Rating Sell-Side Analysts: A Shift From Subjectivity to Empirically Verifiable Facts

Andrew M LaBreche, Notre Dame Law School

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I. Sell-Side Analysts Have Conflicts Of Interest With Investment Banks, Issuers, and Institutional Investors, Which Must Be Exposed By An Objective Rating System.

In the early 1990’s, many investors praised the stock market as they reaped the monetary fruits of their investments. As the 1990’s progressed, these fruits began to sour and the stench of fraud and manipulation swirled the air. It was not that this fraud was new, or entirely unknown. Rather, investors seemed to have far less tolerance for corruption as it turned from advantage to vice.¹ So goes the story of the late 1990’s and the tenor of opinion surrounding the laws that cabin security analyst behavior.

This article will address the current state of unrest surrounding sell-side analysts. It will proceed in three parts. First, it will recap the conflicts of interest that ultimately brought sell-side analysts to the forefront of securities law. Second, this article will examine what legal changes have been made to address these conflicts. Finally, it will propose a simple quantifiable method of rating sell-side analysts. The purpose of creating an analyst rating system is to provide individual investors with a reliable way to gauge analyst conflicts and abilities.

Currently there is no easily accessible way to determine the quality of an analyst. The existing rating mechanisms are inherently tainted by the very conflicts that those ratings would otherwise help expose. A simplified and objective evaluative method of

conveying the accuracy of analyst performance to investors is perhaps the most effective way of warning retail investors of analyst conflicts, by underscoring an analyst’s own performance over time. This is the solution to disclosing analyst conflicts proffered by this article.

II. When Analyst Loyalties Shifted From Brokerage Firms To Investment Banking They Developed Conflicts Of Interest That Have Not Been Fully Exposed To Retail Investors.

Research analysts are financial professionals “who research companies and create reports and recommendations that are used by traders in making investment decisions.” Analysts are commonly separated into two groups: Buy-side analysts, and sell-side analysts. Buy-side analysts provide information to investors who are interested in buying stock in a company. Sell-side analysts are responsible for providing information on companies that intend to sell stock (this information is disseminated to investors). Analysts use a variety of informational sources, such as earnings forecasts, press releases, publicly available documents filed with the SEC and comments by an issuer’s competitors and clients to determine whether a company is over, or under, valued. Based on the analysts’ determination, they will make a recommendation (usually “buy,” “sell,” or “hold”), along with an earnings forecast. This recommendation is a statement regarding the “analyst’s belief about the stock’s intrinsic value relative to its market value; therefore, a buy (sell) recommendation, whether new or reiterated, implies that the

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6 Id.
analyst believes the security is underpriced (overpriced), while a hold recommendation implies that the stock is fairly priced.”

In formulating reports and recommendations, analysts gather information on the industry or individual stock from customers, suppliers, and firm managers.

“Historically, analysts have been relatively free from regulation. Indeed, in some respects, analysts have enjoyed preferred status under the federal securities laws.” As recently as 1983, the Supreme Court proclaimed that the work of analysts is “necessary to the preservation of a healthy market.” That analysts have historically been free from regulation has not been problematic until recently.

Until 1975, when the SEC removed the fixed caps for brokerage fees, analysts were subsidized by brokerage firms and advanced their careers based on their accuracy and reputation. Once brokerage firms were allowed to compete with each other based on the amount they charged for their brokerage fees, analysts lost their main source of income. Competition among brokerage firms for investor trading business became less profitable, which prevented brokerage firms from subsidizing securities analysts. Instead, brokerage firms turned their attention to investment banking. Significantly, analysts were a critical component to sustaining the relationships between investment

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7 Id. at 198.
12 Id. 287.
banks and their issuer-clients. It is these relationships that caused the modern day conflicts of interest that have attracted large-scale public attention in the post-1990 era.

1. Analyst Relationships With Investment Banks Created Conflicts Of Interest That Ultimately Caused Lawmakers To Begin Taking Action.

As brokerage firms lost the ability to generate sufficient profits through brokerage commissions, these firms began engaging in investment banking activities. Investment bankers provide a wide variety of services to firms issuing new shares of stock through an initial public offering (IPO) and thereafter. “These services include pre-IPO activities, related to the pricing, marketing, and distribution of the offering, as well as post-IPO activities such as price stabilization, market making, and analyst research coverage.”

