# *Solving the Sell-Side Research Problem:*

# *Insights from Buy-Side Professionals*

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Since the market peak in the spring of 2000, the press, investors, politicians, and regulators have grown increasingly critical of sell-side research and its potential for conflicts of interest. In a recent development, the Securities and Exchange Commission (SEC) has approved NASD and NYSE rules to address many of these conflicts. The rules will be implemented in phases from July to November 2002.[1] In the fall of 2001, we conducted a survey of buy-side investment professionals to obtain their views on sell-side research, analyst conflicts of interest, and possible remedies. This paper examines the provisions of the recently approved NASD and NYSE rules, comparing them to what these surveyed professionals feel are most needed and most valuable. This discussion is timely not only because buy-side professionals are likely the most knowledgeable regarding the potential conflicts of interest of sell-side analysts but also because the SEC has suggested that further rulemaking is under consideration.[2]

At the time of the survey, Wall Street research credibility had already been called into question in a variety of forums.[3] In the summer of 2001, the U.S. House of Representatives held hearings on sell-side analyst conflicts of interest.[4] The SEC's Office of Investor Education and Assistance issued an "Investor Alert" to educate retail investors on the potential conflicts of interest faced by brokerage analysts.[5] NASD requested comments on "Proposed Amendments to Rule 2210" that would increase firms' disclosure requirements.[6] The Association for Investment Management and Research (AIMR) formed a Task Force on Analyst Independence and invited comments on a proposed issues paper titled "Preserving the Integrity of Research".[7] The Securities Industry Association (SIA) formed an Ad Hoc Committee on Analyst Integrity and drafted a set of guidelines, presented in a monograph called "Best Practices for Research".[8]

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[1] On May 10, 2002, the SEC approved new National Association of Securities Dealers (NASD) Rule 2711 and amendments to New York Stock Exchange (NYSE) Rule 472 to "address conflicts of interest that are raised when research analysts recommend securities in public communications." [SEC (2002), page 3.]

[2] The SEC notes that "some aspects of the rules incorporate novel approaches to dealing with conflicts problems" that may have negative and unforeseen impacts in the marketplace. The SEC requests therefore that the NASD and the NYSE evaluate "the operation and effectiveness" of the rules by November 1, 2003. The SEC also states that it has "commenced a formal inquiry into market practices concerning research analysts and the conflicts that can arise from the relationship between research and investment banking", which will possibly "indicate the need for further SRO rulemaking or additional Commission action." SEC (2002), pages 36-37. "SRO" means self-regulatory organization, such as the self-regulatory arms of NASD and the NYSE.

[3] For example, see *Financial Times*, "Shoot All the Analysts", March 20, 2001, page 22; *Fortune*, "Where Mary Meeker Went Wrong", May 14, 2001, pages 68-82; and *Wall Street Journal*, "Outlook for Analysts: Skepticism and Blame", June 13, 2001, page C1.

[4] "Analyzing the Analysts: Are Investors Getting Unbiased Research from Wall Street" on June 14, 2001, and "Analyzing the Analysts II: Additional Perspectives" on July 31, 2001.

[5] OIEA (2001).

[6] NASD (2001).

[7] AIMR (2001).

[8] SIA (2001).

Some very important developments since the time of the survey have led to additional criticisms of sell-side analysts by the press, investors, politicians, and regulators. For example, although Enron was in the headlines at the time of the survey, it did not file for Chapter 11 protection until December 2001. Congressional hearings quickly followed, including questions of potential conflicts of interest of analysts who maintained buy recommendations on Enron just six weeks prior to the bankruptcy filing.[9] In May 2002, Merrill Lynch agreed to a settlement with the State of New York to end an investigation into their research practices after disclosing analysts' internal emails that trashed stocks they publicly touted.[10] WorldCom's accounting scandal became public knowledge in June 2002 with questions of potential analyst conflicts of interest making headlines within days.[11] Interestingly, however, as of the fall of 2001, the majority of buy-side professionals who took part in the survey already voiced concerns about conflicts of interest that face sell-side research analysts and recommended a variety of changes to address these conflicts.

We conclude that the new NASD and NYSE rules speak to many of the concerns voiced by the majority of the surveyed buy-side professionals. The survey results, however, suggest several areas in which the rules will be difficult to credibly enforce. In particular, the majority of surveyed buy-side professionals are skeptical as to how the incentives and pressures that analysts face from investment banking can be eliminated. The survey results also identify several concerns raised by buy-side professionals that have yet to be addressed by the SROs or SEC, such as the incentives of companies to freeze out sell-side analysts who do not issue positive research and pressure from buy-side clients not to downgrade the stocks they hold.

The remainder of the paper is organized as follows. The survey and results are presented in Section I. Section II provides a brief summary of the buy-side professionals' opinions about the value of sell-side research and the motivations of sell-side analysts. Section III examines how well the new rules address the views and concerns of the survey participants. Section IV concludes and suggests ideas for future research.

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[9] *Wall Street Journal*, "Debt Is Downgraded by Moody's", October 30, 2001, page A4; *Wall Street Journal*, "Most Analysts Remain Plugged in to Enron", October 26, 2001, page C1; *Wall Street Journal*, "Enron's Collapse Roils Insiders and Wall Street – Lehman Faced Possible Conflict as Merger Failed", December 5, 2001, page C1; *Wall Street Journal*, "How Wall Street Greased Enron's Money Engine", January 14, 2002, page C1; and *Wall Street Journal*, "Trading Charges: Lawsuit Spotlights J.P. Morgan's Ties to the Enron Debacle", January 25, 2002, page A1.

[10] *Wall Street Journal*, "Merrill Lynch to Pay Big Fine, Increase Oversight of Analysts – New York Attorney General Wins $100 Million Penalty; E-Mails Exposed Research", May 22, 2002, page A1.

[11] *Wall Street Journal*, "Salomon Likely to Come Under Fire" and "Some Untimely Analyst Advice on WorldCom Raises Eyebrows", June 27, 2002, page A12.

