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## RESEARCH REGULATION REVISITED

*by Steven Lofchie*

Re-examining the financial regulatory system as a whole is perhaps too big a topic to be comprehended. So it may make sense to look at a topic that is more limited, but that is sufficiently broad to serve as at least a partial paradigm.

The recent downfall of Elliot Spitzer makes “research” a particularly good topic to focus upon, because, I would argue, in many ways Mr. Spitzer embodied the best and the worst of the regulatory system. The best in that he brought to light a significant problem that had been apparently missed by other responsible regulators. I think what is more open to criticism, and what is certainly worth reviewing, is the way Mr. Spitzer and the various government entities (federal and state, legislative and regulatory) and the SROs responded to those problems.

### Questions<sup>1</sup>

For example, one might ask:

1. Why was the problem missed by the regulators? Was it recent or longstanding? Is there a way it might have been discovered sooner?
2. Once the problem was discovered, was the enforcement process handled “fairly?” I assume that all, or at least virtually all, of those censured or otherwise disciplined were guilty of something. Thus the primary question I think worth asking is not whether innocent persons were directly punished. Rather it is two secondary questions. Were the guilty parties punished through an appropriate process and in an appropriate manner? Were innocent parties harmed?
3. What do we think of the law, rules and guidance – from Congress, the SEC, the SROs and the industry groups – that resulted from the process? Were they sensible? Were they overdone? Were they not enough?
4. What about the process through which the laws, rules and guidance were adopted? Many of the rules were adopted as part of enforcement actions and the resulting settlement, rather than through the ordinary rulemaking process. Is that a good way to proceed?
5. How were the costs and benefits of the rules evaluated at the time? How do they appear in retrospect?

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<sup>1</sup> Just so that I am not accused of second guessing, I will note that I asked at least some of the questions and made many of the observations a good number of years ago. See Steven Lofchie, Why Wall Street Settlements Cast a Shadow Over Analysts: Where is the Money to be Made in Producing Independent Research if Investment Bankers can't Pay for It, International Financial Law Review Article, February 2003 (“Lofchie IFLR”).

6. How have producers and users of research responded to the new rules? Have the new rules improved the quality of research? Have they changed the quantity? Have they changed the ways in which research is distributed?

7. What should we do going forward? In this regard, it is important to ask, what are we trying to accomplish by regulating research? Is research a good thing? What are the benefits? Should its production be encouraged and how? Are there distinctions that we should make between different types of research, or between research sent to different types of investors?

8. What does the episode say about the role of the States, both in catching the problem and in responding to it?

### **Assumptions, Lessons and Skepticism**

Without knowing the answers to the above questions, I would nonetheless hazard a few observations.

1. **Need for Regulation.** You would have to be a strict libertarian to believe that the research problems do not demonstrate a need for government regulation of financial activities, including research sent to retail investors. There is simply too much at stake and too much to be gained not to monitor financial activities and regulate them.

Assuming that there is a need for regulation and that there has been misconduct (and would be more) without it, that does not answer the question of what that regulation should be. Otherwise, when we discover a need for regulation, we end up by answering the questions as to how much/what type of regulation, with the answer “more.”

2. **Why Was the Problem Missed?** I have no idea, but I am sure it is not because the SEC and the other securities regulators are soft on wrongdoing. Maybe it is because they are focused on formal compliance issues, rather than on more general issues, but I do not know.

One thing I do think is really interesting is that in many respects the problem was first identified by economists and others in the academic world, who noticed very wide disparities in the number of “buy” and “sell” ratings given by investment banks; *i.e.*, that the number of buys vastly outnumbered sells. Economists and academics have in several other instances discovered problems before the regulators, using economic and statistical analyses, apparently looking at different things than the regulators look at. For example, they discovered the absence of price competition at the Nasdaq and they discovered issues with mutual fund market timing.

