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Chapter 8

An Idea for Consideration: The Role of Securities Analysts and other "Gatekeepers" in Securities Regulation[1]

8.1 Capital markets rely on "gatekeepers." There are gatekeepers formally charged with that responsibility, either as regulators or self-regulatory organizations. And there are gatekeepers whose function to insulate the market from abuse is less formal, but nonetheless crucial as a part of the overall regulatory mosaic. These informal gatekeepers are the professional intermediaries who prepare, verify and analyze the corporate issuer's statements to the market.

8.2 The most obvious examples are auditors, securities analysts, and credit rating agencies, but lawyers and investment banking firms also play a gatekeeping role, either by preparing an issuer's disclosure documents or performing due diligence in connection with a public offering of securities. Ideally, use of such reputational intermediaries increases the market's confidence in the reliability of the issuer's disclosures and thereby reduces uncertainty and the cost of capital.

8.3 In principle, gatekeepers are trusted by the market, because they have less reason to lie or distort than does the issuer (or its officers) and because they implicitly pledge a reputational capital which they have built up over decades and many clients. For example, for an auditor to risk its reputation (and ultimately survival) to benefit a single client seems irrational because the potential losses far outweigh the expected profit. Nonetheless, the burst of the high-tech bubble in 2000-2001 revealed instances in which gatekeepers appear to have precisely done that (with the most notable example being the spectacular demise of Arthur Andersen). Gatekeeper failure is thus a real-world phenomenon, however unlikely it may appear in theory. Accordingly, any assessment of Canadian securities markets is incomplete unless it takes stock of the current status of gatekeepers in Canada. In addition, use of such intermediaries permits the main-stream regulators to direct their focus on a risk management basis.

8.4 A chapter on "gatekeepers" has a logical place in our report for several reasons. First, from the "modernization" perspective, the positive role of gatekeepers in the regulatory system is under active consideration. Examples which come immediately to mind are: (i) the decision of the London Stock Exchange to outsource regulation of the disclosure of companies listed on the Alternative Investment Market (AIM) to nominated advisers (NOMADs); and (ii) the decision made under the *Sarbanes-Oxley Act* to require auditor

[1]Much of the analysis (and recommendations) in this chapter are derived from the work of Professor John C. Coffee Jr., a member of the Task Force; in particular, see John C. Coffee Jr., *Gatekeepers: The Professions and Corporate Governance* (Oxford: Oxford University Press, 2006) at Chapter 7.

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attestation of the adequacy of internal financial controls. On the other hand the scope for gatekeepers to abuse the trust placed in them, and for the public to be misled by the apparent accreditation of information when attached to the gatekeeper label has been well discussed and addressed in the context of analysts who are sometimes perceived to be biased – as to which more below.

8.5 Second, when considering the efficiency of a regulatory system one must consider whether greater use of "downstream gatekeepers" could allow a more productive focus by "upstream gatekeepers" (by which we refer to those formally charged with a formal regulatory role) on other important regulatory matters, such as enforcement.

8.6 Third, the objective of enhancing the efficiency of regulation, and the objective of ensuring that downstream gatekeepers meet the public's expectations of their role are clearly objectives consistent with enhancing the competitiveness of our capital markets.

8.7 This chapter will focus on the securities analyst as gatekeeper. As we have outlined in Chapter 5, we regard the securities analyst as an essential component of the C-WKSI framework we have recommended in that chapter. At the foundation of the C-WKSI framework is the requirement for issuers to be subject to the near constant watchful gaze of securities analysts, thereby reducing the need for regulatory review of C-WKSI offering documentation.

Auditors, Credit Rating Agencies and Lawyers as Gatekeepers

8.8 Prior to our discussion of the role of securities analysts as gatekeepers, a brief introduction to other gatekeepers we have studied[2] – auditors, credit rating agencies and lawyers – is in order. Our consideration of the role of gatekeepers has been informed by the work of Professor John C. Coffee Jr., which has been shared with the Task Force, as well as research papers prepared for us by Professors Stephanie Ben-Ishai[3] and Stephen Choi.[4]

Auditors

8.9 Auditors are probably the best known example of a gatekeeper by acting to ensure the full and accurate disclosure of financial information by an issuer. Oversight of auditors has been markedly increased in Canada in recent years. Prior to the collapse of Enron, the accounting profession had already initiated private sector oversight through the establishment of the Accounting Standards Oversight Council of Canada and the Auditing Standards Oversight Council of Canada. Thereafter, the recently created Canadian Public Accountability Board (CPAB) was established and more or less mirrors the United States Public Accounting Oversight Board (PCAOB) and arguably represents the substitution of a stronger regulatory body for a weaker system of self-regulation. It would be premature to review the experience of CPAB to date and we have made no attempt to do so. It may be possible to enhance the effectiveness and efficiency of CPAB by conferring on it carefully circumscribed statutory authority in order to enhance its legitimacy and provide it with the powers similar to other self-regulatory organizations. This recommendation was made by Professor Ben-Ishai and deserves careful consideration.[5]

[2]S. Ben-Ishai, "The Effectiveness of Corporate Gatekeeper Liability in Canada" in Volume VI.
[3]*Ibid*.
[4]S. Choi, "Thoughts on the Regulation of Investment Analysts in Canada" in Volume VI.
[5]Ben-Ishai, *supra* note 2 at 437.

8.10 As reflected in Professor Ben-Ishai's work, an interesting development in Europe is the consideration of permitting auditors to benefit from "liability limiting agreements".[6] The policy considerations behind this concept are readily apparent. The public policy imperative of holding auditors responsible for negligence in the preparation of misleading financial disclosure is clear. On the other hand, are there practical limitations to this imperative when the cost of unlimited financial exposure may lead to the failure of a major accounting firm and the consequential narrowing of the number of independent auditors available for major issuers (arguably, the capital markets cannot afford to lose another member of the so-called "Big 4" accounting firms)? This very serious potential trade-off has led some to consider the wisdom of auditor "liability limiting agreements" – accompanied by full public disclosure so that the public are aware of the limitations associated with financial statements upon which they are asked to rely.