## I. Our Survey on Sell-Side Conflicts

Survey participants were 92 investment professionals, all alumni of the Tuck School of Business at Dartmouth College. The initial request for participation in the web-based survey was emailed on October 15, 2001. One week later, we had obtained 60 responses and emailed a follow up request for participation, eliciting an additional 32 responses by November 21, 2001. The response rate was 76%. Respondents' identities were verified by cross checking email addresses.[12]

The questionnaire consisted of nine multipart questions. Tables 1 through 9 present the results for each question in the order it appeared in the survey. As shown in Table 1, the respondents' work experiences include portfolio management, analysis, and trading in equities and fixed-income securities. Although four individuals indicate they have work experience as sell-side analysts, they also each indicate experience in at least one buy-side category.

Table 1 indicates that respondents work for firms with assets under management that range from less than $ 1 billion (21% of respondents) to more than $100 billion (43% of respondents). Using nonparametric Wilcoxon tests, we test whether the responses of respondents from the largest firms (that is, with more than $100 billion of assets under management) systematically differ from the responses of the others. For the mot part, they do not. In only three question subparts do we reject the null hypothesis that the two populations are identical at a 5% significance level.[13]

## II. The Value of Sell-Side Research and the Motivations of Sell-Side Analysts

### *A. The Value of Sell-Side Research*

What do buy side professionals value most in sell side research? Question 2 of the survey asked the participants to rate a large number of research services provided by sell-side analysts. As Table 2 shows, discussions that buy-side professionals initiate themselves with the sell-side analysts rank highest in value on average. Detailed research reports receive the next highest marks. The least

[12] The original list consisted of 126 individuals whose alumni records self-identified them as current employees of investment firms. Five responded that they had sell-side but not buy-side experience and did not participate in the survey.

[13] Regarding large firm and small firm differences, for Question 5 (Table 5, part E), the respondents from the larger firms provide greater indication that they discount opinions and recommendations of analysts of firms with an investment banking relationship with the company covered. The mean of their responses is 4.38 versus a mean of 4.00 for the responses of those from the smaller firms. For Question 6 (Table 6, part F), the respondents from the smaller firms indicate a stronger belief that analysts should disclose in research reports the actual amount of the stock of the company covered that they are long or short. The mean of their responses is 3.98 versus a mean of 3.38 for respondents from larger firms. For Question 7 (Table 7, part D), the respondents from the larger firms expressed a greater willingness to pay more for independent research if better services were available. Their responses have a mean of 3.72 versus a mean of 3.25 for the others.

valuable research service is the announcement of a new buy recommendation, ranked as "usually" or "always" valuable by only 5% of respondents. With the exception of new buy recommendations, all the services listed were ranked by at least half the respondents as valuable at least some of the time.

Question 2 also permitted participants to type in any other services they find valuable that we did not list. The most common response was that sell-side analysts provide buy-side professionals with valuable access opportunities to company management, setting up lunches, dinners, on site visits, and other networking opportunities. Other write-ins indicated by respondents are listed at the bottom of Table 2.

### *B. The Motivations of Sell-Side Analysts*

Question 3 asked for buy-siders' opinions as to what provides the strongest motivations for sell-side analysts. As shown in Table 3, the respondents ranked 1) compensation tied directly to investment banking business the analyst generates and 2) the analyst's desire to retain and attract investment banking clients as the most important motivations. More than half the respondents also rated rankings from buy-side analysts (presumably *Institutional Investor's* annual poll, for example), trading volume-linked compensation, and pressure from the management of companies covered as usually or always important. Seventy percent of respondents rated the pressure from buy-side clients not to downgrade stocks they hold as an important motivation for sell-side analysts at least some of the time.[14]

## III. The New Rules Evaluated in the Context of the Survey Results

How well do the new rules address the views and concerns of the survey participants? In this section, we systematically step through the provisions of the new rules and then discuss the survey results in the context of these provisions. SEC (2002, page 5) states that NASD Rule 2711 and amended NYSE Rule 472 are "substantially identical and intended to operate identically". Therefore, in this section, we simply reference NASD Rule 2711, which is given in full at www.nasdr.com. Paragraph (a) of NASD Rule 2711, which we do not address, simply provides definitions of the terms used in the rule.

[14] Boni and Womack (2002) provide additional background on the possible motivations of sell-side analysts.

*A. Separation of Sell-Side Research and Investment Banking*

Paragraph (b) of the new NASD Rule 2711 prohibits sell-side research analysts from being "subject to the supervision or control" of investment banking. Investment banking is prohibited from reviewing or approving sell-side research reports except to the extent necessary "to verify the factual accuracy of information in the research report or to review the research report for any potential conflict of interest". Written communications between research and investment banking must be made through or copied to "an authorized legal or compliance officer" of the firm. Oral communications must be documented and conducted through such an officer or in his presence.

Question 9 of the survey was designed to obtain buy-side professionals' opinions on the Securities Industry Association (SIA) "Best Practices for Research" guidelines, which had been released just prior to the survey. One of the guidelines is that research analysts should not report to investment banking. Most (91%) of the survey participants endorsed this guideline. But almost half (48%) were skeptical, however, that this guideline could be credibly implemented (Table 9, part A). Similarly, most (91%) agreed with the SIA guideline that analysts should not submit their research to investment banking. But again, forty percent did not believe this guideline could be credibly implemented (Table 9, part D).

*B. Review of Research Reports and Opinions by the Company Covered*

Paragraph (c) of Rule 2711 prohibits firms from showing research reports to the companies being covered prior to their publication. Exceptions are that sections of the research reports may be shown to companies to verify facts if these sections do not provide the research summary, rating, or price target, and if the research report in its entirety has already been provided to the firm's compliance officer. If after showing the company the research report the analyst changes the rating or price target, then these changes must be approved by the compliance officer, documented, and kept on file for three years. Paragraph (c) also allows a firm to notify a company that it will change its rating of the company's securities one business day before the change is made public. The company must be notified after the close of trading "in the principal market of the subject company's securities". Most (91%) of the buy-side professionals agreed that analysts should not submit their research to the managements of the companies covered prior to publication, but many (40%) did not believe this guideline could be credibly implemented (Table 9, part D).