3. **Rulemaking Process.** Leaving aside the quality of the rules adopted, it bothers me that, to a very significant extent, rules of future conduct applicable to a major industry were adopted through an enforcement process as part of a settlement. Once the problem was identified, I think it would have been better to go through the ordinary rulemaking process in adopting the rules. If we don’t have confidence in the way that the rulemaking process works, we should alter that process, not go around it.

4. **Role of States.** On the one hand, you have to give credit to New York Attorney General Spitzer for uncovering the issue. On the other hand, it is hard to see the logic of an enforcement process that involves, in addition to numerous federal regulatory agencies, 50 states. What possible benefit could be provided to the system by that large a number of enforcement agencies? How do you prevent a desire for revenue or for political advantage from driving that process?

One aspect of state enforcement actions that I generally find troublesome is the separation of the power to bring enforcement actions from responsibility for the health of the relevant regulated industry. That is, it seems to me that a state enforcement official would be far more motivated to bring an enforcement action that generates revenue for the state in light of the fact that, as a practical matter, he can not be held responsible for the failure of the regulated firm, and, assuming that the firm or industry largely operates from outside of his state, he may be fairly indifferent to the health of the firm or industry.

That said, since Spitzer was from New York State, it should be thought that he would have had, more than the officials of any other state, an interest in the health of the financial industry. I do not know whether he did. On the other hand, his success in very high profiled enforcement actions obviously led to his being elected governor and even to being mentioned as a candidate for president.<sup>2</sup> This does raise the question of whether his handling of the enforcement action was for the benefit of the state or for political advancement.<sup>3</sup>

5. **Costs and Negative Effects of the Regulation.** A Senate Committee report on Enron stated:

Concerns have been expressed, however, about whether the research divisions will remain economically viable without being a part of the same entity through which investment banking revenue flows, given that many Wall Street firms derive so much of their profits from investment banking activities. Many average

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<sup>2</sup> New York Times, [After a Rough Start, Spitzer Rethinks his Ways](http://www.nytimes.com/2007/11/27/nyregion/27spitzer.html) [Online], 27 November, 2007, available at <http://www.nytimes.com/2007/11/27/nyregion/27spitzer.html>. TheAtlantic.com, [The Crusader](http://www.theatlantic.com/doc/200410/pappu) [Online], October 2004, available at <http://www.theatlantic.com/doc/200410/pappu>.

<sup>3</sup> See Lofchie IFLR.

In connection with these settlements, New York attorney general Eliot Spitzer has been criticized both for being too hard and too soft. I think you have to start by praising him for breaking the case. He proved himself to be smart and able and ahead of the other regulators. After Spitzer discovered the emails, he had a lot of power to negotiate the terms of a settlement with the industry. There were two ways he could have gone. He could satisfy himself with retribution for harm done (money damages). Or he could try to reshape the securities industry going forward by demanding that firms change their ways of doing business. I am sympathetic to the decision that Spitzer made, any able and ambitious person wants to shape the world going forward ... . However, I think he overreached. Even if he felt that he had proved himself individually better than other regulators and regulatory agencies, he should have deferred to the SEC. Admitting that the SEC did not properly identify the research problem, it is the only agency that is in a position to weigh regulatory costs and benefits for the industry and to investors as a whole.

investors depend on sell-side analysis to assist them in making their investment decision because most can ill-afford much more expensive independent research. Therefore, the SEC must be careful to craft a rule that does not have the unintended result of cutting off access to this relatively affordable information.<sup>4</sup>

This statement seems remarkably optimistic. In other words, Congress directs the SEC to take care of the problem, but, in resolving the problem, the SEC should see to it that there are no real costs.

