, and analysts were saying, with respect to virtually every company they covered, "Buy more, don't sell." Even after the regulatory crackdown, studies show that analyst optimism, although reduced, persists. At the same time, analysts are accurate. A variety of academics have studied the performance of analyst recommendations and, although the results are mixed, most find that analyst picks outperform the market.<sup>37</sup> Those results hold true not just for independent analysts but also for those with conflicts of interest. Indeed, the worst performance by conflicted analysts appears to be concentrated in the key bubble years—1996 through 1999.<sup>38</sup>

Finally, investors rely on analysts' information. Analysts' recommendations and analysts' reports do move stock prices. They move stock prices a

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33. See Fisch, *supra* note 28 (describing incentives created by business relationships and their effect on information provided by analysts).

34. See, e.g., Tomi Kilgore, *SpectraLink Shares Jump on Analyst Upgrade*, MARKETWATCH, Aug. 16, 2006, <http://www.marketwatch.com> (keyword search "Kilgore and SpectraLink") (describing 12% increase in price of SpectraLink shares following analyst upgrade).

35. See Jill E. Fisch, *Regulatory Responses to Investor Irrationality: The Case of the Research Analyst*, 10 LEWIS & CLARK L. REV. 57, 64-65 (2006) (describing empirical studies of analyst recommendations).

36. See Lynn E. Turner, Chief Accountant, SEC, Speech by SEC Staff: The State of Financial Reporting Today: An Unfinished Chapter III, Speech at the Third Annual SEC Disclosure & Accounting Conference (June 21, 2001) (transcript available at <http://sec.gov/news/speech/spch508.htm>) (reporting that only 0.8% of 26,000 analyst recommendations surveyed as of March 1, 2000, were sell or strong sell).

37. See Fisch, *supra* note 35, at 65-66 (summarizing studies).

38. See Brad M. Barber et al., *Comparing the Stock Recommendation Performance of Investment Banks and Independent Research Firms* 3-4 (Sept. 2005) (unpublished manuscript, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=572301](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=572301)).

lot. Sophisticated institutional investors, who should be able to identify reliable information sources, seek out and rely on sell-side research. Interestingly, despite having the opportunity to hire and produce research in house, institutions continue to rely on sell-side analysts, indicating that sell-side research does provide value.

Having observed that analyst research is valuable but biased, regulators have focused primarily on reducing or eliminating the potential for bias by mandating independence.<sup>39</sup> The theory is that if analysts are prohibited from maintaining the other business relationships that I have identified—and the primary regulatory focus has been investment banking relationships—they will lack the incentive to distort their recommendations to favor those business interests, resulting in the provision of more accurate information to investors and the marketplace. Investment banking conflicts have received the majority of the attention in the analyst scandals, which explains why the reform effort has focused on investment banking. The SEC's theory is that mandatory independence will restore the analyst's role as a gatekeeper.<sup>40</sup>

One question is, why independence? Even if separating investment banking from research would improve the quality of research or the accuracy of analyst recommendations, why should regulators impose this requirement as opposed to allowing the market to evaluate the quality of the information provided by analysts and respond accordingly? After all, conflicting business relationships are commonplace, and regulators do not typically interfere with the divided loyalties inspired by those relationships. Producers may sell the same product to two competing firms and, indeed, on terms that favor one firm over another. Although used car salesmen are not allowed to lie, no one expects them to offer an objective and reliable opinion on a car to a prospective buyer.<sup>41</sup>

Now, of course, Congress and the SEC have recently imposed heightened independence requirements on public auditors.<sup>42</sup> One may ask: how are analysts different from auditors? The answer is that auditors have a very special role—a role mandated by the federal securities laws and the public offering process. By statute, publicly traded companies are required to have audited financial statements. Thus, statutory law creates an explicit role for auditors as gatekeepers for the capital markets. Although auditors are not government employees, they are something close. As a result, auditors' ob-

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39. Some additional regulatory restrictions include increased disclosure requirements, limitations on personal trading by analysts, and bans on particular practices that were viewed as highly problematic, such as booster shots.