Credit Rating Agencies

8.11 Credit rating agencies evaluate the creditworthiness of issuers – like other gatekeepers they act as certifying agents by offering their reputation as a mark of an issuer's quality.[7] However, in Canada the credit rating industry is characterized by a lack of competition and a fear among some capital markets participants about the conflicts of interest faced by credit rating agencies by virtue of being paid by the very issuers they analyze and rate. Moreover credit rating agencies are not subject to regulatory oversight in Canada, but are being encouraged to adopt a code of conduct issued by the International Organization of Securities Commissions (IOSCO). All of this leads some to question the efficacy of credit rating agencies as viable gatekeepers.[8]

Lawyers

8.12 Lawyers can act as gatekeepers to the capital markets in a number of ways. As noted by Professor Ben-Ishai[9]:

> With the increasing complexity of financial regulation, lawyers serve as 'critical facilitators' for their clients. Due to this relationship, the lawyer can detect and potentially disrupt wrongful conduct. The on-going nature of the relationship, and the high cost to both parties of ending it, has the potential to constitute lawyers as particularly effective gatekeepers.

8.13 Nonetheless, there has been considerable academic debate over whether lawyers should play a gatekeeping role in the capital markets. On the one hand, those who oppose such a role emphasise the sanctity of lawyer-client privilege and the confidentiality of communications with a lawyer. Conversely, others argue that public policy must strike an appropriate balance between the lawyer's obligations of client loyalty and the protection of the market's integrity.[10] This is not a debate to which the Task Force has devoted time and attention as the basis for any recommendation but is a debate which will undoubtedly continue.

[6]Under the *Company Law Reform Bill* published by the UK government in November 2005, an issuer will be permitted to limit its auditor's liability by entering into a "liability limitation agreement" with the auditor. Shareholders must approve the agreement, it can only apply to the audit for one year, and can only limit the auditor's liability to an amount that is "fair and reasonable in all the circumstances"; see *Ibid*. See also, Financial Markets Law Committee, "Issue 76 – Transparency Obligations Directive" (October 2004) available online at http://www.fmlc.org/papers/transparency.pdf at paragraph 4.4.

[7]Ben-Ishai, *supra* note 2.

[8]*Ibid*. at 441-446.

[9]*Ibid*. at 452.

[10]*Ibid*.

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The Securities Analyst as Gatekeeper[11]

8.14 Securities analysts in the United States were probably the leading casualty of the 2000-2001 stock market crash. They have received much public criticism, which has focused on their significant ratio of buy to sell recommendations (sometimes computed in the United States at levels as high as 100-to-1), their perceived bias towards optimism, and their willingness, in some instances, to endorse the stocks of underwriting clients even when they had personal misgivings. Many critics believe the profession is simply beyond reform; they view sell-side analysts as salesmen and little more.

8.15 To be sure, significant reforms have been implemented on both sides of the U.S./Canadian border. In the United States, the SEC has adopted Regulation AC[12] and Regulation FD;[13] the NASD and the NYSE have adopted much more detailed rules that attempt to seal off securities research from pressure or influence from the underwriting side of the broker-dealer (see NASD Rule 2711 and NYSE Rule 472).[14] Finally, overshadowing all these efforts was the Global Settlement, largely orchestrated by New York Attorney General Eliot Spitzer and the SEC, which mandated the subsidization of independent securities research for a limited period. Specifically, the Global Settlement required the ten principal U.S. underwriting firms to agree to provide independent research reports to their U.S. customers for a five year period beginning in 2004.[15] While not adopting this reform, Canada has adopted other reforms that parallel much that is in the SEC's and NASD's new rules. In particular, Investment Dealers Association of Canada (IDA) Policy 11 requires Canadian broker-dealers to "prominently disclose" in their research reports "any information regarding its ... relationship with any issuer which is the subject of the report that might reasonably be expected to indicate a potential conflict of interest...."[16] To this point, then, Canada has emphasized disclosure rather than adopt structural reforms.

8.16 What has been the impact of these reforms? Some studies suggest that relatively little has changed, except for a decline in research coverage.[17] Professor Boni finds that, following the Global Settlement, "high" recommendations did not decrease (but actually increased), while "low" recommendations (i.e., "sells" or their euphemistic equivalents) decreased.[18] Thus, the impact of the recent reforms can be questioned, and the objectivity and professionalism of the securities analyst remains open to continuing debate. One implication may be that structural reforms are ineffective. Even if investment banking personnel can no longer influence or pressure the securities analyst, indirect pressures may be powerful. At a minimum, the analyst presumably knows that his or her utility to their firm comes from the revenues that the analyst indirectly generates for the firm; thus, the firm's clients cannot safely be offended.

[11]The substance of the remaining paragraphs has been kindly provided by Professor John C. Coffee Jr.

[12]See 17 C.F.R. § 242.500-502 (requiring an analyst to certify that "all of the views expressed in the research report accurately reflect the research analyst's personal views about any and all of the subject securities or issuers").

[13]17 C.F.R. § 243.100-103 (restricting selective disclosure by public companies).

[14]See Securities Exchange Act Release No. 51593 (April 28, 2005) (approving amendments to both rules to preclude securities analyst appearances at "road shows").

[15]The terms of the Global Settlement are available at http://www.sec.gov/litigation/litreleases /finaljudaddaa.pdf

[16]See IDA Policy 11, 26 OCSB 7007 (2003). The conflicts that must be disclosed include services by the broker-dealer to the issuer for "other than normal course investment advisory or trade execution services."

[17]See Leslie Boni, "Analyzing the Analysts after the Global Settlement," in *Financial Gatekeepers*: Can They Protect Investors? (Fuchita and R. Litan, eds.) (2006) at 139-172.

[18]*Ibid*. at 150-151. Professor Boni uses the term "high" to include "buy," "strong buy" and any similar recommendations, and the term "low" to include "sells" (and any equivalent terms).

8.17 Worse yet, the cost of these recent reforms has been considerable. In the United States and in Canada, it appears that integrated broker-dealer firms have cut back on their employment of securities analysts. Because investment banking divisions could no longer use the analyst as a marketing tool, they have reduced their firm's subsidy for research. As a result, the number of corporations which have even a single analyst covering them has declined in both countries, with the impact being most severe for companies with smaller market capitalizations. In the United States, smaller firms have even begun hiring an analyst to publish research on them – a procedure that seems far more conflicted. Thus, an unfortunate trade-off comes into view: recent reforms may have made the analyst less conflicted, but they may also be making the market less transparent. Conceivably, even conflicted research might be better than no research. Viewed in this light, the trade-off appears to be between research coverage and independence, and neither should be easily sacrificed.