*C. Analyst Compensation*

Paragraph (d) of Rule 2711 prohibits firms from tying analyst compensation to specific investment banking deals. Most (89%) of the buy-side professionals agreed with this when asked as an SIA guideline (Table 9, part C). [15] Many (57%) did not believe this guideline could be credibly implemented.

*D. Promise of Favorable Research*

Paragraph (e) of Rule 2711 prohibits firms from offering favorable research reports, ratings, or price targets to a company to obtain its banking business or other compensation. It also prohibits firms from threatening to change currently favorable research ratings, etc., to obtain banking business. Interestingly, one of the respondents volunteered that "often buy reports come out when the bank is trying to get the investment banking business: the point is that listing official representation [for example, in research report disclosures] is helpful but it is also useful to know if the bank is in there bidding for current business too" (see "Other comments", Table 6).

*E. Quiet Period*

Paragraph (f) of Rule 2711 prohibits the managers and co-managers of an initial public offering (IPO) from publishing research reports for 40 calendar days (in other words, imposes a "quiet period") following the IPO. The SEC notes that, consistent with Securities Act Rule 174, dealers (including the underwriters) maintain a quiet period of 25 days following an IPO. The SEC also notes that the new "NASD and NYSE rules apply only to the manager and co-managers of an IPO." [16] The SEC states the NASD and NYSE rules "are an acceptable means to mitigate the pressures to solicit business on the basis of favorable research." [17] Paragraph (f) also imposes a quiet period of 10 days following seasoned offerings. Exceptions are that the underwriter may issue research reports "concerning the effects of significant news or a significant event on the subject company" within the quiet periods and for actively traded seasoned issues.

Most respondents (62%) indicated that new buy recommendations are rarely or seldom valuable (Table 2, part E). Even more (86%) said they discount the recommendations of analysts where there

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[15] Recent press accounts indicate that bonuses tied to investment banking can be enormous. The *Wall Street Journal*, for example, reports Salomon analyst Jack Grubman's annual base salary of $200,000 "was augmented by guaranteed bonuses of at least $11.8 million and $7.8 million for 1998 and 1999, respectively" and "that at least part of his pay involved helping the firm win investment-banking business." (July 22, 2002; page A1, A6.)

[16] SEC (2002), page 27.

[17] SEC (2002), page 28.

is an investment banking relationship (Table 5, part E). Thus, this imposition of a longer quiet period for managing and co-managing underwriters is unlikely to have much impact for buy-side professionals.

### *F. Sell-Side Analysts' Personal Investments and Trading Activity*

Paragraph (g) of Rule 2711 places restrictions on the personal trading and investments of sell-side analysts. Analysts are prohibited from own pre-IPO securities in businesses of the same type that they cover. Analysts are prohibited from trading a security (including options and other derivatives of the security) from 30 days prior to 5 days after publishing a research report, a ratings change, or a price target change for the security. Analysts are prohibited from trading contrary to their most recent recommendation for the security. Exceptions are permitted for unexpected changes in "personal financial condition" and in the assignment of the companies the analyst covers.

Question 4 of the survey was designed to ask the buy-side professionals for their views on analysts' personal trading and investments in the companies they cover. Only 8% believe analysts should be allowed to make pre-IPO investments in companies with which their firm is attempting to do investment-banking business (Table 4, part D). The question did not limit pre-IPO ownership to companies in the same business as that covered by the analyst, however some respondents may have placed that interpretation on the question. The respondents are almost evenly split as to allowing analysts to own stock in the companies covered (Table 4, part A). Fewer believe analysts should ever be allowed to short the stock of companies they cover (Table 4, part B). Only 26% of the respondents believe analysts make better valuations when they have positions in the stocks of the companies they cover (Table 4, part E). Almost all the respondents (96%) believe that if analysts are allowed to take positions, they should not trade a security while preparing research on it or for a reasonable time after (Table 9, part E). Most (76%) believe analysts' trading should be consistent with their recommendations (Table 9, part F).

### *G. Research Pronouncement Disclosures*

To assist market participants in deciding for themselves whether to discount the research of analysts when the potential for conflicts of interest exist, Paragraph (h) of Rule 2711 spells out dozens of specific provisions for increased disclosure as discussed below. Most of the survey respondents (89%) were in favor of increasing disclosure in general as of fall 2001 (Table 6, part H).

*G.1. Ownership and Material Conflicts of Interest*

In research reports and during public appearances, analysts must disclose if they or their households have financial interests in the securities of the companies discussed. Analysts must also disclose "the nature of the financial interest (including, without limitation, whether it consists of any option, right, warrant, long or short position)." They must disclose during public appearances "any other actual, material conflict" that they know or "have reason to know" of. The firm for which the analyst works must disclose if it or its affiliates own 1% or more of any class of common equity securities of the company covered.

Most survey respondents (95%) indicated that analysts should be required to disclose their positions in the stocks they cover (Table 4, part C). Fewer (69%) said that analysts should have to disclose the actual amount of the position (Table 6, part F). Seventy-four percent believe analysts should disclose all conflicts of interest during media appearances (Table 6, part G). Respondents are less inclined on average to require brokerage firms to disclose stock positions: 62% want disclosure (Table 6, part E).

*G.2. Receipt of Compensation*

A firm must disclose if the compensation of the research analysts "principally responsible for preparation" of the research report is determined at least in part by investment banking revenue. A firm must disclose if it managed or co-managed a public security offering or received investment-banking compensation from the company covered in the last year. A firm must disclose if it expects to do investment-banking business with or receive compensation in the next 3 months.

As discussed in earlier sections, the survey respondents believe the desire to attract and maintain investment-banking business for their firm and their compensation derived from that rank highest among analyst motivations (Table 3). Most discount the recommendations of analysts of firms that have an investment banking relationship with the subject company. Not surprisingly therefore, most (93%) want a firm to report when it last acted as an underwriter for the subject company (Table 6, part B); 83% when it last provided advice on mergers and acquisitions (Table 6, part C).