40. *The Impact of the Global Settlement: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. 69 (2003) (testimony of William H. Donaldson, Chairman, SEC).

41. *See, e.g., Chiarella v. United States*, 445 U.S. 222, 239-40 (1980) (Burger, C.J., dissenting) ("As a general rule, neither party to an arm's-length business transaction has an obligation to disclose information to the other unless the parties stand in some confidential or fiduciary relation.")

42. *See* Press Release, SEC, Commission Adopts Rules Strengthening Auditor Independence (Jan. 22, 2003), available at <http://www.sec.gov/news/press/2003-9.htm> (describing auditor independence requirements contained in Title II of Sarbanes-Oxley and SEC rule-making implementing those requirements).

ligations—in contrast to those of analysts—are not defined simply by private contract.

In my opinion, the independence requirement is premised upon the conception of analysts as fiduciaries. I believe that regulators have imposed an independence requirement because they view analysts as fiduciaries to the marketplace or investors.<sup>43</sup> Fiduciary obligations, after all, are the way we impose an independence requirement in the private law context. Fiduciary obligations are what separate certain relationships—principal/agent, lawyer/client, trustee/beneficiary—from the standard arms-length contract, in which each party is entitled to act out of self-interest.<sup>44</sup> Only fiduciaries have an obligation of unselfishness, an obligation which turns self-interest into a conflict of interest.<sup>45</sup> The loyalty and integrity required of a fiduciary have been characterized by Judge Cardozo as “the punctilio of an honor the most sensitive.”<sup>46</sup>

Does this fiduciary conception make sense? It is widely recognized that the financial firms that employ sell-side analysts sell a range of products and services. They provide investment banking services to issuers. They sell fairness opinions in connection with a variety of transactions such as mergers. They provide brokerage services to investors that include purchasing and selling securities on behalf of those investors. In many cases, firms provide investment management services for mutual funds. And they provide investment research. The interests of customers of each of these goods and services vary and, in many cases, are in direct opposition. The interest of an issuer, for example, is to sell its securities at the highest possible price; while the interests of an institutional investor brokerage client is to purchase securities at a low price, maximizing the potential future investment gain. Even within a single category, the interests of customers may conflict. A current shareholder in a covered company may prefer favorable research that maintains the existing stock price; a prospective investor will want a less optimistic report that dissuades him from making a risky investment.<sup>47</sup>

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43. See SEC, Statement Regarding Global Settlement Related to Analyst Conflicts of Interest, Apr. 28, 2003, <http://www.sec.gov/news/speech/spch042803com.htm> (describing limitations on investing banking contacts as “designed to maintain the analyst’s role as gatekeeper in the offering process but to prevent the analyst from serving as marketer or cheerleader for investment banking transactions”); see also John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 302 (2004) (describing as gatekeepers, who “protect the interests of dispersed investors . . . securities analysts, who verify or assess corporate disclosures in order to advise investors”); David Millon, *Who “Caused” the Enron Debacle?*, 60 WASH. & LEE L. REV. 309, 311 (2003) (describing Enron’s analysts as gatekeepers who failed “to perform their watchdog responsibilities”).

44. The Second Circuit stated that “hornbook fiduciary relations are those existing between attorney and client, executor and heir, guardian and ward, principal and agent, trustee and trust beneficiary, and senior corporate official and shareholder.” *United States v. Chestman*, 947 F.2d 551, 568 (2d Cir. 1991).

45. See RESTATEMENT (SECOND) OF AGENCY § 13 cmt. a (1958) (defining a fiduciary as “a person having a duty, created by his undertaking, to act primarily for the benefit of another in matters connected with his undertaking”).

46. *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928).