8.18 In the United States, this problem of diminished research coverage is mitigated by the fact that research still generates sufficient indirect revenues in the form of the brokerage commissions on large capitalization stocks to support itself. The Canadian market has characteristically smaller capitalization firms and thus securities research may be less able to support itself. Put simply, the lack of funding for securities research represents a greater potential crisis for Canada than for the United States. Potentially, much of its market could "go dark" in that no objective analyst would provide continuing assessments on individual companies. In such an information-impoverished environment, not only would smaller companies find it harder to establish themselves and interest investors, but they also become more subject and vulnerable to Internet fraud and manipulation (by short sellers, day traders and others who know that their false rumours will not be challenged by any objective and credible third party).

8.19 Some critics would cut back on recent reforms. Yet, from a public policy perspective, it is unsatisfactory to accept that the choice is between conflicted research and no research. Neither option is acceptable. Still, the only escape from this trade-off between adequate coverage and meaningful independence is to create a subsidy for research that insulates the analyst from the control of conflicted persons. Neither the Global Settlement nor other recent reforms appear to have succeeded in so insulating the analyst (although they may have discouraged the private market from funding research). Thus, if conflicts are to be restricted, a means of subsidizing securities research must be found to supplement the private market. The need for such a subsidy arises largely because of the "public goods" character of securities research, which means that the original producer of research cannot realize its value because of the original producer's inability to exclude "free riders" – persons who use the research without paying the producer. This problem is compounded if the private market reduces its funding for research, as it appears to be doing. Accordingly, public policy needs to recognize three basic goals in dealing with the securities analyst: (1) to discourage conflicts of interest; (2) to restrict pressure on, or retaliation against, the analyst; and (3) to provide funding to assure that lower tiers of the securities market continue to be covered by at least a minimal level of analyst oversight.

8.20 These goals will be addressed sequentially: first we will begin with a snapshot of the industry and focus on the problem of decreasing research activities. We will then map out the principal conflicts of interest and assess techniques for discouraging them. Here, more than simply Chinese Walls or structural separation of investment banking and research need to be considered. One important, but still unutilized, technique involves the use of positive incentives and embarrassment. If analysts are publicly ranked on the accuracy of their prior projections, this may be a more effective means of curbing excessive optimism than structural

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barriers. We will then consider the problem of pressure and retaliation. Although recent reforms have sought to restrict the investment banking firm from pressuring its research staff, little attempt has been made to restrict the issuer, and issuer pressure and threats appear to be a constant feature of the analyst's environment. Although Regulation FD in the United States does limit the issuer's ability to deny information to the analyst, other forms of pressure remain available, both in the United States and Canada.

8.21 We will then turn to the topic of subsidization. As research becomes more objective and accurate, there is ironically less reason for broker-dealers to fund it. The market has dealt with this problem in other forms. What is needed is a mechanism for taxing the market equitably in order to fund research. As will be stressed, research is not a dead weight cost. It creates a positive externality which should benefit the entire industry and offers Canadian exchanges a competitive advantage that foreign competitors cannot match.

A Snapshot of the Industry

8.22 Securities analysts tend to be employed in one of three capacities: (1) the majority are employed on the "buy-side" – that is, by institutional investors and chiefly mutual funds – where they engage in private proprietary research for their employers; (2) most of the remainder are employed on the "sell side," working for large broker-dealer firms that also provide investment banking services to corporations; and (3) the balance – a small but growing minority – work for "independent," sell-side firms, typically broker-dealers that do not provide investment banking services.[19]

8.23 By one recent estimate, 60% of all analysts in the United States are on the buy-side, 30% work for integrated firms on the sell-side, and 10% work for independent firms.[20] In all likelihood, this population has further declined since 2001, as numerous analysts have either been terminated, moved to the buy-side, or left the industry. More importantly, research coverage has clearly declined. The number of stocks that received research coverage by the ten underwriters participating in the Global Settlement declined an average of 14% relative to 2000 and 20% relative to 2001.[21]

8.24 The profession remains, however, highly skilled and compensated. Entry into it is highly competitive. In fiscal 2004, almost 110,000 persons enrolled to take the six-hour Chartered Financial Analyst exam administered by The CFA Institute in the United States.[22] To qualify as a CFA, an applicant must have three years relevant experience in the financial industry, take a three part exam, and pay over $2,000 in fees.[23]

[19]The term "independent" as applied to analysts can mean different things to different people. It can include large brokerage firms that lack any investment banking capacity (for example, A.G. Edwards, Edward Jones, or Prudential), or it can mean purely independent research firms, such as Sanford C. Bernstein & Co., Argus Research, or Standard and Poor's. Even in this last category, conflicts can be hypothesized, as for example Sanford Bernstein is owned by Alliance Capital, a money manager, which is in turn controlled by AXA Financial, an insurance company.

[20]See Jeffrey C. Hocke, *Security Analysis on Wall Street: A Comprehensive Guide to Today's Valuation Methods*, at 19 (1998). Since 1998, it is likely that there has been further migration from the buy-side to the sell-side and independent firms.

[21]See Boni, *supra* note 17 at 141.

[22]See "CFA a prized certification as Wall Street boosts hiring," *Miami Daily Business Review*, July 14, 2004, vol. 79; No. 3; p. 5. This level was up 15% from the number enrolling in 2000 before the stock market nosedived. The passing rate on the exam (for all three parts) was 49% in 2003.

[23]*Ibid*.

Currently, there are some 57,512 active Chartered Financial Analysts worldwide, of whom about 18% work in equity securities analysis.[24] Although a CFA credential is not required to be an analyst, it appears to be becoming standard, at least for the younger generation of analysts.

8.25 What does the sell-side analyst do? Typically, he or she will specialize in a single industry (e.g., banking, telecommunications, or automobiles) and concentrate on a limited number of stocks (usually ten to fifteen).[25] The analyst will prepare detailed research reports on these stocks, which will involve not only analysis of the company's published financial information but meetings with management and industry sources (including customers and suppliers). These reports were in the past available only to clients of the analyst's brokerage firm, but increasingly they are distributed through research resale firms. Also, all analyst estimates on a firm's earnings are gathered and collectively reported by Thomson First Call on its website.

8.26 The buy-side analyst in contrast will perform proprietary research for his or her employer (typically a mutual fund or hedge fund, but possibly an insurance company or pension fund), which research will be private and not disseminated beyond the client. Typically, buy-side analysts will cover more companies,[26] in part because they can rely on sell-side research, and their research will be more focused on immediate investment decisions (as opposed to industry or macro-economic trends).

8.27 Independent analysts may or may not work for a broker-dealer. For example, Sanford Bernstein & Co. is probably the best known independent research firm in the United States and does operate as a broker-dealer, but other firms may publish an investment newsletter or directly sell proprietary research to institutional clients and possibly individual investors.[27] It would be interesting to determine the circumstances that prevail in Canada.