*G.3. Meaning and Distribution of Ratings*

In research reports, a firm must define what each rating in its rating system means and the "definition must be consistent with its plain meaning." In research reports, a firm must disclose, regardless the firm-specific ratings system it uses, the distribution of its ratings that fall into simple "buy", "hold/neutral", and "sell" categories. It must disclose how many companies in each category have been investment banking clients in the last year.

Most survey respondents (89%) agree that firms should clearly define their ratings systems in every research report (Table 9, part B). Only 56% believe it would be helpful if recommendation language were standardized across firms (Table 5, part A). Most (84%) believe analysts should issue more "sell" recommendations (Table 5, part B); and 79% interpret a "hold" recommendation as a "sell" recommendation (Table 5, part G). As already noted, survey respondents indicate a strong preference for disclosure of investment-banking relationships.

### *G.4. Price Charts and Targets*

For companies it has assigned a rating for at least a year, a firm must provide historical (daily frequency) price charts that indicate the dates of recommendation and target price changes. Research reports must disclose the methods used to determine price targets and the risks that may prevent the security price from reaching the target.

Survey respondents ranked detailed research reports among the most valuable service provided by sell-side analysts (Table 2). This suggests that disclosures of valuation methods and risks that enhance the quality of these reports should make them even more valuable. Interestingly, as shown in Table 8, few respondents currently use or would be likely to pay for services that rate analyst performance; and only 31% anticipate an increased demand for such services in the future.

### *G.5. Market Making*

Research reports must disclose if the firm is a market maker in the securities of the company covered. Almost two-thirds of the survey participants want a firm to disclose if they are market makers (Table 6, part D).

### *G.6. Prominence of Disclosure*

Disclosures must be "clear, comprehensive, and prominent." They must appear on the front page or clearly state there where they can be found. Most of the survey respondents (86%) said that disclosure of potential conflicts of interest should be more visible (Table 6, part A).

*G.7. Other provisions*

Other provisions require 1) disclosure if an analyst or member of his household is an officer, director, or advisory board member of the company covered; and 2) disclosure as required by any other applicable laws or rules (for example, NASD Rule 2210). The survey did not address these issues.

*H. Written Policies and the Compliance Officer's Role*

Paragraph (i) of Rule 2711 requires firms to have written supervisory procedures for implementation of the rule. A "senior official" of the firm must annually attest that the procedures are adopted and implemented. Given the skepticism on the part of many survey participants that the SIA guidelines could be credibly implemented (Table 9), this provision is likely to be an important one.

## IV. Conclusions and Suggestions for Future Research

The newly established NASD and NYSE rules are consistent with the recommendations and beliefs of the majority of buy-side professionals in our survey. However, the rules do not yet address several conflicts that concern professional investors, and the most important conflict issues appear to face difficulty being credibly implemented. The results of the survey also suggest some important areas for future research.

The most telling and interesting result is that buy-side professionals consider analysts' buy recommendations as having questionable value. While the retail-investing public and regulators have made analyst recommendations a "hot-button" issue for regulators in the past year, only 5% of the surveyed buy-side professionals rated new buy recommendations as usually or always valuable. Of *all* the research services provided by sell-side analysts, buy recommendations ranked as *least* valuable. So what *do* buy-side professionals find valuable? Most place high value on detailed research reports and discussions they initiate with the sell-side analysts. Also, many of the respondents wrote that the ability of sell-side analysts to arrange opportunities for them to meet with corporate executives is very valuable.

Sell-side analysts enjoy a position of privilege with corporate managements that many buy-side professionals do not. One explanation for this privileged position may be that despite the implementation of Regulation Fair Disclosure ("FD") in October 2000, corporate managements enjoy the option of disclosing some types of information about plans and strategies to select (often sell-side) outsiders. Press reports indicate that managements (at least of some corporations) have used sell-side analysts as mouthpieces for the stories or spin they want relayed to investors. If sell-side analysts do not tell the "right" story, they risk being cut off, at least temporarily, from corporate contacts that analysts (and their buy-side clients) value.[18] The survey results suggest that before the new NASD and NYSE rules, this symbiotic relationship between corporate managements and sell-side analysts worked well enough for the buy-side professionals because they understood the rules of the game and their implications for them: use the valuable detailed research and company contacts but ignore the recommendations intended for retail investors and corporate management.

Under the new NASD and NYSE rules, analysts are prohibited from submitting research to the companies covered for their review of ratings and research summaries. However, the rules do nothing to prevent companies from threatening to freeze out analysts who show negative ratings or research, or to keep analysts from being influenced by the clear desire of companies to receive positive research coverage and ratings. Because most sell-side analysts rely at least in part on information provided from company managements and because their buy-side clients value the networking opportunities sell-side analysts can arrange if they have access to company managements, we conclude that this most important conflict of interest has not been solved. This conclusion is consistent with a recent tally of recommendations by Thomas Financial/First Call: of brokerage firms that cover at least 100 companies, only 3% of recommendations were in a sell category as of July 1, 2002. Sell recommendations are still rare, even from analysts whose firms do not offer investment banking.[19]

While the sell-to-buy recommendation ratio may not change in the future, the number of players who know the "game" probably already has: the vast publicity related to the potential for conflicts among sell-side analysts has most likely resulted in a more savvy retail investor. In fact, a recent *Wall Street Journal / NBC News* poll of Americans found that only 37% of respondents "believe that recommendations from financial advisors are 'primarily motivated' by a desire to help their clients make money."[20] An interesting question for future research is whether the new rules, which require disclosure of the price performance of analysts' past recommendations, dispel these beliefs.

While most surveyed buy-side professionals place relatively little value on new buy recommendations, they put more value on sell recommendations and downgrades. Academic

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[18] Laura Unger, then Acting Chairman of the SEC, warned of the pressures that sell-side analysts face from company managements when she testified to the House Subcommittee on July 31, 2001. For several press accounts of companies' freezing out of analysts, see *Wall Street Journal*, "Incredible 'Buys': Many Companies Press Analysts to Steer Clear of Negative Ratings – Stock Research Is Tainted as Naysayers Are Banned, Undermined and Berated", July 19, 1995, page A1, and *Wall Street Journal,* "Should You Trust Wall Street's New Ratings?", July 17, 2002, pages D1-2.