47. See, e.g., Steven L. Schwarcz, *Temporal Perspectives: Resolving the Conflict Between Current and Future Investors*, 89 MINN. L. REV. 1044 (2005) (describing differing interests of current and future

In addition, analyst research is funded primarily by a firm's issuer and institutional clients, who pay for that research both directly and through brokerage commissions, underwriting fees, and soft dollars. The general public simply is not the analyst's client.<sup>48</sup> If analysts are forced by fiduciary principles to choose between their paying clients and the general public, they will simply abandon the retail investor.<sup>49</sup>

Whether brokers owe fiduciary duties to their customer clients is not a new question. In the context of financial professionals, the law has traditionally drawn a line between investment advisers and broker-dealers, imposing broad fiduciary obligations only upon the former. Congress adopted the Investment Advisers Act to assure that investment advisers—those who provide personalized investment advice—provide unbiased advice.<sup>50</sup> Quoting the legislative history of the Act, the Supreme Court specifically found that Congress intended investment advisers to be treated as fiduciaries.<sup>51</sup> As a result, the Act reflects “a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.”<sup>52</sup>

Congress explicitly exempted broker-dealers from the Investment Advisers Act.<sup>53</sup> Significantly, Congress made this decision despite the fact that brokers, at the time the statute was passed, were known to provide research to their customers, so-called “brokerage house advice.”<sup>54</sup> Additionally, Congress was aware that brokers might provide this advice despite having other business interests that might cause their advice to be biased.<sup>55</sup>

Courts have agreed with this approach, holding that, as a general matter, brokers do not owe broad fiduciary obligations to their customers.<sup>56</sup> As

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shareholders).

48. See, e.g., FIN. SERVS. AUTH., CONFLICTS OF INTEREST: INVESTMENT RESEARCH AND ISSUES OF SECURITIES 15 (2003), <http://www.fsa.gov.uk/pubs/cp/cp171.pdf> (“Investment banks that produce investment research do so mainly for the benefit of their investment clients . . .”).

49. In other work, I document how analysts have done exactly that, reducing the quality and quantity of research that is available to the retail investor. See Fisch, *supra* note 28.

50. Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (2000).

51. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 188 (1963).

52. *Id.* at 191-92.

53. Section 202(a)(11)(C) of the Advisers Act exempts from the definition of an investment adviser a broker or dealer “whose performance of [advisory] services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor.”

54. Certain Broker-Dealers Deemed Not To Be Investment Advisers, Exchange Act Release No. 34-51523, Investment Company Act Release No. 2376, 70 Fed. Reg. 20,424, 20,428 (Apr. 19, 2005) [hereinafter Final Merrill Release], available at <http://www.sec.gov/rules/final/34-51523.pdf>.

55. *Id.* at 20,433 n.93 (“Despite such conflicts, Congress nonetheless determined to except brokers providing such advice from the scope of the Advisers Act.”).

56. See, e.g., Associated Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc., 3 F.3d 208 (7th Cir. 1994) (describing limited fiduciary obligations of brokers under both federal and state law); Hotmar v. Lowell H. Listrom & Co., 808 F.2d 1384 (10th Cir. 1987) (rejecting argument that broker acquired a fiduciary duty by giving advice to customer with respect to non-discretionary account); Merrill Lynch Pierce Fenner & Smith Inc. v. Boeck, 377 N.W.2d 605, 609 (Wis. 1985) (rejecting claim that broker had fiduciary obligation to correct investment advice unless client maintained a discretionary account).

the Second Circuit has explained, there “is no general fiduciary duty inherent in an ordinary broker/customer relationship.”<sup>57</sup> Although special circumstances such as investor allocation of discretionary authority to the broker may lead to the imposition of fiduciary principles, these cases may be understood within the framework of traditional agency law.<sup>58</sup>

In contrast, other securities professionals—brokers in particular—are not covered by the Investment Advisers Act and do not owe broad fiduciary obligations to their clients. The SEC reiterated this distinction in the context of adopting the Merrill Lynch Rule, which broadened the statutory exemption in the Investment Advisers Act that permits brokers to provide incidental investment advice.<sup>59</sup> Interestingly the SEC acknowledged that broker advice to customers was subject to potential conflicts of interest, but expressly condoned that conflict, requiring only that the potential conflicts be disclosed to customers.<sup>60</sup>