8.28 Not all companies are covered by an analyst. While it is usually estimated that over 10,000 companies are publicly traded in the U.S. today (many in unregulated over-the-counter markets), fewer than 6,000 are regularly covered by even a single analyst.[28] Even within this 6,000 figure, less than half of these companies are covered by two analysts, meaning that a single analyst's opinion may be decisive. Recently, there has been a marked decline in the total number of public companies that securities analysts cover, which decline seems directly attributable to the reduced profitability of research to broker-dealer firms. As noted earlier, analysts at the firms participating in the Global Settlement reduced their coverage by roughly 20%.[29] More generally, Reuters Research, which tracks over 4,000 public companies in the United States, has reported in 2004 that some 666 of these firms now have no analyst covering them, up from only 85 just two years earlier.[30] An even

[24]See Coffee, *supra* note 1 at 273 n.1.

[25]For this estimate, see John L. Orcutt, "Investor Skepticism vs. Investor Confidence: Why the New Research Analyst Reforms Will Harm Investors" (2003) 81 Denv. U. L. Rev. 1, 8.

[26]*Ibid*. at 9. Orcutt estimates that buy-side analysts cover on average 30-40 companies.

[27]Examples of such research groups are the Gartner Group or Forrester Research.

[28]Orcutt, *supra* note 25 at 12.

[29]See Boni, *supra* note 17 and accompanying text.

[30]See Roben Farzad, "Back to Basics: A Year and a Half After Eliot Spitzer Tried to Clean Up Wall Street Research, The Jury is Still Out on Whether Honest Research Can Pay," Boston Globe, August 8, 2004 at D1.

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safer generalization is that much of the "small cap" market is today not covered by any securities analyst.[31] In response to this shortfall in analyst coverage, smaller companies have taken to hiring an analyst (usually a "freelance" analyst not employed by any firm) to publish research reports on them, thereby raising a new issue surrounding analyst independence.

8.29 Professors Choi and Pritchard have sampled U.S. and Canadian firms at various levels of market capitalization to compare the level of analyst coverage. The following table was prepared by them based on a sample of 10 U.S. and Canadian firms at each level of market capitalization:[32]

Market Capitalization in millions (Canadian dollars in parentheses)	Average # Analysts U.S.	Average # Analysts Canada	% With No Analysts U.S.	% With No Analysts Canada
$1,000-$2,000 ($1,150-$2,300)	10.7	8.3	0	0
$900-$1,000 ($1,000-$1,150)	8.2	7.1	0	0
$800-$900 ($920-$1,000)	5.4	7.0	10	0
$700-$800 ($800-$920)	8.6	7.7	0	0
$600-$700 ($690-$800)	4.6	3.6	10	0
$500-$600 ($575-$690)	4.9	3.9	0	10
$400-$500 ($460-$575)	4.0	3.7	10	30
$300-$400 ($345-$460)	5.6	5.8	10	0
$200-$300 ($230-$345)	3.7	2.5	10	20
$75-$200 ($86-$230)	1.8	3.2	10	20
Overall	**5.8**	**5.3**	**6**	**8**

8.30 Although this sample is small, it shows a roughly comparable level of coverage, except for the fact that Canadian companies have significantly lower average market capitalizations. They report that 83% of TSX-listed companies have a market capitalization of under $700 million (U.S. dollars), and this is the breakpoint at which some Canadian companies cease to be followed by an analyst.

8.31 Reduced research coverage might matter little if one thought that analysts were mere hucksters who hyped stocks and misled investors. However, the most surprising fact about analyst coverage is that it has consistently been shown to move the market and create value for investors who trade on analyst recommendations. Studies have consistently documented that economically significant and market-adjusted positive returns can be earned by investors trading on analysts' recommendation changes.[33] This research does indicate, however, that the market response to analyst research is stronger for negative research than positive research, possibly implying considerable market scepticism of analyst "buy" recommendations.

[31]One estimate provided by Thomson/First Call is that nearly 60% of all publicly traded companies in the U.S. receive no analyst coverage and that overall analyst coverage is down by 35% since 2001. See "Reuters Says Investrend Research Affiliate Fundamental Research Scores With Investors" *Financial Wire*, July 19, 2004. This estimate probably includes companies traded over-the-counter on the "Pink Sheets".

[32]Stephen J. Choi, "Thoughts on the Regulation of Investment Analysts in Canada" (May, 2006) at 66.

[33]See, e.g., N. Jegadeesh et. al., "Analyzing the Analysts: When Do Recommendations Add Value?" (2004) 59 J. Fin. 1083; K. Womack, "Do Brokerage Analysts' Recommendations Have Investment Value?" (1996) 51 J. Fin. 137; Boni, *supra* note 17, at 157-165. For a fuller review of this research literature, which is voluminous, see S. Ramnath, S. Rock, and P. Shane," A Review of Research Related to Financial Analysts Forecasts and Stock Recommendations," (2006) (available at SSRN: http://ssrn.com/abstract=848298).

Conflicts of Interest: A Roadmap

8.32 It has escaped no one's attention that analysts are subject to conflict of interests, but the range and character of these conflicts seldom receives adequate attention. Identifying the range of analyst conflicts is important, because recent reforms respond to some, but not all, of these conflicts. Essentially, analyst conflicts can be grouped under six headings.

Personal Conflicts

8.33 Conceivably, analysts may rationally issue or maintain a favourable rating on a stock because they own it. Indeed, companies long recognized and exploited this conflict by giving or selling key analysts their stock prior to their IPO. A 2001 SEC study found that nearly one-third of the analysts surveyed had made pre-IPO investments in a company that they later covered after the IPO.[34] This same study also found that broker-dealer monitoring of "the private equity investments of employees, including analysts, was poor"[35] and that broker-dealers were generally "unable to identify all of their employees' investments in companies that the firm took public."[36]

8.34 Perhaps even more surprising, evidence was uncovered in the wake of the Internet bubble's collapse that some analysts had traded in a manner inconsistent with their public recommendations – for example, selling securities that they were contemporaneously recommending as a "buy."[37] Such behaviour suggests that the analyst's own rating or recommendation was disbelieved by the analyst, implying again that pressure from the issuer may be driving analyst ratings. Some firms responded to these disclosures by prohibiting their own analysts from buying stock in companies that they cover.[38] The rules of the principal self-regulatory organizations still do little to control these conflicts.[39] The SEC has, however, adopted Regulation AC, which requires analysts to certify that they truly agree with their own stock recommendations.[40] Definitional as this may sound, the rule was sensibly intended to empower the analyst so that analysts could better resist pressure from their employer. Even if veiled, that pressure may remain where the analyst does not generate direct revenue for the firm.