Although these services constitute a substantial portion of an investment bank’s involvement with issuers, a primary function of investment banking is underwriting the IPO. The mechanics of this process are fairly simple. The issuer wants to appear as a reputable and financially solid company. The investment bank wants the issuer’s stock to sell and also wants future business from the issuer. Positive analyst reports and recommendations, both during the IPO and thereafter, are the key to ensuring these

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14 Moses, infra note 25, at 93.
events occur. This is where the conflict begins. These three actors all have incentives to do whatever is necessary to sell the stock in an IPO and later in secondary markets. However, retail investors want accurate information about the stock that they are purchasing. Therefore, the retail investors’ interests are not aligned with those of the issuers, investment banks and analysts. Upon a more searching review, the conflicts are even greater than they initially appear.

Investment banks and issuers have a financial interest in the recommendations and projections made by their analysts. As stated by Laura Unger, previously Acting Chairman of the SEC, positive recommendations in general tend to be good for the firm’s bottom line, as they can “trigger higher trading volumes, resulting in greater commissions for the firms.” Most full-service firms that offer investment banking services put enormous pressure on their analysts to give favorable recommendations and reports to issuers. Several examples include: using analysts to woo issuers as part of the investment banking team; sending analysts on “road shows” to pre-sell the new issue; paying analysts based on the profitability of the firm’s investment banking division or giving investment bankers input into their bonuses; and offering analysts opportunities to invest, either directly or through pools, in the stock of the same companies they were assigned to cover. Essentially, analysts were being coerced into promising (and

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22 Dugar & Nathan, supra note 20.
delivering) issuers favorable recommendations in exchange for the issuer’s agreement to use the investment banker as the underwriter for the IPO.26 They were then pressured to continue issuing favorable reports and recommendations to ensure repeat business.27 Analysts were convinced to go along by 1) the prospect of becoming wealthy themselves through spinning,28 2) bonuses or pay based on the amount of investment banking generated by the fraudulent recommendations, or 3) the prospect of negative evaluations and ratings by the issuers.

A final problem is that analysts are dependent on the subjective, and biased, opinions of issuers and institutional investors for their ratings and ranking in the industry. The most common and widely used analyst ranking guide is the Institutional Investor, which formulates analyst ranking based on questionnaires sent to issuers and institutional investors.29 Issuers (as well as investment banks) care a great deal about the reports and

27 Cole, supra note 15, at 126.
29 See Institutional Investor Website – www.iimagazine.com/RankingsII.aspx?src=http://www.iimagazine-rankings.com/aart/methodology1a.asp; Scott E. Stickel, Reputation and Performance Among Security Analysts, 47 J. Fin. 1811, 1811 (1992). (stating that money managers and institutions rank analysts in Institutional Investor based on stock picking, earnings forecasts, written reports, and overall service. However, these factors are not necessarily evaluated on how accurate they are, but are simply the subjective reflections of the evaluators.). The Wall Street Journal also provides a ranking of analysts annually in its Best on the Street Analyst Survey, but this information is directed toward more sophisticated investors and it only ranks a handful of analysts. The rating system creates a performance scale that gives analysts credit for timely buy and sell recommendations. Each analyst’s score is calculated based on the estimated total return, including price changes and dividends, of each eligible stock as well as the number of the stocks the analyst covered in an industry. See, e.g., Best on the Street 2006 Analyst Survey, WALLST. J., May 22, 2006, at R1. These rankings arguably reflect analyst accuracy indirectly, but analysts are known to visit management just prior to the Journal’s review, leading to potential bias in the journal’s management survey. See Stickel, note 29, at 1812 n.2. Other analyst ratings and comparative services are available on the internet from pay sites such as Starmine. See Starmine Website – http://www.starmine.com/index.phtml?page_set=sm_products&sub_page_set=sm_monitor.
recommendations that analysts provide.\textsuperscript{30} Unfortunately, the subjectivity of this ranking mechanism creates enormous incentives for analysts to issue reports and recommendations that satisfy the demands of issuers and institutional investors (in order to attain high rankings), along with investment bankers (in order to garner higher salaries and guarantee job security). It is well-documented that if an analyst does not comply with issuer and investment banking demands, then that analyst’s evaluations, ratings, and access to the issuer-company’s information will suffer.\textsuperscript{31}

By the time the technology bubble burst in the late 1990’s, issuers and investors had begun to complain about fraudulent reports and recommendations issued by sell-side analysts. As stated by Senator Richard Shelby, “Millions of investors lost billions of dollars on investments that were influenced by the euphoric environment fostered by misleading advice.”\textsuperscript{32} Despite the public outcry, the early indications of skewed analyst reports were no secret. Numerous media outlets had repeatedly underscored this problem.\textsuperscript{33} Congress, the SEC and Self-Regulatory Organizations (SROs) began taking action.