Although the DC Circuit recently invalidated the Merrill Lynch Rule as beyond the SEC’s statutory authority,<sup>61</sup> the adoption of the Rule can be understood in the context of Easterbrook and Fischel’s rationale for fiduciary duties. Easterbrook and Fischel, writing in 1993 before the analyst scandals, proposed a contractual model of fiduciary duties, rather than a paternalistic one.<sup>62</sup> Easterbrook and Fischel explained that fiduciary duties are an efficient method of contractual gap-filling when it is too difficult to specify the parties’ obligations explicitly. A fiduciary relation, they argue, “is a contractual one characterized by unusually high costs of specification and monitoring.”<sup>63</sup> In determining whether to apply fiduciary principles, then, the court’s task is to determine what obligations the parties would have agreed to if bargaining were sufficiently cheap. The court’s obligation is to impose the terms of this hypothetical bargain.

The value of the Easterbrook and Fischel approach is twofold. First, it rejects the paternalistic application of fiduciary principles to situations in which the parties had the option of contractually specifying obligations that they chose to forgo. An investor can, for example, seek disclosure of analyst

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57. *Indep. Order of Foresters v. Donald, Lufkin & Jenrette, Inc.*, 157 F.3d 933, 940 (2d Cir. 1998).

58. *See, e.g., SEC v. Zandford*, 535 U.S. 813, 813 (2002) (recognizing fiduciary relationship in which elderly man and his mentally retarded daughter gave broker “discretion to manage the account and a general power of attorney to engage in securities transactions without their prior approval”).

59. *See* Final Merrill Release, *supra* note 54.

60. *See* 17 C.F.R. § 275.202(a)(11)-1(a)(1)(ii) (2007) (requiring advertisements, contracts, and other documentation relating to such accounts to “include a prominent statement that: ‘Your account is a brokerage account and not an advisory account. Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interest. We are paid both by you and, sometimes, by people who compensate us based on what you buy. Therefore, our profits, and our salespersons’ compensation, may vary by product and over time.’”).

61. *See* *Fin. Planning Ass’n v. SEC*, No. 04-1242, 2007 U.S. App. LEXIS 7356, at \*19 (D.C. Cir. Mar. 30, 2007) (holding that the rule “is in direct conflict with both the statutory text and the Committee Reports”).

62. Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425 (1993).

63. *Id.* at 427.

conflicts of interest and refuse to trade on the basis of recommendations released by conflicted analysts or those who fail to provide such disclosure. Second, the Easterbrook and Fischel approach recognized that after-the-fact imposition of fiduciary obligations imposes a cost on subsequent relationships. Using the specific example of broker recommendations, Easterbrook and Fischel observed that treating brokers as fiduciaries would likely cause the market to adjust in ways that would not increase investor protection but simply increase cost of and access to information.<sup>64</sup> Similarly, the SEC recognized that the Merrill Lynch Rule encourages innovation in the provision of services to investors by freeing brokers from the risk that they will be treated as fiduciaries in connection with the provision of those services.

Applying this analysis suggests several reasons why the imposition of fiduciary obligations on analysts is undesirable. First, issuers and institutional investors—arguably the analysts' true clients because they pay for analyst research, directly or indirectly—are sophisticated customers that can address concerns about analyst independence explicitly by contract. To the extent that analyst research is more credible in the absence of conflicts of interest, analysts should be able to charge a premium for that research if they contractually commit to avoid investment banking or other conflicts. Similarly, if institutions are concerned about analyst conflicts of interest, they can bargain for independence, limiting their consumption of research to analysts that maintain freedom from investment banking or other relationships. To the extent, however, that other business relationships create synergies or lower the costs of production, customers may be willing to accept those relationships. In either case, the market is an appropriate tool for ascertaining the extent to which independence is valuable.

The traditional justifications for the imposition of fiduciary duties are simply inapplicable. Institutional investors do not require the paternalism associated with fiduciary duties. Contracting for analyst independence is not complex or expensive. And analysts do not exercise discretionary authority over the property of their institutional and issuer clients. Now this analysis only goes so far, of course, because arguably the intended beneficiaries of analyst regulation are not the institutions but the retail investors. Even if small investors do not really pay for analyst research, one can argue that they are misled by it. The markets may be efficient overall because sophisticated investors are "in on the game," but small investors are losing money.

