Investor Publications

U.S. Securities and Exchange Comission

Analyzing Analyst Recommendations

November 2020

Understanding, Anticipating and Managing Business Risk

Gary Gensler

Chair of the U.S. Securities and Exchange Commission

Natural, economic, social, financial and technological. The risks facing businesses have always been plentiful, but today they are more complex and more interconnected than ever before. This is fostering rapid and significant change across the global marketplace—change that brings new opportunities for growth and success, as well as unexpected and sometimes unwelcome challenges. For the past century, Zurich has helped companies across the United States, and around the world, better understand and manage change and the risk it presents. Whether it's large or small, global or local, we know your business. This is why we take the time to learn what makes your company unique; what it needs to foster growth, to enter new markets, to explore new processes and technologies, and to recover from business interruptions. With our insight, we are able to deliver insurance solutions that help our customers manage risk. By openly sharing our insights and learnings, we are also able to help the broader business community better understand the risks it faces in today's complex world. On this note, I am proud to introduce "The Sharp Side of Risk: Understanding, Anticipating and Managing Business Risk," a research report focused on how key business sectors are planning to grow in a world of interconnected risks and economic uncertainty. This collaboration with Forbes is just one example of how we continually seek to learn from the industries we serve. We hope you find it both informative and enjoyable.

The mission of the SEC is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. The SEC strives to promote a market environment that is worthy of the public's trust.

https://www.sec.gov/

Contents

Executive Summary

Research analysts study publicly traded companies and make recommendations on the securities of those companies. Most specialize in a particular industry or sector of the economy. They exert considerable influence in today's marketplace. Analysts' recommendations or reports can influence the price of a company's stock—especially when the recommendations are widely disseminated through television appearances or through other electronic and print media. The mere mention of a company by a popular analyst can temporarily cause its stock to rise or fall—even when nothing about the company's prospects or fundamentals has recently changed.

Analysts often use a variety of terms—buy, strong buy, near-term or long-term accumulate, near-term or long-term over-perform or under-perform, neutral, hold—to describe their recommendations. But the meanings of these terms can differ from firm to firm. Rather than make assumptions, investors should carefully read the definitions of all ratings used in each research report. They should also consider the firm's disclosures regarding what percentage of all ratings fall into either "buy," "hold/neutral," and "sell" categories.

All investments involve some degree of risk. In finance, risk refers to the degree of uncertainty and/or potential financial loss inherent in an investment decision. In general, as investment risks rise, investors seek higher returns to compensate themselves for taking such risks.

Every saving and investment product has different risks and returns. Differences include: how readily investors can get their money when they need it, how fast their money will grow, and how safe their money will be. In this section, we are going to talk about a number of risks investors face. *They include:*

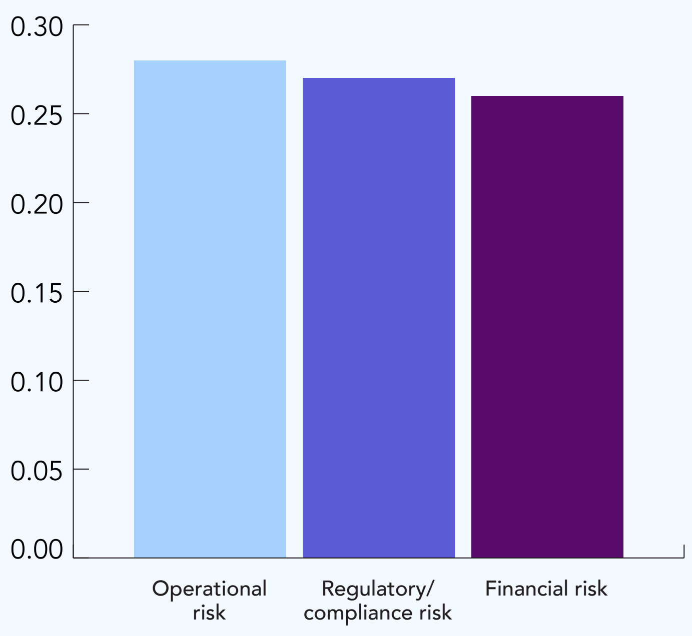


Figure 1.
Has your company ever suffered financial damages due to unforeseen risks in any of the following areas?
(Percentage of survey respondents answering "yes")