\textsuperscript{30} See Stickel, \textit{supra} note 29.
\textsuperscript{33} In 1992, the Wall Street Journal published a copy of a memorandum from the managing director of corporate finance at Morgan Stanley making the firm’s expectations for it’s analysts explicit:

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

\textit{The Rohrbach Memo: “No Negative Comments,”} Wall St. J., July 14, 1992, at A6.; In 1998, Business Week reported that, at the major wall street houses, “every analyst has a potential conflict of
2. Lawmakers’ Attempts at Mitigating Analyst Conflicts Of Interest Have Only Been Partially Successful.

Congress first addressed analyst conflicts of interest by enacting section 501 of the Sarbanes-Oxley Act, which ordered the SEC to create rules that apply to all analysts, investment banks and issuers. Section 501 imposes a mandatory rulemaking obligation on the SEC to adopt, or authorize and SRO to adopt, rules “reasonably designed to address [analyst] conflicts of interest.”\footnote{Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §501, 116 Stat. 791 (2002).} In accordance with this congressional mandate, the SEC has promulgated two significant regulations.

The SEC’s first attempt at regulating analyst conflicts was through Regulation Full Disclosure (Regulation FD), which prohibits issuers from disclosing any non-public material information to analysts.\footnote{Selective Disclosure and Insider Trading, 64 Fe. Reg. At 72,590.} Part of an analyst’s duty is to speak with the management of the issuing company.\footnote{See Gretchen Morgenson, \textit{See No Evil, Speak no Evil}, Forbes, Dec. 15, 1997, at 162, 164, available at 1997 WL 16677879.} Before this regulation, analysts often obtained material non-public information (almost always including the issuer’s actual future earning projections).\footnote{\textit{Id}.} This information provided an opportunity for analysts to manipulate reports and recommendations that disfavored retail investors while simultaneously passing the legitimate reports and recommendations, based on the material non-public information, to the investment bank’s institutional investors.\footnote{Moses, \textit{supra} note 25, at 100.} Analysts did this to foster favor with their institutional clients in the hopes that providing

\textit{interest.”} Jeffrey M. Laderman, \textit{Wall Street’s Spin Game}, Bus. Wk., Oct. 5, 1998, at 148; \textit{See also} Jake Ulick, \textit{Year of the Scandal}, CNN Money (Dec. 17, 2002), \texttt{http://money.cnn.com/2002/12/17/news/review_scandals/} (stating in 2002 that “it was long argued that analysts’ stock research at big securities firm was tainted by the investment banking fees their employers sought and earned.”).
them with material non-public information would generate repeat business. The result was an unfair asymmetry of information that disadvantaged individual retail investors. Regulation FD was critical to restoring an equilibrium of information available to both institutional and retail investors.

The SEC’s second major regulatory reform was Regulation Analyst Certification (Regulation AC). Analysts were frequently making recommendations that were not supported by any factual evidence and that the analysts themselves believed to be false.\textsuperscript{39} Regulation AC requires that analysts certify that the “analyst believes that the report accurately reflects his or her personal views and disclosing any compensation or other payments received in connection with the recommendation or views.”\textsuperscript{40} If an analyst violates this rule the SEC may take action against the analyst, but the regulation does not create a private right of action through which an individual may seek legal recourse.

Finally, SROs have enacted new rules to deal with analyst conflicts, which have been approved by the SEC. The first rule prevents analysts from tying favorable rating to investment banking services\textsuperscript{41} and establishes a quiet period of 40 days where the analyst cannot issue a report regarding an IPO.\textsuperscript{42} Second, the SROs enacted a rule to prevent senior investment banking management from having a supervisory role over analysts\textsuperscript{43} and also required that counsel must monitor any interaction between the two.\textsuperscript{44} Third, the rules require that any current or expected financial ties between investment banks,

\textsuperscript{39} See Joint Press Release, \textit{infra} note 53.
\textsuperscript{40} Fisch, \textit{supra} note 9, at 1069; \textit{See also} Regulation Analyst Certification, 17 C.F.R. § 242 (2002) \textsuperscript{[hereinafter Reg. AC].}
\textsuperscript{41} Reg. AC, \textit{supra} note 40.
\textsuperscript{42} \textit{Id.}
\textsuperscript{43} Fisch, \textit{supra} note 40.
\textsuperscript{44} \textit{Id.}
analysts and issuer must be disclosed,\textsuperscript{45} including personal ties.\textsuperscript{46} The rules also forbid analysts to trade on these securities thirty days before and five days after they issue a report,\textsuperscript{47} and analysts may no longer trade contrary to their most recent recommendations. Finally, the rules require that firms explain their stock rating systems in plain English and provide statistics on the percentage of ratings per term, relative to the number of investment banking clients in each category.\textsuperscript{48} As mentioned by Eliot Spitzer, analysts rating systems were less than clear and were often used to confuse retail investors, while institutional investors understood that those rating had different meanings.\textsuperscript{49}

By 2001, analyst conflicts were so pronounced that the SEC recognized the need to publicly warn investors of the dangers generated by these arrangements.\textsuperscript{50} However, warnings to the retail investors were not enough. Additional protections were needed, and, by 2002, judicial and regulatory solutions had begun to remold the legal landscape governing security analysts.