Of course this is true, and my answer to this concern is twofold. First, where a retail investor and an investment professional truly have a personal relationship such that the investor reasonably relies on the professional's investment advice, that relationship is, and should be, characterized as an investment advisory relationship. Such relationships are subject to the Investment Advisers Act, which includes the imposition of fiduciary obligations. It is important, however, to distinguish between personalized invest-

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64. *Id.* at 428.

ment advice and the generic provision of issuer and market information, at no cost, to the marketplace as a whole. Although I do not argue that the provision of such information should be immune from regulatory oversight—and indeed, it remains subject to the antifraud provisions of the federal securities laws—I do not believe it should create fiduciary obligations.

Second, regulators are limited in their ability to protect small investors from unreliable or unsuitable information. Concededly, investors rely on a wide variety of information from dubious sources—sources far more dubious than conflicted research analysts. I have described elsewhere SEC regulatory actions based on allegations that individuals were able to manipulate the market and inflate stock prices by hyping stocks through Internet chat rooms and phony answering machine messages.<sup>65</sup> To the extent that the SEC has correctly found that the market responds to these schemes, it appears that non-trivial numbers of investors are willing to trade on information virtually regardless of its source. At the same time, it is doubtful that the SEC has the ability to distinguish reliably between suitable and unsuitable information for investors, particularly in light of the variety of well-documented market irrationalities and biases that might cause seemingly irrelevant information, such as hemlines, to be a reasonable basis for investment decisions.

#### IV. THE COSTS OF ANALYST INDEPENDENCE

I indicated earlier that one of the arguments against the imposition of fiduciary obligations is the ensuing cost. Let me talk a little further about the costs of mandated analyst independence. First, let's take a look at the so-called independent analysts. Independent analysts are, in the view of regulators, the appropriate model for the provision of research to the marketplace. Indeed, the Global Research Settlement requires the defendant investment banks to provide \$432.5 million for independent research reports, which are being distributed to their customers.<sup>66</sup>

But the independent analysts are not as independent as one might think. I explore this issue in more detail elsewhere, but consider the example of Morningstar, the poster child of independent analysis. Morningstar started off by rating mutual funds—you may be familiar with the Morningstar Five Star rating, which, incidentally, has a major effect on the movement of funds into and out of mutual funds.<sup>67</sup> Morningstar now does a whole lot more. Morningstar has expanded its equity research substantially—it has become one of the largest independent research providers, and it is selling

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65. Fisch, *supra* note 35, at 70-73. For a recording of a phony answering machine message fraud scheme, see SEC, "Wrong Numbers" and Stock Tips on Your Answering Machine, <http://www.sec.gov/investor/pubs/wrongnumberscam.htm> (last visited Mar. 3, 2007).

66. SEC Fact Sheet, *supra* note 7.

67. Nicholas Stein, *Morningstar's Bright Future Turns Cloudy*, FORTUNE, Jan. 10, 2005, at 94, 94-95.

its research to five of the defendant investment banks in connection with the terms of the Global Research Settlement.<sup>68</sup>

But Morningstar may suffer from conflicts of interest as well. Among its other businesses, Morningstar sells its data and research to big institutions, including mutual funds. So Morningstar relies increasingly on income from customers, those same customers that it purports to rate independently.<sup>69</sup> Morningstar also purchased investment advisory firm Ibbotson Associates, expanding its provision of consulting and advisory services and increasing concerns that the company was “get[ting] paid from both sides of the table.”<sup>70</sup> In the last few years, Morningstar has been the subject of investigations by the SEC, the Labor Department, and N.Y. State Attorney General Eliot Spitzer, although the SEC subsequently announced that it had closed its investigation.<sup>71</sup> The investigations by the Labor Department and Spitzer reportedly focus on possible conflicts of interest.<sup>72</sup>