[19] *Wall Street Journal*, "Should You Trust Wall Street's New Ratings?", July 17, 2002, pages D1-2.

[20] *Wall Street Journal,* "Americans Distrust Institutions in Poll", June 13, 2002, page A4.

research, conducted prior to the new NASD and NYSE rules, shows that trading strategies that use analyst upgrade and downgrade information may produce abnormal profits. For example, Womack (1996), Barber, Lehavy, McNichols, and Trueman (2001), and Barber, Lehavy, McNichols, and Trueman (2002) show that strategies of investing in portfolios of stocks upgraded by analysts but particularly disinvesting in those receiving analyst downgrades may yield abnormal risk-adjusted returns before consideration of transaction costs. Michaely and Womack (1999) suggest that investors may improve on these strategies if they control for analyst underwriting relationships.[21] A question for future research is whether the new NASD and NYSE rules, the publicity of the past year, and resulting better-educated average retail investor, will change how the market reacts to analyst recommendations. If so, do these strategies still offer the potential for yielding abnormal returns?

Another interesting result of the survey is that the buy-side respondents themselves indicate that pressure from buy-side clients not to downgrade the stocks they hold is an important motivation for sell-side analysts at least some of the time. The NASD and NYSE rules do not yet address this potential conflict of interest.

One solution suggested for the conflicts of interest problem is to increase the use of research produced by independent analysts. Many of the professional investors we surveyed (46%) pay for independent research (Table 7, part A). About half (51%) state that the independent research they buy is typically more useful than sell-side research; 65% anticipate that an increased demand for independent research; and 54% say their firms would be willing to pay more for independent research but that more or better quality services are needed (Table 7, parts B, C, and D). Only 23% would be unwilling to pay for independent research because they are able to de-bias and use sell-side research at a lower cost. Interestingly, several of our survey participants noted that no research is truly independent (for example, Table 7, "Other comments").

Clearly, the greatest skepticism expressed by those surveyed revolved around the credible separation of research and investment banking. The new rules prohibit firms from promising favorable research or threatening to downgrade ratings when trying to obtain a company's banking business. Nothing in the rules changes the incentive for a company to consider a bank's current research coverage when selecting a bank. Nor do the rules change the incentive of a bank to maintain positive research when courting a company's banking business. Recent press accounts suggest that

[21] An unresolved question has been whether these strategies are profitable after accounting for transaction costs. See Michaely and Womack (2002) for a survey of the analyst recommendation literature.

positive research is sometimes less a result of promises initiated by banks than of threats by companies courted.[22]

Pressures from companies for positive research in return for banking business are nothing new. Krigman, Shaw, and Womack (2001) demonstrate that a key reason for companies switching from their IPO lead underwriters to other underwriters for secondary offerings is to obtain research coverage from higher reputation sell-side analysts. This finding suggests an incentive for underwriters to issue positive research post-IPO regardless of whether they have promised to do so *ex ante*. The new rules also do nothing to prevent analysts from issuing "booster shots" around lock-up period expirations after the quiet period. Firms do have to disclose investment-banking relationships, however. Indeed, given survey respondents' skepticism that rules separating research and investment banking could be credibly enforced, the most important provisions in the new rules may be those requiring greater disclosure of investment banking relationships.

Many of the survey respondents were not optimistic in the fall of 2001 that separation of investment banking and research could be credibly implemented. Since the time of the survey, federal regulators, the SROs, and the individual states, have increased enforcement of existing rules governing analyst conflicts. As of the writing of this article, NASD is preparing regulatory action against Jack Grubman and his employer, Citigroup's Salomon Smith Barney unit.[23] The SEC is stepping up formal investigations of analyst conflicts.[24] Individual states appear to be increasingly prepared to fill voids left by federal regulators.[25] Records on Grubman's research have been subpoenaed by New York's attorney general, Eliot Spitzer.[26] A Morgan Stanley effort to reduce the reach of state regulators was "politely blunted" in Washington, D.C.[27] The credible threat of enforcement actions, perhaps not envisioned at the time of the survey, might have the greatest impact on how sell-side analysts conduct research in the future.

[22] For example, see *Wall Street Journal*, "Merrill Defends Ties to Enron Before Congress", July 31, 2002, page C1.
[23] *Wall Street Journal*, "NASD Prepares Action Against Star Analyst", July 22, 2002, pages A1, A6.
[24] *New York Times*, "SEC Taking a Closer Look at Wall St.", June 1, 2002, pages B1, B14.
[25] *Wall Street Journal*, "Local Enforcers Gain Clout on Street", June 21, 2002, pages C1, C13.
[26] *New York Times*, "SEC Taking a Closer Look at Wall St.", June 1, 2002, pages B1, B14.
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**Table 1 Survey Participants' Work Experience and Assets under Management**

This table presents the results for Question 1 of a fall 2001 survey of 92 buy-side professionals. Participants were asked to indicate all areas in which they have work experience (part A) and the amount of assets under management of their current employer (part B).

Part A. Work Experience (Number and % of Respondents, some respondents have worked in two or more capacities so that the numbers total to more than 92)

| | | |
|---|---|---|
| • Equity portfolio manager | 52 | (57%) |
| • Buy-side equity analyst | 52 | (57%) |
| • Buy-side equity trader | 3 | ( 3%) |
| • Sell-side equity analyst | 4 | ( 4%) |
| • Fixed-income portfolio manger, trader, or analyst | 18 | (20%) |
| • No experience in equity portfolio management or analysis | 0 | ( 0%) |

Part B. Employing Firms' Assets under Management (Number and % of Respondents)

| | | |
|---|---|---|
| • Managed assets under $ 1 billion | 19 | (21%) |
| • Managed assets between $ 1 billion and $ 10 billion | 14 | (15%) |
| • Managed assets between $ 10 billion and $ 100 billion | 19 | (21%) |
| • Managed assets over $ 100 billion | 39 | (43%) |

**Table 2 The Value of Sell-Side Research**

This table presents the number of responses in each category for survey question 2.):
"How valuable to you are the following sell-side research services provided by brokerage firms?"
(The responses in each category, as a fraction of the total, are shown in parentheses.)