3. The Global Settlement Is Limited In Application And Has Not Provided Individual Investors With Sufficient Information To Determine Whether Specific Analysts Are Conflicted.

In 2001, as the NASDAQ continued to plummet, analyst recommendations remained consistently positive. Internet companies were clearly failing, yet analysts

\textsuperscript{45} Reg. AC \textit{supra} note 40.
\textsuperscript{46} \textit{Id.}
\textsuperscript{47} Fisch, \textit{supra} note 40.
\textsuperscript{48} \textit{Id.}
\textsuperscript{49} \textit{Id.}
continued to issue “buy” ratings frequently, while “sell” ratings “held steady on the zero percent range.” The investigations began.

On April 25, 2002, the SEC, National Association of Securities Dealers (NASD), and the New York Stock Exchange (NYSE) announced that they were conducting a joint investigation with then Attorney General Eliot Spitzer into research analysts and their potential conflicts of interest. The investigators found that 1) research reports were issued that were not based on principles of fair dealing and good faith and did not provide a sound basis for evaluating facts, contained exaggerated or unwarranted claims about companies and contained opinions for which there were no reasonable basis, which violated various rules of the NYSE and NASD, and 2) analysts were receiving undisclosed payments for their reports. The joint investigation resulted in what is now known as the “Global Settlement.” The settlement involved ten of the largest Wall Street firms. Under the Global Settlement, the settling firms agreed to pay $1.4 billion; $875 million in penalties and disgorgement, $433 million to fund independent research, and $80 million to fund and promote investor education.

More important features of the settlement, which were intended to insulate research analysts from investment banking, include: 1) physical separation of research and investment banking departments (Chinese Walls), 2) prohibiting the investment

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52 See Joint Press Release, infra note 53.
55 These firms include Merrill Lynch, Bear Stearns, J.P. Morgan, Lehman Brothers, Piper Jaffray, UBS, Goldman Sachs, Citigroup Global markets, Credit Suisse First Boston and Morgan Stanley. See Joint Press release, supra note 53.
56 *Id.*
banking department from determining the research analyst’s budget, 3) prohibiting research analyst compensation being based directly, or indirectly, on investment banking revenues, 4) prohibiting investment bankers from having any role in evaluating analysts job performance, and 5) prohibiting research analysts from helping the investment banking department from soliciting business from issuers, including participating in road shows.\(^{57}\) The Global Settlement also requires that each firm provide independent research from at least three independent research firms for a period of five years.\(^{58}\) Finally, the Global Settlement requires research analysts to disclose historical ratings and price target forecasts to the public.\(^{59}\)

While the Global Settlement has made major strides toward ensuring analyst independence, problems persist. The most noticeable is that it only applies to those investment banks and individuals involved in the settlement itself, and the requirement of retaining independent analysts only applies to those participants for five years (ending in 2009).\(^{60}\) Perhaps one of the most contentious issues is whether all of these changes combined can adequately address analyst behavior when the analysts and investment bankers are literally still two parts of the same firm. Chinese Walls are porous,\(^{61}\) and analyst compensation could change from year to year based on technically non-

\(^{57}\) Id.  
\(^{58}\) Id.  
\(^{59}\) Id.  
\(^{60}\) Global Settlement, supra note 53.  
\(^{61}\) Fisch, supra note 9, at 1095; see also John Morgan, An Analysis of Stock Recommendations, 34 Rand J. Econ. 184 (2003) (“Nevertheless, from time to time, research analysts face pressure to “breach” the Chinese wall and issue upwardly biased stock reports that favor the interests of the firm’s investment banking clients.”).
investment banking factors, when in reality the investment banking profit-generation is still the primary reason for compensation.\(^{62}\)

Clearly these requirements and prohibitions have lessened the pressure placed on sell-side analysts to remain complacent in the fraudulent business activities of investment banks and issuers. However, “buy” recommendations and underpricing continues to be the norm,\(^{63}\) while “sell” recommendations have remained suspiciously low.\(^{64}\) Many analysts are still tethered to the same multi-faceted firms that provide both research and investment banking services to issuers. Many of the technical structural problems that have allowed and encouraged these conflicts of interest may have been addressed by the reforms, but the atmosphere of analyst dependency and coercion has not vanished altogether. Analysts who consistently issue negative reports and recommendations, no matter how truthful they may be, are unlikely to have a long-lasting career at the firm where they are employed.\(^{65}\) What then can be done?

