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## Regulating securities analysts

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### ARTICLE INFO

#### Article history:

Received 3 September 2005

Available online 8 August 2008

#### Keywords:

Analysts

Regulation

Disclosure

Investment banking

Recommendations

Conflict of interest

Information production

Career concerns

### ABSTRACT

We examine the effects of regulations designed to address the potential conflict of interest that arises when sell-side analyst research is not independent of investment banking. We focus on two types of regulation: (1) internal barriers between equity research and investment banking that restrict communication; and (2) disclosure requirements relating to analyst compensation. We find that information barriers can increase research effort and improve report quality by limiting an investment bank's ability to distort its analyst's incentives. However, this type of regulation can also reduce information production and lower the quality of reports if an investment bank benefits directly from research activity. Disclosure requirements, on the other hand, unambiguously lead to more informative prices and a higher report quality relative to either information barriers or no regulation.

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## 1. Introduction

Retail and institutional investors have long relied on research conducted by brokerage (sell-side) analysts to help inform their investment decisions. Recently, however, securities firms and their analysts have been the objects of intense scrutiny by lawmakers and market participants for allegedly producing overly optimistic research in order to attract and retain investment banking clients. To address the widespread concern over the influence of investment banking on analyst research, various regulatory agencies have introduced rules governing the relationships among securities firms, analysts, and investors. Many observers perceive the reforms to be a necessary step in curbing conflicts

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of interest related to investment banking. At the same time, some market participants have argued that the reforms could compromise the quality of analyst research.<sup>1</sup>

In this paper, we provide a theoretical examination of the effects of conflict-of-interest regulations on analyst research. Our modeling approach is founded on the notion that analysts' incentives are the main channel through which investment banking concerns can distort research reports.<sup>2</sup> This point of view is consistent with regulators' recent emphasis on analyst compensation. For example, in outlining to U.S. Congress the April 2003 Global Settlement involving ten of the largest Wall Street firms, securities regulators stated their belief that the firms "used a compensation system that created an improper incentive for analysts to issue research that was overly positive, inaccurate, or otherwise lacked objectivity" (U.S. Senate, 2003). Thus, given the recent public policy focus on the linkage between analysts' incentives and the conflict-of-interest problem, it becomes critical to understand how regulations can lead to a restructuring of these incentives and to a concomitant change in research effort, reporting behavior, and overall research quality.

To address these issues, we consider a stylized model in which both the production and the dissemination of information by an analyst can depend endogenously on the regulatory regime. In the model, an investment bank employs an analyst to conduct costly research on a company and to issue stock reports to the public. The analyst is motivated partly by career concerns, which provide him with an incentive to increase long-term accuracy by generating information and reporting objectively. The investment bank, however, seeks to win future business from the company and will design the analyst's incentives to induce optimistic reporting and support the company's stock price. Absent any regulation, this conflict of interest dampens research effort and diminishes the value of analysts' reports to investors.<sup>3</sup>

The analysis focuses on two regulatory approaches to this problem that have dominated public discussion and guided recent policy changes. Both regulatory approaches fundamentally affect what information is observable by different market participants. The first approach aims to insulate equity research from investment banking activities by erecting or significantly strengthening internal barriers that limit the flow of information between an analyst and the rest of the securities firm. Many of the recently-adopted structural reforms can be broadly interpreted as attempts to achieve such a separation.<sup>4</sup> We refer to such structural remedies as *information barriers*. The second type of regulation seeks to impose *disclosure requirements* on securities firms so that investors are better informed about the true incentives underlying an analyst's reporting behavior.<sup>5</sup>

<sup>1</sup> Regarding Rule 2711 of the National Association of Securities Dealers (NASD) on "Research Conflicts of Interest," Marc E. Lackritz, president of the Securities Industry Association, commented: "[It] will impose technical regulatory requirements at significant costs that may impair the ability of firms and their analysts to provide timely, relevant investment recommendations." (Opdyke, 2002).

<sup>2</sup> Other possible sources of conflict exist, including using analyst recommendations internally in advance of their public dissemination ("front-running"), allowing analysts to trade on their personal accounts, avoiding negative recommendations to retain asset management clients, or using research reports to churn stocks and generate trading commissions. While such distortions are potentially important, we do not consider them here as they are less directly relevant to the much-publicized problem of how investment banking concerns can compromise analyst research.

<sup>3</sup> One might argue that investment banks are often able to directly interfere with the content of their analysts' reports rather than having to indirectly elicit optimistic reporting. Our modeling approach subsumes such a case, since even with direct interference the bank would have to compensate the analyst for changes in the report that adversely affected the analyst's long-term career prospects.

<sup>4</sup> Reforms instituted by the NYSE and the NASD in 2002 include requirements that (1) analysts not be supervised by the investment banking department; (2) investment banking personnel be prohibited from discussing research reports with analysts prior to distribution, unless personnel from a firm's legal/compliance department are present; and (3) analysts not be allowed to attend "pitch meetings" in which investment bankers solicit underwriting business from corporate clients (National Association of Securities Dealers, 2002; New York Stock Exchange, 2002). Likewise, as part of the 2003 Global Settlement, ten of the largest Wall Street firms agreed to erect physical and operational firewalls to insulate analyst research from investment banking.

<sup>5</sup> For example, the U.S. Securities and Exchange Commission's Regulation Analyst Certification (AC), adopted in April 2003, requires analysts to disclose in research reports whether they received any direct or indirect compensation for their report. Analysts who cannot certify that they did not receive compensation for a specific report must disclose the magnitude and source of compensation (Securities and Exchange Commission, 2003). Likewise, in its 2003 Statement of Principles for Addressing Sell-Side Analyst Conflicts of Interest, the International Organization of Securities Commissions (IOSCO) recommended that jurisdictions consider requiring analyst employers to disclose how their analysts are compensated (IOSCO, 2003).

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