[34] See Rachel Witmer McTague, "Unger Says Securities Firms Complied Poorly With Rules Relating to Analysts' Investments" (August 6, 2001) 33 SEC. REG & LAW 1136, 1138. See also Orcutt, *supra* note 25, at 23.

[35] *Ibid*. at 24.

[36] *Ibid*.

[37] See Jessica Sommar, "Red-Faced SEC Targets Two-Faced Analysts," N.Y. Post, May 24, 2002 at 41.

[38] Merrill Lynch is the leading, but not the only, example. See "New Merrill Lynch Policy Prohibits Analysts From Buying Shares in Companies They Cover," Securities Law Daily, July 11, 2001.

[39] The NYSE requires disclosure of financial positions held by a firm and its analysts in the securities of a recommended issuer, but is satisfied with a broad, conditional boilerplate disclosure that "the firm and its employees may own securities of a recommended issuer." See NYSE Rule 472. The NASD requires disclosure of ownership of options, but not common shares. See NASD Rule 2210.

[40] In 2003, in response to disclosures suggesting that analysts were trading against their own recommendations and sometimes even receiving direct compensation from issuers for their recommendations, the SEC adopted a new regulation – Regulation Analyst Certification ("Regulation AC") – which requires brokers, dealers and certain affiliated personnel to include in research reports a certification by the analyst that the views expressed by the analyst reflected his or her own personal view. See Securities Act Release 33-8193 (Feb. 27, 2003).

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Brokerage Commission Conflicts

8.35 Analysts are more likely to generate brokerage commissions for their employer by issuing positive recommendations (i.e., "buys") than negative recommendations (i.e., "sells"). Almost definitionally, this is because any investor can potentially buy on a "buy" recommendation, while only those owning the stock (or willing to take the risky step of selling short) can profit from a "sell" recommendation. Hence, the audience for "buy" recommendations is much broader and likely to produce more commissions. Also, if "sell" recommendations are strongly phrased, they may "spook" the market, causing small investors to flee the market and invest in other assets and leaving institutional clients of the brokerage firm holding large stakes that they cannot easily liquidate. Hence, institutional investors, as much as the issuer, tend to disfavour public "sell" recommendations by analysts.

Investment Banking Conflicts

8.36 Since brokerage commissions were subjected to competition in 1975, the profit center of many large broker-dealer firms shifted toward investment banking, and away from brokerage. During the 1990s, broker-dealers competed to land investment banking clients (both for underwritings and merger and acquisition transactions) by hiring the "star" analysts who could most influence the client's market valuation.

8.37 Much evidence has shown that analyst ratings are very sensitive to the identity of the firm's investment banking clients. Analysts at underwriting firms appear to inflate their estimate of firm clients,[41] and higher investment banking fees correlate with more positive predictions.[42] Not only does the quantitative evidence strongly suggest that analysts inflate their ratings of firm clients (although analysts may legitimately have a favourable view of companies), but from time to time documentary evidence has surfaced from within broker-dealers corroborating that firm policy was not to make "negative comments" about clients. In 1992, the Wall Street Journal obtained and published a memorandum signed by the managing director of corporate finance at Morgan Stanley in which he bluntly instructed all firm employees that:

> 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.[43]

8.38 This conflict not only affects the analyst employed by the lead underwriter to the company, but also other analysts at other underwriting firms that want this lucrative business and that therefore may be even more prepared to inflate their research opinions in order to curry favour and win a role as a co-managing underwriter.

[41]See Roni Michaely & Kent L. Womack, "Conflict of Interest and the Credibility of Underwriter Analyst Recommendations" (1999) 12 Rev. Fin. Stud. 653; Hsiou Wei Lin & Maureen McNichols, "Underwriter Analysts' Earnings Forecasts and Investment Recommendations" (1998) 25 J. Acct. & Econ. 101.

[42]For a review of multiple studies, see Fisch and Sale, "The Securities Analyst as Agent: Rethinking the Regulation of Analysts" (2003) 88 Iowa L. Rev. 1035, 1048-49.

[43]See "The Rohrbach Memo: 'No Negative Comments'", Wall Street Journal, July 14, 1992, at A-6. The memorandum went on to insist that this "no negative comment" rule be incorporated into the firm's Research Compliance Manual.

Issuer Access Conflicts

8.39 Even when the issuer is not a client, the analyst still has a further reason to soft-pedal criticism and inflate evaluations: the analyst needs to maintain access to the issuer in order to perform his or her job. Issuers traditionally released information about themselves to "friendly" analysts in advance of public disclosure. Such "selective disclosure" is now forbidden by the SEC's Regulation FD, which was adopted, after much controversy, in 2000. Nonetheless, companies still may stonewall an analyst they consider hostile, cutting such an analyst off from telephone conference calls and refusing to answer his or her questions. This fear of retaliation and lost access leaves open the question of whether "sell-side" analyst research can ever be fully objective.

Buy Side Conflicts

8.40 To the extent that an analyst is not subsidized by investment banking revenues, then the analyst is dependent upon brokerage commissions. Such commissions are disproportionately paid by institutional investors, who characteristically hold substantial long positions in stocks, which they cannot liquidate easily. As a result, institutional investors are often displeased when an analyst issues a "sell" recommendation, particularly when it comes as a surprise, because they are essentially locked-in to their positions and cannot sell them off before public investors react and cause a sharp price decline. Although these clients want unbiased research themselves, they prefer to receive it privately and do not like public "sell" recommendations that can panic the retail investor.[44] This explanation that institutional investors resist "sell" recommendations accounts for the fact that even well-known "independent" firms, such as Sanford Bernstein & Co., which does virtually no investment banking business, still have the same (or higher) "buy" to "sell" ratios characterizing their recommendations as do brokerage firms that handle a substantial volume of underwritings.[45]

Herding As An Influence

8.41 Multiple reasons can explain why independent analysts who sense a problem with a corporation may fail to sound the alarm. Enron supplies a good illustration because, as late as October 2001, just two months before Enron's bankruptcy, sixteen out of the seventeen analysts covering Enron maintained "buy" or "strong buy" recommendations on its stock.[46] Yet, much publicly available information already suggested that Enron was overpriced and could not maintain its prior rate of growth.[47]

[44]See Bradley, Jordan and Ritter, Analyst Behavior Following IPOs: The "Bubble Period" Evidence, (Working Paper 2004) at 6 (noting that "firms, such as Sanford Berstein, where little investment banking business is done, still are faced with an important conflict. Institutional investors who are long in a stock … want that analyst to publicly have a "buy" recommendation.")