III. Individual Investors Must Have Access To An Objective Measure Of Poor Analyst Performance.

\(^{62}\) Specifically, “[e]ven without any direct linkage, a falloff in investment banking revenues will affect the overall profitability of a financial firm, indirectly reducing the compensation available for analysts. Analysts can readily recognize that a reduction in firm revenues will affect their compensation. As a result, they will continue to have an incentive to take an optimistic spin on the companies that they follow.” Choi and Fisch, supra note 11, at 312. Analysts have good reason to fear that their salaries, or jobs, may be in jeopardy. The new regulatory reforms that prevent Wall Street firms from paying for research with investment banking revenues have already caused these firms to trim their research departments. See Susanne Craig, Left Out of Shrinking Research Pool, Companies Resort to Buying Coverage, Wall St. J., Mar. 26, 2003, at C1.


\(^{65}\) Choi and Fish, supra note 62.
“A central objective of the federal securities laws was protection of the retail investor, and the SEC continues to view investor protection as its primary goal.”\footnote{Jill E. Fisch, \textit{REGULATORY RESPONSES TO INVESTOR IRRATIONALITY: THE CASE OF THE RESEARCH ANALYST}, 10 Lewis & Clark L. Rev. 57, 74 (2006).} The reforms detailed above are intended to advance that objective. However, the reforms have not completely dispelled the coercive atmosphere within which analysts must operate. As mentioned earlier, analysts have typically been dependent on other financial sectors for subsidization of their activities.\footnote{Moses, \textit{supra} note 25, at 92.} Unfortunately, the financial sector that analysts are currently dependent upon encourages misinformation rather than accuracy.\footnote{\textit{Id.} See also Professor John C. Coffee, Jr., Prepared Statement Concerning Accounting and Investor Protection Issues Raised by Enron and Other Public Companies, Before the Comm. On Banking, House. And Urban Affairs, 107\textsuperscript{th} Cong. (March 5, 2002), \textit{available at} http://banking.senate.gov/02_03hrg/030502/coffee.htm; see also Michael Siconolfi, At Morgan Stanley, Analysts Were Urged to Soften Harsh Views, Wall St. J., July 14, 1992, at A1.} Large financial firms have generally offered analyst services as part of the overall package of its investment banking services to issuers.\footnote{Choi and Fisch, \textit{supra} note 11, at 286-87 (describing the history of subsidizing research through fixed brokerage commissions).} This practice remains true today. Despite the recent reforms, the problem is that analysts continue, and will continue, to face indirect pressure from these investment banks and issues to generate favorable reports and recommendations, and it is not clear that this information is any more accurate than it was prior to the reforms.\footnote{\textit{See supra} notes 61-63.} The key then is not necessarily imposing more structural reforms. Rather, it is exposing the very product of analyst deception (inaccurate projections and recommendations) by rating analysts based strictly on their performance.

As mentioned earlier, issuers and institutional investors currently rank analysts based on subjective factors rather than empirical data. It is well-documented that negative analyst reports and recommendations will result in similarly negative ratings from issuers.\textsuperscript{71} This aspect of an analyst’s professional life has gone largely unchanged and has received surprisingly little commentary or criticism. Yet an analyst ratings have been clearly linked to an analyst’s professional standing, reputation, career advancement and salary.\textsuperscript{72} These ratings directly correlate with an analyst’s willingness to cooperate with the wishes of the issuers.\textsuperscript{73} Therefore, this article proposes, at a minimum, providing an independent, easily accessible, simple and reliable method for rating analysts. The Global Settlement required the ten settling banks to provide historical information on their analysts so as to allow retail investors to assess for themselves the accuracy of these analysts.\textsuperscript{74} This article’s author can say with complete confidence that the information produced as a result of this settlement is not easy for investors to find and, absent advanced degrees in law, economics or finance, does very little in terms of aiding individual investors in determining whether these analysts have performed well or not.\textsuperscript{75}