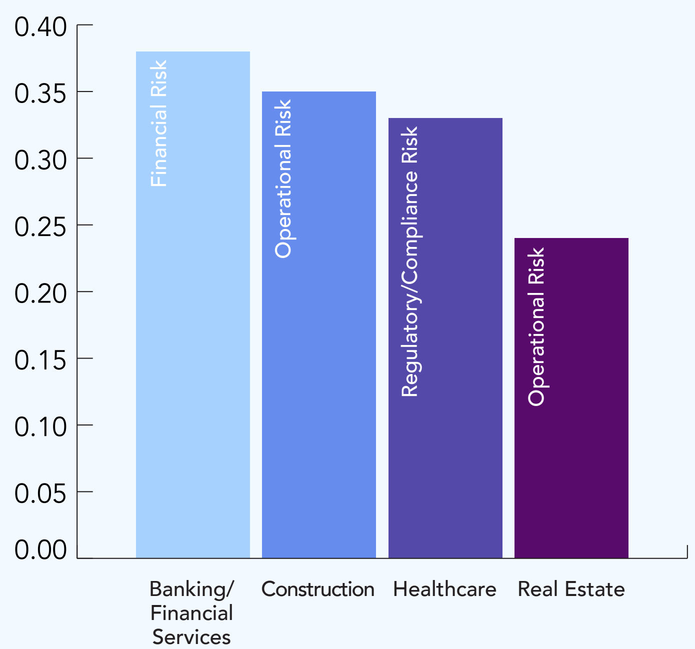


Figure 1a.
Top areas of risk by industry

As a general matter, investors should not rely solely on an analyst's recommendation when deciding whether to buy, hold, or sell a stock. Instead, they should also do their own research—such as reading the prospectus for new companies or for public companies, the quarterly and annual reports filed with the SEC—to confirm whether a particular investment is appropriate for them in light of their individual financial circumstances. This alert discusses the potential conflicts of interest analysts face, describes the New York Stock Exchange (NYSE) and FINRA rules concerning analyst recommendations, and provides tips for researching investments.

Who Analysts Are and Who They Work For

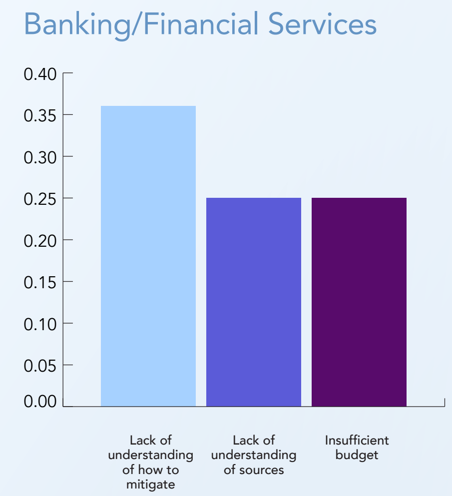
Analysts historically have served an important role, promoting the efficiency of our markets by ferreting out facts and offering valuable insights on companies and industry trends. Analysts generally fall into one of three categories:

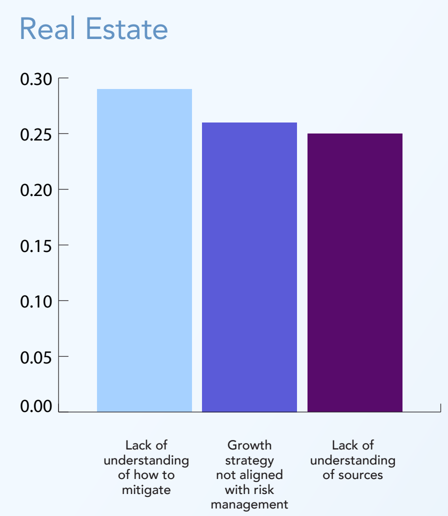
Sell-side analysts typically work for full-service broker-dealers and make recommendations on the securities they cover. Many of the more popular sell-side analysts work for prominent brokerage firms that also provide investment banking services for corporate clients—including companies whose securities the analysts cover.

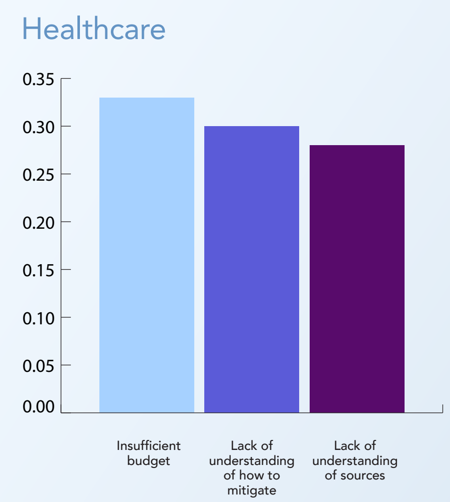
Buy-side analysts typically work for institutional money managers—such as mutual funds, hedge funds, or investment advisers—that purchase securities for their own accounts. They counsel their employers on which securities to buy, hold, or sell and stand to make money when they make good calls.