Similarly, although research firm Sanford Bernstein frequently appears at the top of lists of so-called independent analysts, it is owned by mutual fund Alliance Capital. As the Wall Street Journal has observed, this relationship creates a risk that the firm’s research could be influenced by the interests of its mutual fund parent.<sup>73</sup> “[T]he firm’s big holdings could rise or fall on the analysts’ upgrades or downgrades.”<sup>74</sup> The risk was sufficient to prevent Sanford Bernstein from qualifying as a provider of independent research for purposes of the Global Research Settlement.<sup>75</sup> The SEC has also fined Sanford Bernstein and one of its analysts, Brad Hintz, for violating conflict of interest rules.<sup>76</sup>

Why do conflicts persist even at supposedly independent research firms? Because investment banking conflicts are not the only business relationships that create a risk of influence. At the same time, the structure of the research market doesn’t support an adequate supply of research absent subsidization through other business operations. If firms are unable to subsidize research, they will cut back, and studies indicate that they have done so. The quantity of research available to the marketplace—and to the small

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68. *Id.* at 98.

69. *Id.* at 95, 98.

70. Arden Dale, *Morningstar Bolsters Advice Lineup: Ibbotson Deal Adds Heft In Investment Strategy; Magellan’s Turnaround*, WALL ST. J., Mar. 2, 2006, at C11 (quoting Mercer Bullard, Univ. of Miss. law professor) (internal quotation marks omitted).

71. John Spence, *SEC Passes on Morningstar Action: Notice in 2004 Warned Of Potential Civil Charges Over Reporting of Bad Data*, WALL ST. J., Feb. 9, 2006, at C15.

72. *Id.*; Kathleen O’Donnell, *Morningstar to Buy 401(k) Manager: Deal for Ibbotson Associates Adds \$3.5 Billion in Assets But Raises Conflict Concerns*, WALL ST. J., Dec. 13, 2005, at C17 (describing the investigations).

73. Susanne Craig & Ann Davis, *Analyze This: Research Is Fuzzier Than Ever: A Year After Firms’ Settlement, NASD Is Launching Inquiry Into How Ratings Are Applied*, WALL ST. J., Apr. 26, 2004, at C1.

74. Davis & Craig, *supra* note 16.

75. See Randall Smith & Ann Davis, *Dark Horse Leads Stock-Research Sweepstakes*, WALL ST. J., Dec. 16, 2003, at C1.

76. Susanne Craig, *Brokerage House, Analyst Are Fined In Conflict Case*, WALL ST. J., Feb. 9, 2006, at C5.

investor in particular—has dropped dramatically since these regulatory reforms.<sup>77</sup> I go into the statistics in more detail elsewhere, but firms have substantially reduced their expenditures on sell-side research.<sup>78</sup> Moreover, future developments such as the end of the temporary subsidy provided by the Global Research Settlement and the possible elimination of soft dollar payments for research, payments that currently account for approximately 90% of the revenue of independent research firms, are likely to reduce the amount of research further.<sup>79</sup>

The biggest effect is on the research coverage of small issuers: the small companies, the small caps, and the start-up companies that are just looking for public investors—a huge number of them have no coverage at all. Not a single analyst is willing to talk about their stock. And if analysts do not provide coverage, the market with respect to that issuer's securities will not be very efficient, and people will not invest in the company.<sup>80</sup>

An interesting market development that we have seen in response to this problem is paid research or research for hire.<sup>81</sup> A number of research firms advertise their services to small issuers along the following lines: "You're a small company; no analyst will pay attention to you. Pay us \$25,000, and we'll write a report; send that report out to institutional investors; put it on our website; and then people will know about you." Well, talk about a conflict of interest! The issuer is paying the analyst to write a report. Will the analyst write a good report or a bad report? How much future business can the analyst expect from that issuer, or any other issuer, if he or she writes a bad report?

In fact, issuer-financed research is a great idea. In an article that I wrote with Stephen Choi, we proposed a voucher-financing system for analysts' research where issuers would pay for the research.<sup>82</sup> The key to our proposal, however, was that we took the job of selecting the analyst's firm away from the issuer's management because the whole point of information in the marketplace is to evaluate and potentially discipline management. Consequently, management cannot operate as the gatekeepers and select the source of this research. Along these lines, there have been some preliminary efforts to remove the taint associated with paid research by providing a neutral mechanism for selecting the research provider.<sup>83</sup>

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77. Indeed, the effect has increased the gap between the information available to market professionals and to retail investors. See Ann Davis, *Increasingly, Stock Research Serves the Pros, Not 'Little Guy,'* WALL ST. J., Mar. 5, 2004, at A1.