Notwithstanding, this unreasonable optimism, when the SROs looked at the “costs” of the various research rules (meaning in this case the diminution in the amount of research produced), the SROs seemed to find they had succeeded: they had regulated without imposing any costs. In their report on the topic,<sup>5</sup> the SROs cite a number of academic and media sources indicating that the number of research reports and companies covered has declined materially, but then cited some contrary data and concluded that the diminution in the quantity of research may at least in part be due to economic trends.<sup>6</sup>

I find this inability of the SROs to accurately measure the possible negative effect of the research rules or regulation generally to be distressing. First off, the regulators had just uncovered significant amounts of benefits flowing to firms as a result of their improper and fraudulent research. Second, the regulators had just imposed a remarkably complicated regulatory system (which is expensive to implement and maintain) on firms producing research. In sum, benefits had decreased, and costs had increased. It is only common sense that firms would put fewer resources into research and produce less research given this combination. But the SROs could find no evidence of that. The SROs were, on the other hand, able to find the benefits of the new rules. But is hard to assess any regulations, if you can't measure in some way both their costs and their benefits.

6. **Benefits of Research.** Everyone seems to agree that “research” is a good thing, that it increases the efficiency of the capital markets by encouraging investors to direct their assets to the issuers that are most likely to grow. On the other hand, it is somewhat unclear to me personally why investment banks publish research broadly. I understand that they used to do so because it improperly generated investment banking revenue. And they may continue to do so because it generates a certain amount of trading revenue from investors that are glad for the research.

On the other hand, I had been taught that once any information is very broadly known, the information is taken into account in the price of securities, and the information loses its

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<sup>4</sup> Financial Oversight of Enron: The SEC and Private-Sector Watchdogs Report of the Staff to the Senate Committee on Governmental Affairs (October, 8, 2002)

<sup>5</sup> Joint Report by NASD and the NYSE On the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules (December 2005)

<sup>6</sup> See, e.g., Amy Stone, Yes, Wall Street Research is Better, Business Week [Online], 28 June, 2004, available at [http://www.businessweek.com/bwdaily/dnflash/jun2004/nf20040628\\_1253\\_db014.htm](http://www.businessweek.com/bwdaily/dnflash/jun2004/nf20040628_1253_db014.htm).

value. It seems to follow that investors can only get value out of research if the broker-dealers do not broadly distribute the research, meaning broker-dealers should give it only to select clients who will trade through them. Research that goes up on the Internet and out to thousands of investors very quickly loses value to anyone not sitting by a computer screen trading.<sup>7</sup> So why do firms produce research? What is its value?

Leaving aside any uncertainty, it seems to me that the regulators should want to encourage the production of research. However, they can be successful in given encouragement only if they understand why investment banks produce research and how they are paid for it. Then they may be able to figure out how to encourage the production of more and better research.

7. **Retail vs. Institutional.** One of the interesting aspects of the research problems is that it is generally agreed that retail and institutional investors were very differently impacted. That is, it is my understanding that institutional investors put very little credence in the rating and the recommendations contained in broker-dealer research, and that they valued the more substantive or qualitative aspects of the research. On the other hand, retail investors could not really evaluate the quality of the research, and focused only on the surface; *i.e.*, the rating or the recommendation. One possible implication of this fact, assuming it is a fact, is that less regulation is required of research that is directed solely at institutional investors.

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<sup>7</sup> See Lofchie IFLR.

The end result of the SRO Rules and the global settlement is that research, even if it is part of a larger investment banking and trading operation, is expected to run as a separate profit centre. The main problem is that no-one knows where the profit is going to come from.

Like many other producers of intellectual property, the investment banks writing research have what might be called a Napster problem. Once they have published research and sent it out to subscribers in an email, or published it on the internet, it is readily available to everyone. How then are the firms going to capture value for the quality of the research. And if no value is found, where is the incentive for the firms to produce high quality research?

That is the tough question. How can the regulators design a system that encourages firms to produce good research going forward? Focused as they are on past problems, on the declaiming of disclosures and the promulgation of prohibitions, the regulators are ignoring incentives.

Requiring the firms that are parties to the global settlement to subsidize independent research is likely to delay and disguise the problem. But eventually any subsidy will run out. Then where is the money in writing good research? Meanwhile the newspapers report that Spitzer is moving on to other issues.