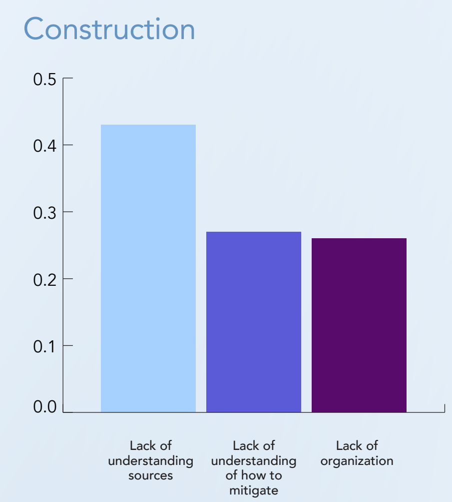
Independent analysts typically aren't associated with firms that underwrite the securities they cover. They often sell their research reports on a subscription or other basis. Some firms that have discontinued their investment banking operations now market themselves as more independent than multi-service firms, emphasizing their lack of conflicts of interest.

Figure 2.
Top three barriers to effective risk management, by industry









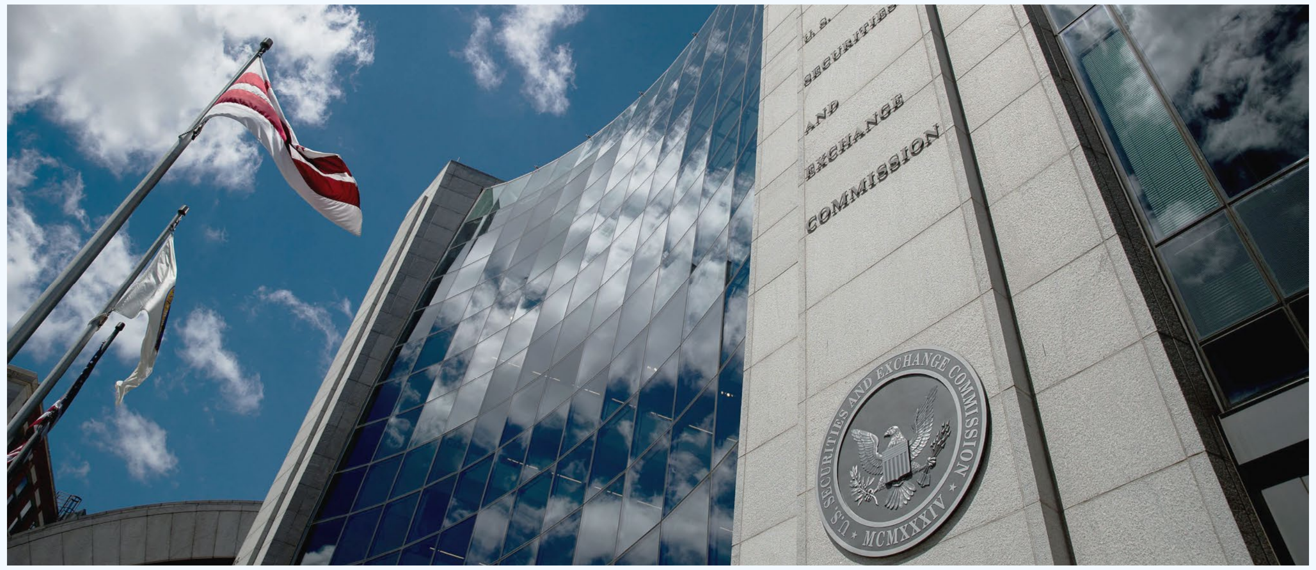
The rules of the NYSE and FINRA require analysts in some circumstances to disclose certain conflicts of interest when recommending the purchase or sale of a specific security. On May 10, 2002, the SEC approved proposed changes to these rules, strengthening the disclosures that analysts and firms must make. The NYSE and FINRA decided upon an implementation schedule of between 60 and 180 calendar days for the new rules in order to provide reasonable time periods for firms to develop and implement policies, procedures and systems to comply with the new requirements. These rules implement key structural reforms aimed at increasing analysts' independence and further managing conflicts of interest. They also require increased disclosure of conflicts in research reports and public appearances. Key provisions of the rules include the following:

• No Promises of Favorable Research — NYSE and FINRA rules now prohibit analysts from offering a favorable research rating or specific price target to induce investment banking business from companies. The rule changes also impose "quiet periods" that bar a firm that is acting as manager or co-manager of a securities offering from issuing a report on a company within 40 days after an initial public offering or within 10 days after a secondary offering for an inactively traded company. *Significance of the Change: Promising research coverage to a company will not be as attractive if the research may not be issued within the initial days following the offering.*