| | Category: | Rarely Valuable 1 | Seldom Valuable 2 | Sometimes Valuable 3 | Usually Valuable 4 | Always Valuable 5 | Mean |
|---|---|---|---|---|---|---|---|
| A. | Daily news, calls, faxes, and mails initiated by research sales people | 13 | 14 | 44 | 16 | 4 | 2.82 |
| | | *(0.14)* | *(0.15)* | *(0.48)* | *(0.18)* | *(0.04)* | |
| B. | Discussions you initiate with sell-side analysts | 5 | 2 | 26 | 48 | 11 | 3.63 |
| | | *(0.05)* | *(0.02)* | *(0.28)* | *(0.52)* | *(0.12)* | |
| C. | Detailed research reports | 2 | 6 | 44 | 33 | 7 | 3.40 |
| | | *(0.02)* | *(0.07)* | *(0.48)* | *(0.36)* | *(0.08)* | |
| D. | Short revisions to research reports | 11 | 23 | 44 | 11 | 2 | 2.67 |
| | | *(0.12)* | *(0.25)* | *(0.48)* | *(0.12)* | *(0.02)* | |
| E. | Announcements of new buy recommendations | 22 | 35 | 30 | 4 | 1 | 2.21 |
| | | *(0.24)* | *(0.38)* | *(0.33)* | *(0.04)* | *(0.01)* | |
| F. | Announcements of new sell recommendations | 14 | 20 | 33 | 18 | 7 | 2.83 |
| | | *(0.15)* | *(0.22)* | *(0.36)* | *(0.20)* | *(0.08)* | |
| G. | Removal or downgrades of buy recommendations | 18 | 27 | 30 | 14 | 3 | 2.53 |
| | | *(0.20)* | *(0.29)* | *(0.33)* | *(0.15)* | *(0.03)* | |
| H. | Portfolio strategy commentary | 16 | 27 | 35 | 9 | 3 | 2.51 |
| | | *(0.18)* | *(0.30)* | *(0.39)* | *(0.10)* | *(0.03)* | |

Other services typed in by respondents: arranging visits and conferences with the companies covered by the sell-side analyst; access to senior management; quantitative research/data; calls initiated by sell-side analysts; information on what buy-side peers are telling the analysts; one-on-one private communications; revenue trends and comments on management attitudes; industry analysis; technical analysis; macroeconomic analysis; earnings estimates

**Table 3 The Motivations of Sell-Side Analysts**

This table presents the number of responses in each category for survey question 3.):
"How important do you believe each motivation listed below is to sell-side analysts?"
(The responses in each category, as a fraction of the total, are shown in parentheses.)

| | Category: | Rarely Important 1 | Seldom Important 2 | Sometimes Important 3 | Usually Important 4 | Always Important 5 | Mean |
|---|---|---|---|---|---|---|---|
| A. | Analyst's desire to retain and attract investment banking clients | 0 | 1 | 11 | 43 | 37 | 4.26 |
| | | - | *(0.01)* | *(0.12)* | *(0.47)* | *(0.40)* | |
| B. | Compensation linked to trading volume in the stocks he covers | 2 | 9 | 24 | 34 | 22 | 3.71 |
| | | *(0.02)* | *(0.10)* | *(0.26)* | *(0.37)* | *(0.24)* | |
| C. | Compensation linked directly to investment banking business he generates | 0 | 1 | 8 | 39 | 42 | 4.36 |
| | | - | *(0.01)* | *(0.09)* | *(0.43)* | *(0.47)* | |
| D. | Rankings from buy-side analysts based on insight and quality of research | 0 | 5 | 18 | 40 | 27 | 3.99 |
| | | - | *(0.06)* | *(0.20)* | *(0.44)* | *(0.30)* | |
| E. | Pressure from buy-side clients not to downgrade stocks they hold | 5 | 22 | 40 | 17 | 6 | 2.97 |
| | | *(0.06)* | *(0.24)* | *(0.44)* | *(0.19)* | *(0.07)* | |
| F. | Pressure from the management of the companies the analyst covers | 0 | 3 | 25 | 45 | 18 | 3.86 |
| | | - | *(0.03)* | *(0.27)* | *(0.49)* | *(0.20)* | |
| G. | Desire to make the best buy and sell calls to increase long-term reputation | 2 | 21 | 36 | 26 | 6 | 3.14 |
| | | *(0.02)* | *(0.23)* | *(0.40)* | *(0.29)* | *(0.07)* | |

Other motivations typed in: being viewed as having significant impact or gaining attention of their internal sales forces; research notes; analysts suffer cognitive dissonance: they have multiple goals that often compete; inv. banking provides greater pressure than institutional investor clients; it's all about banking; because banking business has declined, they are more focused on getting stocks right; public polls such as Wall Street Journal; less well-known analysts sometimes desire to "make a name" for themselves with a dramatic projected stock price target, etc.; identifying "home runs"; the boutiques often provide better advice because they know their field better; promoting inventory; ego

**Table 4 The Trading Activities of Sell-Side Analysts**

This table presents the number of responses in each category for survey question 4.):
"Some investment banks have adopted policies to restrict the trading activities of their analysts. Please indicate your opinion regarding sell-side analysts' personal investing and trading activities." (The responses in each category, as a fraction of the total, are shown in parentheses.)

| | Category: | Strongly Disagree 1 | Disagree 2 | Neutral 3 | Agree 4 | Strongly Agree 5 | Mean |
|---|---|---|---|---|---|---|---|
| A. | Analysts should be allowed to take long positions in the stocks they cover. | 22 *(0.24)* | 17 *(0.18)* | 9 *(0.10)* | 22 *(0.24)* | 22 *(0.24)* | 3.05 |
| B. | Analysts should be allowed to take short positions in stocks they cover. | 38 *(0.41)* | 18 *(0.20)* | 6 *(0.07)* | 9 *(0.10)* | 21 *(0.23)* | 2.53 |
| C. | Analysts should be required to disclose their positions in stocks they cover. | 2 *(0.02)* | 1 *(0.01)* | 2 *(0.02)* | 9 *(0.10)* | 78 *(0.85)* | 4.74 |
| D. | Analysts should be able to make private equity investments in pre-IPO companies that their firm is attempting to do investment banking with. | 61 *(0.66)* | 14 *(0.15)* | 9 *(0.10)* | 4 *(0.04)* | 4 *(0.04)* | 1.65 |
| E. | Analysts that own/short stocks they follow will make better valuation calls. | 24 *(0.26)* | 22 *(0.24)* | 22 *(0.24)* | 19 *(0.21)* | 5 *(0.05)* | 2.55 |