\textsuperscript{71} See generally Harrison Hong and Jeffery D. Kubik, Analyzing the Analysts: Career Concerns and Biased Earnings Forecasts, 58 J. Fin. 313 (2003).
\textsuperscript{72} See John Morgan & Phillip C. Stockton, An Analysis of Stock Recommendations, 34 Rand J. of Econ. 183, 187 (2003) (arguing that the Institutional Investor All-American Research Team poll, “based on a survey of the money managers and institutions, is widely viewed as a measure of an analyst’s standing in the industry.”); see also Stickel, supra note 29 (“at most brokerage houses, position on the All-American Research Team is one of the three most important criteria for determining analyst pay.”); see also Stickel, supra note 29, at 1812 (“All-Americans are generally higher paid”).
\textsuperscript{73} See Hong, supra note 71.
\textsuperscript{74} Global Settlement, supra note 54.
\textsuperscript{75} Stickel, supra note 29 (“at most firms, the important factors affecting pay are an evaluation of the analyst by the brokerage sales force, standing in the [Institutional Investor] poll, and job offers from competitors. A smaller set of firms expand the set of factors to include investment banking business generated, trading volume in recommended stocks, and the success of buy and sell recommendations. Accuracy of earnings forecasts is rarely an explicit factor[.]”).
In 2007, Stephen Choi suggested making information regarding analyst accuracy much simpler and more accessible.\textsuperscript{76} After thoroughly describing a multitude of analyst studies, he concluded that “[s]tudies have shown that prior analyst earning-per-share forecast accuracy is significantly correlated with the accuracy of an analyst’s current earnings-per-share forecast.”\textsuperscript{77} Based on this conclusion, he suggested that regulators should focus on forcing analysts to disclose a number of factors that are relevant to analyst accuracy.\textsuperscript{78} One of Choi’s most important factors was previous analyst accuracy. Currently, the U.S. regulatory laws only require that analysts provide information on their own system of rating categories and the percentage of the analysts’ recommendations that fall into each category.\textsuperscript{79} Without more, an individual investor could justifiably assume that an analyst’s breakdown of recommendations into categories suggests more about the stock being covered than about the analysts themselves. Because of conflicts of interest, these recommendations often have a more significant meaning. They may show an analyst’s tendency to over or undervalue stocks. For this reason, a simple disclosure that displays the analyst’s historical accuracy will be the most effective method of predicting that analyst’s future accuracy and discovering conflicts of interest.

2. Individual Investors Must Have Access To An Objective Measure Of The Accuracy of Analyst Stock Price Projections In Order To Determine If Analysts Are Conflicted.

In light of Stephen Choi’s more general suggestion, this article’s solution is to require that analysts be rated based on their target stock prices as compared to that

\textsuperscript{77} \textit{Id.} at 194.
\textsuperscript{78} These factors included 1) prior analyst forecast accuracy, 2) number of industries and firms followed by an analyst, 3) analyst firm-specific and general experience, 4) analyst forecast frequency, 5) age of forecast, and 6) Bold forecasts and herding. \textit{Id.} 194-96.
stock’s closing price. The need for a new and simple system of analyst ratings is twofold. First, the information regarding an analyst’s history, which is currently provided by the investment banks in the Global Settlement, is difficult to find and even more difficult to understand, especially by average investors. Second, the simplest and most easily accessible analyst ratings are provided in the *Institutional Investor*. As previously mentioned, these ratings are based on subjective evaluations by issuers and institutional investors rather than empirical data that indicates objectively how each analyst’s projections fair in juxtaposition to actual results. This situation can be simply remedied.

First, the SEC should place analyst ratings on its website where it is easily available to individual investors. Placing ratings on the SEC’s website has the additional benefit of increasing investor confidence in the analyst ratings by formally stamping those ratings with the SEC’s seal of approval. Second, analyst ratings should be based on a simple objective formula that is easily understood by investors. The rating should be broken into two components. The first rating will be based on the analyst’s stock price projections for all covered stock made during the previous year. However, because it is entirely possible that an honest and non-conflicted analyst simply had a bad year, there should also be a rating for a five-year period. The formula used should look at every stock target price projection made by that analyst and compare it with the actual

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80 Stickel, supra note 29.
81 Jill Fisch has suggested a similar idea that involves a Securities and Exchange Commission Analyst Website, which would enable firms to subsidize research while providing the information necessary to allow researchers and investors to evaluate the quality of that research. Fisch, supra note 2, at 40. While many of the disclosures that Fisch proposes to make available to individual investors on the SEC’s website would be helpful, this article argues that this information should be placed in a separate portion of the website in order to keep the analyst rating the focal point for individual’s who are researching analysts. The concern with placing too much information on the website is that it will overwhelm investors and undermine the efficacy of the simple mechanism for rating analysts.
stock closing price in order to generate the percentage that the analyst over or underestimated.

For example, assume an analyst projected a target price of $100 for a company’s stock that is currently trading at $70. After the projection, the stock’s actual closing price was $80. The analyst’s projected increase was $30 ($100 - $70 = $30). The stock’s actual increase was only $10 ($70 + $10 = $80 closing price). By taking the actual increase and dividing it by the analyst’s projected increase ($10 / $30 = .33) and multiplying that number times 100 (0.33 x 100 = 33%), it is easy to determine by what percentage the analyst over or under-projected. Thus, in this example, the analyst over-projected by 33 percent, which should be denoted “+” 33% (similarly if the analyst had under-projected, the percentage should be preceded by a “-”). This formula should be used to compare all target and closing stock prices. Using all over and under-projections for the year, these numbers are then averaged to formulate one single number that indicates the analysts over or under-projections for the year. Then, using the same formula, the average over or under-projections for all stock prices must be calculated for a five or ten-year period.