• Limitations on Relationships and Communications — The rule changes prohibit research analysts from being supervised by the investment banking department. In addition, investment banking personnel are prohibited from discussing research reports with analysts prior to distribution, unless staff from the firm's legal/compliance department monitor those communications. Analysts are also prohibited from sharing draft research reports with the target companies, other than to check facts after approval from the firm's legal/compliance department. *Significance of the Change: These provisions help protect research analysts from influences that could impair their objectivity and independence.*

• Analyst Compensation — The rule changes bar securities firms from tying an analyst's compensation to specific investment banking transactions. Furthermore, if an analyst's compensation is based on the firm's general investment banking revenues, that fact must be disclosed in the firm's research reports. *Significance of the Change: Prohibiting compensation from specific investment banking transactions significantly curtails a potentially major influence on research analysts' objectivity.*

• Firm Compensation — The rule changes require a securities firm to disclose in a research report if it managed or co-managed a public offering of equity securities for the company or if it received any compensation for investment banking services from the company in the past 12 months. A firm also must disclose if it expects to receive or intends to seek compensation for investment banking services from the company during the next 3 months. *Significance of the Change: Requiring securities firms to disclose compensation from investment banking clients can alert investors to potential biases in their recommendations.*



In addition to paying close attention to the disclosures that firms and analysts make, here are some steps you can take to assess whether and to what extent analyst conflicts may exist:

We advise all investors to do their homework before investing. If you purchase a security solely because an analyst said the company was one of his or her "top picks," you may be doing yourself a disservice. Especially if the company is one you've never heard of, take time to investigate

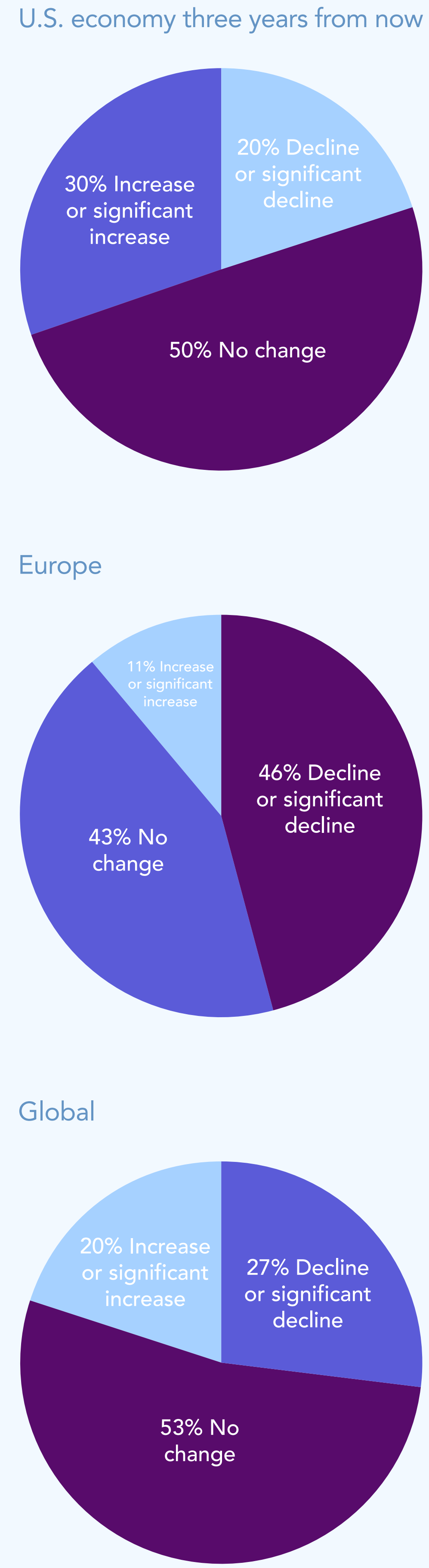


Figure 3.
Growth predictions

The fact that an analyst—or the analyst's firm—may have a conflict of interest does not mean that his or her recommendation is flawed or unwise. But it's a fact you should know and consider in assessing whether the recommendation is wise *for you.*

It's up to you to educate yourself to make sure that any investments you choose match your goals and tolerance for risk. Remember that analysts generally do not function as your financial adviser when they make recommendations—they're not providing individually tailored investment advice, and they're not taking your personal circumstances into consideration.

November 2020

Investor Publications

U.S. SECURITIES AND EXCHANGE COMMISSION