[45]As of October 2002, Sanford C. Bernstein & Co., the best known independent research firm, had a "sell" or "strong sell" recommendation on only 5.4% of the stocks it rated, which was below the 8.1% sell and strong sell percentage for all brokerage firms. See S. Choi and J. Fisch, "How to Fix Wall Street: A Voucher Financing Proposal for Wall Street" (2003) 113 Yale L. J. 269, 284-285.

[46]See "The Collapse of Enron: The Role Analysts Played and the Conflicts They Face: Hearings Before the Senate Committee on Governmental Affairs," 107th Congress, 2d Sess. (Feb. 27, 2002) (prepared testimony of Frank Torres, Legislative Counsel, Consumers' Union). The seventeenth analyst had a "hold" rating on Enron, and none were suggesting that the stock should be sold.

[47]See Paul Healy & Krishna Palepu, "The Fall of Enron" (Spring 2003) J. Econ. Persp., Spring, at 3 (noting that Enron's stock price was trading at seventy times its earnings and six times its book value and seemed overpriced by all standard criteria).

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8.42 Assuming that not all these analysts were conflicted in any of the foregoing senses, why would they be slow to respond? For the past decade, economists have had an explanation for why few analysts dissent from the consensus prediction. Money managers and analysts, they argue, fear making an individual mistake far more than a collective mistake, because they are in competition with each other and are evaluated principally on their relative performance.[48] Hence, analysts and money managers tend to herd, fearing to deviate far from the consensus prediction. If the consensus prediction is wrong, they suffer little injury vis-à-vis their colleagues who made similar predictions. Of course, if the analyst correctly predicts a downturn in a firm's earnings or stock price, he or she will attract favourable attention. But, even in this case, a problem remains: if the analyst prematurely predicts a downturn and the market does not drop promptly, investors who relied on his or her judgment may lose money and are not appeased by the fact that the analyst is eventually proved correct.

8.43 The empirical evidence supports this hypothesis that career concerns motivate securities analysts to stick close to consensus earnings forecasts – and in particular to avoid downward deviations. According to this research, accuracy does not improve analysts' career prospects as much as do predictions that err systematically on the side of optimism.[49] The policy implications of this research are discouraging, because it implies that, even if traditional economic conflicts could be purged, the sell-side analyst still might not behave as the independent gatekeeper that public policy wants. Careerist concerns would still likely bias objectivity.

Reforms for Conflicts

8.44 What reforms seem most likely to work? What reforms are the least intrusive? The answers dovetail. To date, the United States has pursued several distinct strategies at once. The first and most intrusive reforms were structural in character. Both the Global Settlement and new NASD and NYSE rules restricted the ability of investment banking personnel to communicate with, or about, their firm's analysts or to influence analyst compensation. The problem with this strategy is that, even if investment banking personnel are disqualified, others in the firm may (and logically should) share the same incentives and apply the same criteria to the evaluation of the firm's analysts: i.e., did the research division generate a profit for the firm? As a result, the analyst's own incentives and willingness to make objective criticisms do not change materially. Not surprisingly then, the evidence to date is that the ratio of "buy" to "sell" recommendations has not changed much and may have even grown worse.[50]

8.45 A second strategy pursued in the United States in both recent NASD and NYSE rules and the Global Settlement has been disclosure. Broker-dealer firms are required to disclose and explain their recommendation categories and disclose the overall breakdown of their recommendations among those categories: i.e., what percentage are "buys"?; what percentage are "holds"?; what percentage are "sells"? Again, the impact of

[48]The term "herding" was coined in a 1990 article. See David S. Scharfstein & Jeremy Stein, "Herd Behavior and Investment" (1990) 80 Am. Econ. Rev. 465.

[49]See Harrison Hong, et al., "Security Analysts' Career Concerns and the Herding of Earnings Forecasts" (2000) 31 Rand J. Econ. 121, 122-23; see also Ivo Welch, "Herding Among Security Analysts" (2000) 58 J. Fin. Econ. 369; Harrison Hong & Jeffrey Kubik, "Analyzing the Analysts: Career Concerns and Biased Earnings Forecasts" (2003) 58 J. Fin. 313, 345 (optimism more important than accuracy).

[50]See *supra*, notes 17 and 18 and accompanying text.

this reform is not clear, because the proportions of "buy" and "sell" recommendations are roughly similar after the reforms. Even if "sell" recommendations do increase, however, these "low" recommendations seem likely to be given primarily to non-clients.[51] In fairness, however, if broker-dealers do publish research that is tough on non-clients but softer on clients, the total picture that should emerge from the research of many analysts should be relatively more accurate than in the past.

8.46 The practical problem, however, is that the investor may not see the aggregate picture. The investor may consult the research of only one broker-dealer (typically, because it will be solicited by only one broker-dealer). On this premise, the appropriate public policy response should be to create a data bank, accessible to all retail investors, that would show, with respect to every public issuer, the current research reports and recommendations of all analysts following that company. This research could be condensed to a simple pie-chart diagram that would show, for example, with respect to a hypothetical stock that currently five analysts recommended that stock, three had put a "hold" on it, and one had issued a sell recommendation.

8.47 Ideally, an investor using the Internet could move with a single click from this pie chart to each individual recommendation. Such a system faces obstacles (as shown by the fact that it has not yet arisen in the private market). Broker-dealers may consider their research proprietary and not wish to release their research publicly in some cases (particularly in cases where their research was constrained by the fact that the subject firm was an important client). Hence, collectivizing research reports into an easily accessible data bank may require regulatory action, although it would be minimally intrusive regulation.

8.48 One approach to this end might be to require broker-dealers who are members of an exchange to agree to file electronically with the exchange all current research reports that relate to companies listed on that exchange. This parallels the traditional requirement that listed issuers file their annual reports and SEC filings with their principal exchange, where they were made available for public inspection. (Although this requirement would not be mandatory with respect to analysts who were employed by non-broker-dealers, these independent analysts would probably want the visibility that came with inclusion and would comply voluntarily).

8.49 Disclosure reform must go one important step beyond simply assembling a data bank. A powerful tool for rendering analyst research more objective would probably be the publication of the analyst's "scorecard". If the reforms implemented under the Global Settlement have produced few visible changes, public policy needs to raise the potential embarrassment cost to the analyst so that there is a market penalty for treating the employer's clients too softly. Analysts have powerful careerist motives leading them to want a reputation for objectivity and accuracy. Potentially, this motivation could overcome even the subtle pressures that remain within the broker-dealer firm to "support" the firm's clients.