Other comments typed in: this is not the important issue: analysts are paid on their ability to attract banking business for the firm so personal trading is almost irrelevant; they should be required to hold stocks for 6 months to avoid trading in and out; should not be able to front-run their ratings changes; personal account positions should not conflict with published opionions; the key is disclosure of ownership and restricting trading for a period of time while they change their recommendations; analysts should own only open-end mutual funds to avoid any semblance of a conflict of interest; the focus should be on how analysts are compensated (i.e., investment banking business brought in), personal trading is a secondary issue

**Table 5 Analyst Recommendations**

This table presents the number of responses in each category for survey question 5.):
"Recommendation categories (for example, strong buy versus recommended list or outperform versus attractive) vary from brokerage firm to brokerage firm. Please indicate the extent to which you agree or disagree with the following statements." (The responses in each category, as a fraction of the total, are shown in parentheses.)

| | Category: | Strongly Disagree 1 | Disagree 2 | Neutral 3 | Agree 4 | Strongly Agree 5 | Mean |
|---|---|---|---|---|---|---|---|
| A. | It would be helpful if recommendation categories were standardized across firms. | 4 *(0.04)* | 9 *(0.10)* | 27 *(0.29)* | 35 *(0.38)* | 17 *(0.18)* | 3.57 |
| B. | Analysts should issue more negative or sell recommendations. | 1 *(0.01)* | 2 *(0.02)* | 11 *(0.12)* | 38 *(0.41)* | 40 *(0.43)* | 4.24 |
| C. | I keep track of the consensus of analyst recommendations in the stocks I follow. | 16 *(0.18)* | 29 *(0.32)* | 15 *(0.16)* | 27 *(0.30)* | 4 *(0.04)* | 2.71 |
| D. | I use the consensus of recommendations as a contrary indicator of attractiveness. | 8 *(0.09)* | 25 *(0.28)* | 36 *(0.40)* | 19 *(0.21)* | 2 *(0.02)* | 2.80 |
| E. | I discount the opinions and recommendations of analysts where there is an investment banking relationship. | 1 *(0.01)* | 3 *(0.03)* | 9 *(0.10)* | 46 *(0.50)* | 33 *(0.36)* | 4.16 |
| F. | My decision-making is often influenced more by changes to "strong buy" categories than attractive/outperform categories. | 12 *(0.13)* | 14 *(0.16)* | 31 *(0.34)* | 28 *(0.31)* | 5 *(0.06)* | 3.00 |
| G. | I interpret "hold" recommendations as sell recommendations. | 1 *(0.01)* | 4 *(0.04)* | 14 *(0.15)* | 60 *(0.65)* | 13 *(0.14)* | 3.87 |
| H. | "Removal" from an analyst's buy list is more informative than initiation of "buy". | 3 *(0.03)* | 8 *(0.09)* | 26 *(0.29)* | 39 *(0.43)* | 14 *(0.16)* | 3.59 |

**Table 6 Disclosure**

This table presents the number of responses in each category for survey question 6.):
"This question is directed at disclosure of investment banks' activities and ownership in analysts' research reports. Please indicate the extent to which you agree or disagree with each of the following statements." (The responses in each category, as a fraction of the total, are shown in parentheses.)

| | Category: | Strongly Disagree 1 | Disagree 2 | Neutral 3 | Agree 4 | Strongly Agree 5 | Mean |
|---|---|---|---|---|---|---|---|
| A. | Disclosure of investment banking activities and other potential conflicts should be more visible in recommendation reports (e.g. on the front page). | 1 *(0.01)* | 6 *(0.07)* | 5 *(0.05)* | 40 *(0.43)* | 40 *(0.43)* | 4.22 |
| B. | Brokerage firm reports should disclose exactly when the firm last acted as underwriter to the company covered. | 1 *(0.01)* | 2 *(0.02)* | 4 *(0.04)* | 43 *(0.47)* | 42 *(0.46)* | 4.34 |
| C. | Brokerage firm reports should disclose exactly when the firm last provided merger/acquisition advice to the company covered. | 3 *(0.03)* | 5 *(0.05)* | 8 *(0.09)* | 41 *(0.45)* | 35 *(0.38)* | 4.09 |
| D. | Brokerage firm reports should disclose for how long the firm has acted as a market maker in the stock of the company covered. | 3 *(0.03)* | 7 *(0.08)* | 22 *(0.24)* | 33 *(0.36)* | 27 *(0.29)* | 3.80 |
| E. | Brokerage firm reports should disclose the actual value of stock in the company reported on that the brokerage firm is long or short. | 6 *(0.07)* | 12 *(0.13)* | 17 *(0.18)* | 33 *(0.36)* | 24 *(0.26)* | 3.62 |
| F. | Brokerage firm reports should disclose the actual value of stock in the company reported on that the analyst is personally long or short. | 9 *(0.10)* | 12 *(0.13)* | 8 *(0.09)* | 29 *(0.32)* | 34 *(0.37)* | 3.73 |
| G. | Analysts should disclose conflicts of interest (ownership/ banking relationships) during all media appearances. | 2 *(0.02)* | 5 *(0.05)* | 17 *(0.18)* | 39 *(0.42)* | 29 *(0.32)* | 3.96 |
| H. | The current level of disclosure in brokerage firm reports is sufficient. | 32 *(0.35)* | 50 *(0.54)* | 6 *(0.07)* | 3 *(0.03)* | 1 *(0.01)* | 1.82 |

Other comments include: disclosures are sufficient for professional/institutional investors, but the public/retail investors need more;
there is a trend to have more buy-side analysts as guests for financial programs: they have conflicts which should also be addressed;
the investment banking business is very fluid, so discosures will be out of date by the time of printing; potential business is more important than past business; don't forget derivatives related to the underlying equities or convertible bonds; they should indicate their entire stock picking record;
often buy reports come out when the bank is trying to get the investment banking business: the point is that listing official representation is helpful but it is also useful to know if the bank is in there bidding for current business too.