An alternative method would be to use this formula to provide a more detailed breakdown for each year over a five or ten-year period. This would allow investors to examine with more specificity how the analyst performed each year. A yearly breakdown would provide information on whether the analyst has succumbed to a conflict during a particular year or number of years, which would be a warning that the analyst could relapse into similar practices in the future. No matter how the actual years are broken down (by individual years or in categories of five or ten years), the proposed
system would be a drastic improvement to the current disclosure and rating systems, which often reflects issuer and institutional investor bias and animosity rather than objective indications of actual analyst performance.\textsuperscript{82}

These two numbers will give investors a quick and easy way of checking the overall accuracy of the analysts that are analyzing the stocks in which the investor is interested. Because conflicted analysts have incentives to underestimate earnings in order to make the issuer look like it exceeded expectations (especially during an IPO), a negative accuracy score will be an indication that analysts are conflicted.\textsuperscript{83} Obviously, the degree of over and underestimation will determine to what extent analysts may be conflicted (or genuinely unskilled at their job). Further, by providing several temporal indications of analyst performance, the rating system takes account for the possibility of analysts having an off year. As suggested by Stephen Choi, this information should be listed for every analyst and placed in numerical order from the highest to lowest, based on the particular industry sector for which the analyst is involved.\textsuperscript{84} By breaking the analyst ratings down into particular industry sectors, the individual investor will be able to quickly compare analysts with each other in the particular industry.\textsuperscript{85} This is important because stock prices in certain industries may perform above or below the expectations of all analysts in that sector while stock prices in other industries react much differently to market forces. By looking at analysts in sectors, the investor may be able to look at a disappointing rating of one analyst and realize that all other analysts in that sector also did poorly that year, thereby suggesting that a conflict of interest was not present.

\textsuperscript{82} Stickel, \textit{supra} note 29.
\textsuperscript{83} See generally Griffith, \textit{supra} note 28. Note that analysts may also have incentives to over-estimate.
\textsuperscript{84} Choi, \textit{supra} note 76, 197.
\textsuperscript{85} Analysts tend to specialize in certain industries, thus it would be helpful to rank them within their particular industries. Fisch and Sale, \textit{supra} note 9, at 1041.
This basic formula will provide individual investors with a quick reference point for determining the quality of analysts, especially for those who drastically over or under project future stock prices. However, the formula does not address the problem of analyst recommendations. Because some analysts do not provide information on future stock price projections, another piece of information should be placed on the SEC’s website in addition to a percentage that indicates an analyst’s over and under projections.

3. Individual Investors Must Have Access To An Objective Measure Of How Accurate Analyst Stock Recommendations Are In Order To Determine If Analysts Are Conflicted.

Some analysts do not project actual stock prices, but rather issue recommendations to buy, sell or hold.\(^86\) In fact, to many individual investors, these recommendations are the only source of information that they examine in order to make investment decisions. In order to aid individual investors who use only these recommendations, analysts should also be rated by their accuracy based on these recommendations. There are two options for this type of analyst rating system. First, the SEC could completely change the non-standardized recommendation systems that analysts currently use, by creating one standardized system. Generally analysts use a recommendation system that contains three, four or five recommendation categories.\(^87\) It would be difficult to ascertain how to quantify an analyst’s accuracy, relative to other analysts, without standardizing the various recommendation systems currently utilized by analysts. Therefore, one option is for the SEC to standardize this system and then create a quantifiable rating system based on stock performance relative to each analyst’s actual recommendations.

\(^{86}\) See generally Fisch, supra note 2.
\(^{87}\) See generally Ronald J. Colombo, BUY, SELL, OR HOLD?, 73 Brook. L. Rev. 91 (2007).
For example, assume the SEC created a recommendation system containing three categories (buy, sell, hold) that ranked analysts on a 1-3 scale per recommendation. If the analyst issues a buy (sell) recommendation and the stock’s price rises (falls), then that analyst would be given a score of “3,” the highest score. If the stock price remains the same (or stays within a price range set by the SEC) then that analyst would receive a 2. Finally, if the stock price fell (rose), then the analyst would receive a 1, the lowest score. Additionally, if the analyst issued a “hold” recommendation and the stock price remains the same, then the analyst would be given a “3.” If the analyst issued a “hold” and the stock price increases or decreases (beyond a set range), then the analyst would be given a “2.” It may seem as though an increase should raise the analyst’s score more than a decrease in this situation, since the net benefit to individuals is positive. However, the purpose of this rating system is to determine accuracy in an objective manner rather than rating the effect an analyst’s recommendation has on consumer profit. This is especially true since analyst conflicts are often demonstrated by underpricing.88