8.50 This motivation needs to be harnessed and activated. If analysts were objectively ranked in terms of the accuracy of their projections for an issuer's future earnings, the result would be to discourage overly

[51]Cases have recently arisen, however, in which securities analysts have given adverse ratings to clients of their investment banking divisions. See J. Fineman, "Pro and Con, all under one roof: J.P. Morgan's analyst criticizes Heinz despite his bank's ties," Int'l Herald Tribune, July 27, 2006 at 14. Encouraging as this is, the fact that it elicited a newspaper article in an international newspaper suggests that this is still a rare occurrence.

aggressive projections (and overly pessimistic ones, as well). Such rankings are feasible with respect to standardized information (such as earnings per share), and indeed The Wall Street Journal already publishes such an analyst ranking on an annual basis.[52] Again, such rankings would have their greatest value if they were made easily accessible to the retail investor. To achieve this, they could be combined with the same exchange-mandated website discussed above. Ideally, the investor could move electronically with one or two clicks from (1) a chart of all analyst recommendations on a stock to (2) each analyst's specific report on that stock, to (3) the rating of each analyst with regard to that stock. A distinct synergy emerges from combining all analyst ratings of an issuer with a ranking of analysts based on their historical accuracy on a single website. However, to achieve this synergy, regulation is probably necessary.[53]

8.51 At worst, such a reform might encourage herding, but it might also motivate the ambitious analyst wishing to make a name for herself or himself to take a highly visible position that made it a potential leader.

Protecting the Analyst: The Problem of Pressure and Retaliation

8.52 The focus of both the Global Settlement and Sarbanes-Oxley was on pressure on the analyst from within the broker-dealer firm. The analyst can also be pressured from the outside, both by the issuer and by buy-side institutional investors. In the United States, the issuer's ability to cut off the analyst from the flow of material information has been constrained by Regulation FD, which requires the issuer to make more or less contemporaneous disclosure of material information when it discloses information selectively to analysts, institutions, or shareholders likely to trade.

8.53 Other forms of pressure and retaliation remain readily available. At the lower end of the pressure scale, the issuer can simply refuse to take questions at an online conference from a disfavoured analyst. More importantly, although it is legally risky, many issuers do continue to hold private meetings with favoured analysts (at which material information may not be selectively disclosed, but at which the issuer's body language can be usefully interpreted by the favoured analyst). Finally, brokerage firms earn the loyalty (and commissions) of institutional investors by providing them with "concierge services" – a term that refers to the brokerage firm sponsoring meetings between buy-side analysts and an issuer's senior management. If the issuer is angry with the broker-dealer's analyst covering it, it will predictably deny the broker-dealer the ability to host such meetings.

8.54 What realistically can be done about pressure and retaliation that does not originate within the broker-dealer firm? Within recent years, the SEC considered the possibility of using stock exchange listing rules to require listing firms to accept as a condition of their listing that they would not retaliate against an analyst who had criticized them (or was otherwise disfavoured). The SEC backed away from this proposal, however, when it drew a cold reaction from the NYSE and Nasdaq. Still, rules that prohibit an issuer from retaliating against an analyst are far less intrusive than structural reforms. The real issue is whether they are feasible. Corporations can threaten to take business away from an underwriter or, more typically, they can simply bar an analyst from a conference. It is debatable how broad a remedy should be provided. Should it reach the

[52] It is an open question whether this ranking should be done on a company-by-company basis or on an industry sector basis (which would generally be in terms of all the stocks that the analyst ranked). It could, of course, be done both ways.

[53] For a discussion regarding analyst ranking, see Choi, *supra* note 4.

former case as well as the latter? Arguably, the better course of valour may be to limit relief to cases involving action taken against the individual analyst. So limited, SRO arbitration panels could order appropriately tailored relief if they found a violation.[54] Such a procedure involves lower costs and can be expeditious.

8.55 One more politic and diplomatic way of approaching this goal of reducing the pressure on analysts would be to draw up a code of ethics or best practices for dealing with securities analysts. The auspices of the Investment Dealers Association ("IDA") might be used to convene a blue ribbon committee of corporate CEOs, investment bankers, and analysts. Such a model code would have greater legitimacy, and compliance with it could again be mandated by stock exchange listing rules.[55]

Ensuring Research for a Healthy Market

8.56 The basic problem has already been stated: securities analysts tend to focus on large capitalization stocks (because that is where they can generate brokerage commissions sufficient to fund their budgets), but Canada is characteristically a small to mid-capitalization issuer market. Stocks so orphaned by the market may wither or slumber (despite real business progress) or they may become targets for manipulation.

8.57 The case for subsidizing securities analysts rests on the following pillars:

1. *Because securities research is a "public good," the private market cannot supply it adequately*. The producer of securities research cannot control its distribution; rather, research tends to disseminate quickly, with many subsequent users receiving it gratuitously. This ability to "free ride" (or the "non-excludability" of subsequent users) is the essential characteristic that defines a "public good". To illustrate, a standard example is public television: many watch, but few contribute a share of its costs proportionate to their use. In general, "public goods" tend to be underprovided by the market because the entrepreneur cannot capture the full value of its services.

2. *Because broker-dealers today have less freedom to control securities research, they cannot earn the same profits from it as in the past and so have reduced their funding for securities research within their firm.* This is the ironic consequence of recent reforms. These reforms may be justified, but their hidden cost is that the investment banking division will not make the same financial commitment to securities research because the firm profits from it less.

3. *Securities research has long focused on those stocks that trade the most heavily, but the Canadian market is characterized by a preponderance of small capitalization stocks.* Heavily traded stocks generate more brokerage commissions for the broker-dealer firm than thinly traded stocks. Hence, these firms allocate their analysts to the more heavily traded stocks.

[54]The ultimate penalty if an SRO arbitration panel's order were ignored or defied would be delisting. To avoid overuse of such a Draconian penalty, it may be desirable to provide some form of internal appellate review within the SRO.

[55]The IDA does not have jurisdiction over corporate issuers and thus could not be the appropriate enforcing body. However, it could handle arbitration hearings with the stock exchange agreeing to take action to enforce their decrees.

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4. *Analyst coverage is critical for a young, small capitalization company that seeks to grow.* Investors, particularly, retail investors, cannot absorb or evaluate all the information that an issuer provides. They need a professional intermediary to digest and evaluate information that is often too complex for them to analyze. In this sense, the securities analyst is an essential gatekeeper.