78. Fisch, *supra* note 28.

79. *Id.*

80. See Choi & Fisch, *supra* note 23, at 290-91 (describing social value of equity research).

81. See Susanne Craig, *Firm to Research Stock 'Orphans,'* WALL ST. J., June 7, 2005, at C3; see also Fisch, *supra* note 28, 43-44 (describing research for hire).

82. Choi & Fisch, *supra* note 23, at 314-28.

83. See Craig, *supra* note 81 (describing a proposal by Nasdaq and Reuters to form the Independent Research Network that would screen independent research firms and provide coverage for "orphan" issuers).

## V. ALTERNATE REFORM STRATEGIES

If mandatory independence is not the answer, what is? Very briefly—and I consider more detailed alternative regulatory proposals in other work<sup>84</sup>—my suggestions here start from the premise that, for the reasons described above, our traditional approach to broker regulation has been through narrowly tailored rules that address specific risks of abuse. Thus, if we are concerned that brokers are not taking sufficient care with respect to the protection of customer assets, we impose rules regarding recordkeeping and segregation of funds. If we are worried about brokers charging excessive fees, we require confirmations that break down broker charges individually. Note the difference between these types of rules and the imposition of broad-based fiduciary principles, which are costlier precisely because they are standard-based and create uncertain liability exposure.

Applying this approach to the analyst scandal suggests several possibilities. First, if we are concerned with personal trading by analysts and their firms, particularly the trading-based market effect of the release of the analyst's recommendation, we could restrict this type of trading or require increased disclosure of short-swing trading profits. Many of you are familiar with section 16 of the Securities Exchange Act of 1934, which addresses short-swing trading by corporate insiders.<sup>85</sup> Officers, directors, and 10% stockholders must disclose their personal trading, and if they buy and sell within a six month period, they have to turn their short-swing trading profits over to the issuer. One of the effects of section 16 is that it prevents corporate insiders from taking advantage of information disparities by trading right before a favorable press release or other good news. Regulators could impose the same type of restriction on analysts and their firms. This restriction would not prevent analysts from subsidizing research through personal and proprietary trading but would prevent them from trading on the market impact of their public statements as opposed to the long-term prospects of the company.

One could respond to this suggestion by pointing to the fact that the regulatory reforms adopted in response to the analyst scandals already require disclosure of personal and proprietary trading. This is true. But the disclosure requirements do not extend to all analysts, and even when they do, they require very limited disclosure.<sup>86</sup> Independent analysts who are not members of the New York Stock Exchange or NASD are not even subject to a disclosure requirement and are free to engage in whatever proprietary trading they want.

Standardizing analyst ratings and recommendations would also be valuable. Firms use different names and different numbers of ratings, limiting investors' ability to compare them. In addition, regulators could respond to

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84. See Choi & Fisch, *supra* note 23; Fisch, *supra* note 28.

85. Securities Exchange Act of 1934, § 16, 15 U.S.C. § 78p (2000).

86. Disclosure of firm and analyst trading positions has improved since this Lecture was delivered.

overly optimistic recommendations by requiring firms to distribute their recommendations uniformly across the full spectrum of ratings.<sup>87</sup> If a firm used three ratings such as buy, sell, and hold, it would be required to include an equal number of covered issuers in each of the three categories. This solution would immediately address the problem of 95% of recommendations being buy recommendations. The resulting buy recommendations would, in turn, be more informative. The system would reduce issuer retaliation against analysts for negative recommendations because the percentage of negative recommendations would be so much higher. This reform would also reduce the incentive for analysts to terminate coverage because they would need to cover some “bad” companies in order to maintain the required distribution, a development that would result in a lot of new information for the market.