After giving each recommendation made by the analyst a score, the same averaging method as used in the prior section should be implemented. For example, assume an analyst made four recommendations with the following accuracy ratings: Buy (3), Hold (2), Buy (1), Buy (2). By adding all of the numbers together (3 + 2 + 1 + 2 = 8) and dividing by the total number of possible points (3 x 4 = 12), the overall analyst rating is calculated (8/12 = 0.667), which is then converted into a percentage (0.667 x 100 = 66.7%). Thus, in this example, the analyst was accurate 66.7% of the time. As with the stock price rating system detailed above, this system should also reference several

88 See generally Griffith, supra note 28.
different points in time in order to account for uncontrollable market forces that may have 
affected the success of the analyst’s projections in unforeseen ways.

Another option is to leave the divergent recommendation systems currently used by 
analysts as they are. Without resorting to an algebraic formula that would artificially 
standardize these different systems, analysts could be rated simply on the accuracy of 
their strongest “buy” recommendation. The justification for this approach is that most 
analysts issue their strongest buy recommendations for the majority of stock they cover. If an analyst issues a “sell” (or “strong sell”) recommendation, then there is little reason 
to doubt the honesty of that recommendation since the issuer, investment banker and 
institutional investors currently holding that stock will all be upset with the analyst.
Therefore, the SEC could simply rate each analyst based on a comparison of the analyst’s 
strongest buy recommendation as compared to the stock’s actual performance.

Under this system, after analysts issue their highest buy recommendation, the 
stock may rise in price (past a point set by the SEC). If so, then these analysts should be 
considered to have given an accurate recommendation. Therefore, they should be given a 
“1.” If, however, the stock price remains the same or falls, then they should be given a 
“0.” For example, assume an analyst issues four of her strongest buy recommendations. 
Three of those recommendations were ultimately inaccurate, as represented by falling 
stock prices. The result would be: 0, 0, 0, 1. As above, these numbers are added 
together (0 + 0 + 0 + 1 = 1), and divided by the total number of possible points (1 x 4 = 4) 
to calculate the average (1/4 = 0.25). This number is then converted to a percentage (0.25 
x 100 = 25%), which shows a 25% accuracy score. As with the other rating systems

89 See supra notes 63-64.
90 See supra note 33.
above, the results for all of that analyst’s strongest buy recommendations should be averaged together for one overall percentage score. This process should be repeated over the various time periods determined above. By doing so, individual investors will be able to quickly locate reliable and simple information that will serve as an easy method for evaluating sell-side analysts.

IV. An Objective Analyst Rating System Must Be Implemented Before Market Conditions Improve and Investor Tolerance of Corruption Re-Emerges.

This article has explored the historical and current explanations for the conflicts of interest experienced by sell-side analysts. By detailing the recent legal reforms intended to resolve for these conflicts, it is apparent that the conflicts have not been entirely alleviated.91 This article proposes a useful solution, which is to rate analysts in a simple and easily accessible manner. All individual investors do not have advanced degrees necessary to understand the complicated data provided by investment banks, firms and analysts as required by the Global Settlement. Further, most of that data is currently unreasonably difficult to locate.

As stated in the beginning of this article, investors are noticeably complacent when fraudulent activity generates individual wealth.92 This was the situation that occurred during the 1990’s and which came to an abrupt halt as technology stocks plummeted. The market has risen again, with individuals making substantial profits and overlooking the corruption that will temporarily sustain their euphoria. However, as quickly as the market rose, it has begun to fall, thereby completing the cycle. With that fall, the same corruption will again spark investor intolerance, which is certain to draw media attention.

91 See supra notes 61-65.
92 See Laderman, supra note 1.
and provoke another regulatory backlash. Yet this situation can be avoided by providing the appropriate information to investors.

Currently, individual investors have no easily accessible and reliable source of information to evaluate analyst performance. The most well-known and widely available sources of analyst rankings are 1) based on biased and subjective information, 2) often extremely difficult to locate, 3) too difficult for individual investors to understand, or 4) provided at a cost that investors should not have to pay in order to ensure they are not being defrauded. A simple, credible and easily-accessible solution based on objective data from the analysts themselves would be an incredibly useful tool to individual investors trying to assess the quality of sell-side analysts. Perhaps this information would merely show that analysts are no longer conflicted and are skilled at what they do, but if that is true, the current objective information regarding analyst performance is suspiciously hidden from view.