5. *The task of the analyst is marginally more difficult and expensive in Canada than in the U.S.* Because the SEC has more detailed requirements for secondary market disclosure (and has recently expanded the occasions on which its Form 8-K must be filed, shortening the period within which it must be filed to four business days), the analyst has a somewhat richer database in the form of SEC filings with which to work. Canada instead has a broad continuous disclosure obligation that is less specific.[56] In Canada, more information may have to be acquired by the analyst through personal interviews, and this is costly.

6. *Securities research creates value for shareholders.* Despite all the recent (and often deserved) criticisms of securities analysts, the empirical evidence continues to show that investors are better off building their portfolio based on securities analyst recommendations than simply by following a policy of indexing or random selection. Thus, subsidizing analysts benefits both companies and investors.

8.58 For all these reasons, the Canadian economy (and Canadian investors) will likely suffer if securities research "dries up" and the lower tiers of the Canadian securities market receive less coverage. In the language of law and economics, diminished analyst coverage amounts to a "negative externality."

8.59 Assuming that, based on the foregoing, the case for subsidization is strong, how should a subsidy be provided? Who should bear its costs? Simply paying broker-dealers to hire analysts or paying independent analysts to write research reports would be pointless. Broker-dealers would continue to focus on large capitalization stocks, ignoring the smaller ones. Also, there is little basis for believing that the market is more efficient or investors are better served when ten analysts cover an issuer instead of only 9 analysts. The focus must be instead on extending coverage to reach the "small cap" issuer. Probably, the simplest mechanism for subsidizing a minimal level of analyst coverage with regard to these smaller issuers would utilize the stock exchanges as the centrally positioned bodies that could distribute the subsidy and tax their costs to the industry equitably.

8.60 Canadian exchanges could agree that no company should trade without at least one analyst regularly covering it. Of course, this standard would result in delistings – unless the exchange filled the gap, by itself, hiring the analyst to cover those companies that would otherwise go uncovered (and then passed on the costs to its members and listed companies). The exact allocation of these costs between listed companies and broker-dealers need not be resolved here, but the companies receiving the research coverage should not bear the entire cost.[57]

[56]See National Instrument 51-102 – *Continuous Disclosure Obligations*. This is not a criticism of this Instrument, but simply a prediction that more general instructions produce less total disclosure.

[57]There is clearly a variety of ways in which the cost of a roster of analysts could be financed, for example: (1) through a levy against all issuers requiring the service; (2) through a levy against all issuers as a contribution to the capital market from which all benefit (spread across the entire denominator of listed companies the cost to each individual company would likely be negligible); or (3) through a fund provided from surplus fine money collected by regulators and SROs.

8.61 Multiple justifications support this approach of mandating that exchanges hire an analyst for "uncovered" companies. These include:

1. As the body selecting the analysts, the exchange would be relatively objective and independent. Certainly, it is more objective than the issuer or its investment banker. Alternative proposals, such as distributing vouchers to shareholders who would then purchase research with them, suffer from the deficiency that most shareholders cannot distinguish good from bad research, or new from stale research.[58]

2. The exchange could hire in volume and thus could negotiate the lowest possible rates. Suppose an exchange discovered that it had 100 companies that were "uncovered" and these were in 20 distinct industries. In all likelihood, it would need the services of 20 different analysts. It could hire and negotiate the terms of these contracts as a virtual monopolist; that is, it would have more leverage than any single firm or broker-dealer. Moreover, there are economies of scale associated with such mass hiring, as each analyst would likely be hired to cover multiple companies.

3. The exchange could employ an objective standard (accuracy of prior predictions) to determine which analysts to hire. The goal here is to create a competition for relative accuracy. Issuers and investment banking firms have a variety of conflicts of interest and would not necessarily hire on this criterion. Thus, this proposal dovetails with the earlier proposal that the exchange rank and publish ratings for analysts based on the accuracy of their prior earnings projections.

4. The exchange could pass on its costs to the entire industry, thus spreading the tax equitably in a way that other private actors could not do. As earlier noted, public goods are usually supported by tax dollars or private contributions. Just as the Government supports parks with tax dollars because it cannot easily exclude "free riders" from them, so too the exchange can spread the costs of subsidizing analysts across all issuers and broker-dealers. The exact allocation of this tax need not be addressed here. Possibly, the "uncovered" company would pay a higher listing fee; possibly, all companies would contribute to some extent by paying marginally higher listing fees. Arguably, this tax should fall more on broker-dealers than listed companies so that it does not deter new listings. Broker-dealers could be taxed through the assessments they normally pay the exchange to support it, which assessments are usually based on trading volume (and this proposal is intended to increase trading volume).

5. Enhanced research coverage should encourage increased trading and industry profit. As noted earlier, securities research benefits investors,[59] but the private market is unable to provide it without some form of collective action. If investors benefit from research, they will predictably trade more. Thus, simply on this self-interested basis, research justifies a subsidy, and the tax should be placed, at least in part, on the securities industry, rather than all citizens through public expenditures.

[58]For this proposal, see Choi and Fisch, *supra* note 45.
[59]See *supra* note 33 and accompanying text.

8.62 At bottom, this proposal is based on the premise that exchanges should do more than simply provide a venue for trading. Historically, they long have. Beginning over a century ago, the NYSE encouraged investors to trade on it by requiring listed companies to publish their financial statements in order to generate greater transparency. Exchanges have also been significant SRO enforcers, thus providing another non-trading service to benefit investors.

8.63 This proposal posits that exchanges should extend their pursuit of transparency by guaranteeing some degree of analyst oversight for all listed companies. Such oversight creates value for shareholders and ultimately may pay for itself by generating a higher trading volume on the exchange.

8.64 Nor is this proposal without precedent. The Singapore Stock Exchange has aggressively pursued foreign listings, particularly at the small and mid-cap level.[60] Part of its strategy has been to support analyst coverage of these smaller companies. In this light, research analyst subsidies might give Canadian exchanges a competitive advantage over AIM, which makes no similar effort. Nor is it likely that AIM could compete on this basis, because London-based analysts could not easily follow Canadian stocks. Providing a guarantee of analyst coverage then benefits investors, smaller issuers and the exchanges themselves. That could be a sufficiently powerful coalition to overcome even the usually dominant force of inertia.

[60] See Elliot Wilson, "Scandal Cools Taste for China Plays," The Standard, March 7, 2005 (describing business strategy of the Singapore Stock Exchange).