It should also be easier to determine whether analysts are doing a good job. A third possible reform would be required public disclosure of analyst ratings.<sup>88</sup> Several private firms are now rating analysts on the basis of their performance.<sup>89</sup> Retail investors can obtain some of this information—some for free and some for a small fee.<sup>90</sup> But the retail investor can not obtain all of the information—much more is provided to institutional investors.<sup>91</sup> Additionally, the ratings information is not provided together with the analyst’s public statements. It would not be very difficult to move from these types of ratings to a number that must be affixed to any public dissemination by the analyst of a recommendation or report. So if an investor is reviewing an analyst’s report on IBM, the investor can see that this particular analyst is rated 9 on a scale of 1 to 10. And there would be a place where the investor could learn what a 9 rating means.

Similarly, a lot of analyst information is bundled before it is released to the public. Thomson Financial provides widely followed consensus estimates, reflecting information to which investors may not have direct access.<sup>92</sup> But while Thomson Financial reports that the consensus analyst recommendation is “buy,” the investor does not know which analysts’ recommendations are reflected in that consensus, what their conflicts are, or what

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87. Studies show that the distribution of recommendations has improved, but it is by no means uniform. See Fisch, *supra* note 28 (describing shifts in composition of ratings and recommendations).

88. In other work, I develop a more extensive proposal for disclosure of analyst performance. See Fisch, *supra* note 28.

89. See, e.g., Investars 2005, <http://www.investars.com> (last visited Mar. 3, 2007); StarMine, <http://www.starmine.com> (last visited Mar. 3, 2007).

90. But see StarMine, [http://www.starmine.com/index.phtml?page\\_set=investor](http://www.starmine.com/index.phtml?page_set=investor) (explaining that StarMine’s analyst rating service for individual investors has been discontinued because “we are currently focusing our resources on our institutional-grade StarMine Professional research service”).

91. See, e.g., Alistair Barr, *Rating the Independent Researchers; Despite Restrictions, Some Researchers Are Tracked*, CBS MARKETWATCH, Aug. 6, 2004, <http://www.investars.com/articles/article08062004-2.asp> (stating that some research firms will not provide access to rating services that provide information to retail investors).

92. T. Clifton Green, *The Value of Client Access to Analyst Recommendations*, 41 J. FIN. & QUANT. ANAL. 1, 4 (2006) (explaining the production of Thomson Financial’s First Call consensus estimates).

their performance track record is. Even a consolidated or average performance rating would add a great deal of informativeness.

A final possibility is increased analyst accountability for outright fraud. At the beginning of this Lecture, I talked about the analyst scandals. The scandals did not go unnoticed by plaintiffs' lawyers. There has been extensive litigation and arbitration against analysts and their firms. Most of the efforts to recover against analysts, even for knowing false statements, however, have been unsuccessful due to various legal obstacles such as statute of limitations, loss causation, and limitations on fraud on the market.<sup>93</sup> It is somewhat ironic that, at the same time that regulators are condemning business relationships that present even the potential for bias, courts are limiting analyst exposure, not for breach of fiduciary duty, but for fraud.

## VI. CONCLUSION

Analysts play a key role in transmitting information to the marketplace. The analyst scandals have caused regulators to seek to increase the reliability of analyst information by mandating independence. I have argued that, in essence, mandated independence casts the analyst in the role of fiduciary. Fiduciary obligations, however, are inconsistent with the business model upon which analyst research is based and by which it is financed. As a result, mandatory independence threatens the financial viability of sell-side research and risks the counterproductive consequence of reduced market efficiency.

Instead, I argue that it would be more appropriate to address analyst misconduct through narrowly tailored regulations similar to those that regulators have enacted in the past. As the market responds to the effect of the new analyst rules, regulators may be called upon to reexamine the consequences of the fiduciary model.

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93. See, e.g., *Hevesi v. Citigroup Inc.*, 366 F.3d 70 (2d Cir. 2004); *Demarco v. Lehman Bros., Inc.*, 222 F.R.D. 243 (S.D.N.Y. 2004); *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 273 F. Supp. 2d 351 (S.D.N.Y. 2003).