**Table 7 Independent Research**

This table presents the number of responses in each category for survey question 7.):
"Please indicate your opinion regarding 'independent' (non-brokerage) research services."
(The responses in each category, as a fraction of the total, are shown in parentheses.)

| | Category: | Strongly Disagree 1 | Disagree 2 | Neutral 3 | Agree 4 | Strongly Agree 5 | Mean |
|---|---|---|---|---|---|---|---|
| A. | My firm does pay for independent research, and the existing companies that offer it are sufficient for my needs. | 1<br>*(0.01)* | 14<br>*(0.15)* | 35<br>*(0.38)* | 33<br>*(0.36)* | 9<br>*(0.10)* | 3.38 |
| B. | The independent research I buy is typically more useful than the sell-side research I receive. | 0<br>*0.00* | 10<br>*(0.11)* | 35<br>*(0.38)* | 34<br>*(0.37)* | 13<br>*(0.14)* | 3.54 |
| C. | I anticipate that the demand for and usage of independent research services will increase in the future. | 0<br>*0.00* | 9<br>*(0.10)* | 23<br>*(0.25)* | 49<br>*(0.53)* | 11<br>*(0.12)* | 3.67 |
| D. | My firm would be willing to pay more for independent research, but more or better quality services are needed. | 3<br>*(0.03)* | 11<br>*(0.12)* | 27<br>*(0.30)* | 40<br>*(0.44)* | 9<br>*(0.10)* | 3.46 |
| E. | It is unlikely that I would ever be willing to pay substantially more dollars for independent research because I am able to de-bias and use sell-side information. | 8<br>*(0.09)* | 30<br>*(0.33)* | 31<br>*(0.34)* | 17<br>*(0.19)* | 4<br>*(0.04)* | 2.77 |

Other comments include: we have our own internal research team; no "independent" research service is truly independent; firms are reluctant to pay high fees for independent services; my firm has increased substantially our dollars to non-broker research sources, including to nontraditional sources such as doctors on health care trends; there are times we pay for information, and it doesn't have to be packaged as a buy or sell opinion; with Reg. FD, the use of independent services is growing; we pay for independent research that offers a different perspective (e.g., broad surveys of branch managers or customers); about half the time you can call a sell-side analyst and verbally get his "unbiased" view on a company which can be contradictory to his published reports; independent research is more applicable for us as we generally do not advise on individual stocks; with Reg. FD, most shops have access to the same information, so the question is who analyzes the information better or finds better ways to utilize it; my experience with independent research has generally been disappointing; most are not that independent: some are used by hedge funds to start rumors to move stocks to their advantage.

**Table 8 Analyst Rating and Benchmarking Services**

This table presents the number of responses in each category for survey question 8.):
"Please indicate your opinion regarding services that rate and benchmark the performance of sell-side analysts, such as BulldogResearch.com, Validea.com, and Starmine.com." (The responses in each category, as a fraction of the total, are shown in parentheses.)

| | Category: | Strongly Disagree 1 | Disagree 2 | Neutral 3 | Agree 4 | Strongly Agree 5 | Mean |
|---|---|---|---|---|---|---|---|
| A. | As far as I know, my firm has never used brokerage rating or benchmarking services. | 4 *(0.05)* | 8 *(0.09)* | 20 *(0.23)* | 36 *(0.41)* | 19 *(0.22)* | 3.67 |
| B. | I anticipate that the demand for and usage of brokerage rating services will increase in the future. | 3 *(0.03)* | 14 *(0.16)* | 43 *(0.50)* | 22 *(0.26)* | 4 *(0.05)* | 3.12 |
| C. | My firm or I would likely be willing to pay substantial dollars for competent brokerage rating services. | 20 *(0.23)* | 26 *(0.30)* | 32 *(0.37)* | 6 *(0.07)* | 3 *(0.03)* | 2.38 |

**Table 9 SIA Guidelines**

This table presents the number of responses in each category for survey question 9.):
"The Securities Industry Association recently wrote a monograph 'Best Practices for Research'. It recommends guidelines for sell-side analysts. Please indicate whether you agree with the guidelines and whether they could be credibly implemented." (The responses in each category, as a fraction of the total, are shown in parentheses.)

| | Category: | No Opinion | Disagree with Guideline | Agree with Guideline But Concerned That It Could Not Be Credibly Implemented | Agree with Guideline And Feel That It Could Be Credibly Implemented |
|---|---|---|---|---|---|
| A. | Research should not report to investment banking. | 3<br>*(0.03)* | 5<br>*(0.06)* | 43<br>*(0.48)* | 39<br>*(0.43)* |
| B. | A formal ratings system should have clear definitions that are published in every report or otherwise readily available. | 8<br>*(0.09)* | 2<br>*(0.02)* | 18<br>*(0.20)* | 63<br>*(0.69)* |
| C. | A research analyst's pay should not be directly linked to specific investment banking transactions. | 2<br>*(0.02)* | 8<br>*(0.09)* | 52<br>*(0.57)* | 29<br>*(0.32)* |
| D. | An analyst should not submit research to investment banking or to corporate managements for approval of recommendations. | 3<br>*(0.03)* | 6<br>*(0.07)* | 36<br>*(0.40)* | 46<br>*(0.51)* |
| E. | Analysts should not trade a security while they are preparing research on it or within a reasonable period of time after issuing research on it. | 2<br>*(0.02)* | 2<br>*(0.02)* | 7<br>*(0.08)* | 80<br>*(0.88)* |
| F. | The analyst's personal trading should be completely consistent with investment recommendations. | 5<br>*(0.06)* | 14<br>*(0.16)* | 21<br>*(0.23)* | 50<br>*(0.56)* |