Andreas Krause



Chapter 10 Regulation of financial analysts

Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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## Outline

Problem and model assumptions

Unregulated analysts

Chinese Walls

Disclosure of wages



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#### Problem and model assumptions

Unregulated analysts

Chinese Walls

Disclosure of wages



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Types of financial	analysts			

Buy-side financial analysts provide reports on companies aimed at investors

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- Buy-side financial analysts provide reports on companies aimed at investors
- Sell-side financial analysts work for companies on mergers and acquisitions and security offerings

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- Buy-side financial analysts provide reports on companies aimed at investors
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- Traditionally financial switched between these roles

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Regulatory aims				

Financial analysts are forecasting the future value of securities

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Regulatory aims				

Financial analysts are forecasting the future value of securities, using information (signals) they receive

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Regulatory aims				

- Financial analysts are forecasting the future value of securities, using information (signals) they receive
- ▶ The more precise their signal, the better the forecast

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- Financial analysts are forecasting the future value of securities, using information (signals) they receive
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- ▶ The aim would be to maximize the quality of such forecasts

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- Financial analysts are forecasting the future value of securities, using information (signals) they receive
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- Financial analysts are forecasting the future value of securities, using information (signals) they receive
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- Regulatory interventions affect the remuneration of financial analysts

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# Signals

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Signals				

The true value of a stock is either high  $P_H$  with probability  $\pi$  or low  $P_L < P_H$  otherwise

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- ▶ The true value of a stock is either high  $P_H$  with probability  $\pi$  or low  $P_L < P_H$  otherwise
- Analysts obtain a signal  $s_i$  on this value

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- ▶ The signal is correct with probability  $Prob_i(H|P_H) = Prob_i(L|P_L) = \rho_i \ge \frac{1}{2}$

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- We have strong analysts and weak analysts with  $\rho_S > \rho_W$

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- An analyst is strong with probability  $\gamma$

Signals

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Forecast error				

Financial analysts make a prediction  $\hat{P}$  based on their signal

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Forecast error				

Financial analysts make a prediction  $\hat{P}$  based on their signal and the forecast error is  $E\left[\left(\hat{P}-P_{j}\right)^{2}\right]$ 

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- ▶ If the prediction is wrong we have  $(\hat{P} P_j)^2 = (P_H P_L)^2$

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- Forecast error of an analyst is  $(1 \rho_i) (P_H P_L)^2$

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• Combining this for the strong and weak analyst we get  $E\left[\left(\hat{P}-P_{j}\right)^{2}\right] = \left(\gamma(1-\rho_{S})+(1-\gamma)\left(1-\rho_{W}\right)\right)\left(P_{H}-P_{L}\right)^{2}$ 

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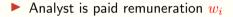
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Analyst profits				

• Analyst is paid remuneration  $w_i$ , depending in its type

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Analyst profits				

- Analyst is paid remuneration  $w_i$ , depending in its type
- Obtaining strong signals costs c<sub>I</sub>

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Analyst profits				

- $\blacktriangleright$  Analyst is paid remuneration  $w_i$ , depending in its type
  - Obtaining strong signals costs c<sub>I</sub>
  - Costs of forecast errors from loss of reputation are c<sub>P</sub>

Problem and assumptions	No regulation 000	Chinese Walls	Disclosure 0000	Summary 0000

- Analyst is paid remuneration  $w_i$ , depending in its type
- Obtaining strong signals costs c<sub>I</sub>
- Costs of forecast errors from loss of reputation are c<sub>P</sub>

• Profits: 
$$\Pi_A = \gamma w_S + (1 - \gamma) w_W - \frac{1}{2} c_I \gamma^2 - c_P E \left[ \left( \hat{P} - P_j \right)^2 \right]$$

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► We assume financial analysts are competitive

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Investment bank j	orofits			

Investment banks obtain additional investment bank business V from the covered company

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Investment bank	profits			

Investment banks obtain additional investment bank business V from the covered company if they forecast a high value P<sub>H</sub>

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- Investment banks obtain additional investment bank business V from the covered company if they forecast a high value P<sub>H</sub>
- The high value is predicted if the value is high and the signal is correct or the value is low and the signal wrong, for each type of analyst

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- Investment banks obtain additional investment bank business V from the covered company if they forecast a high value P<sub>H</sub>
- The high value is predicted if the value is high and the signal is correct or the value is low and the signal wrong, for each type of analyst

► 
$$Prob(V_H) = \gamma (\rho_S \pi + (1 - \rho_S) (1 - \pi)) + (1 - \gamma) (\rho_W \pi + (1 - \rho_W) (1 - \pi))$$

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+  $(1 - \gamma) (\rho_W \pi + (1 - \rho_W) (1 - \pi))$ 

Investment bank get this additional revenue if the forecast is high

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Investment bank get this additional revenue if the forecast is high and pay the salaries of the analyst

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Investment bank get this additional revenue if the forecast is high and pay the salaries of the analyst

$$\Pi_B = Prob \left( P_H \right) V - \left( \gamma w_S + (1 - \gamma) w_W \right)$$

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$$\square \Pi_B = Prob(P_H)V - (\gamma w_S + (1 - \gamma) w_W)$$

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Analysts optimize over the likelihood of obtaining a precise signal



• Analysts optimize over the likelihood of obtaining a precise signal, solving  $\frac{\partial \Pi_A}{\partial \gamma} = 0$ 

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Analysts optimize over the likelihood of obtaining a precise signal, solving ∂Π<sub>A</sub>/∂γ = 0
 This gives γ = w<sub>S</sub>-w<sub>W</sub>/c<sub>I</sub> + c<sub>P</sub>/c<sub>I</sub> (ρ<sub>S</sub> - ρ<sub>W</sub>) (P<sub>H</sub> - P<sub>L</sub>)<sup>2</sup>

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- linvestment banks maximize their profits by setting wages  $w_i$  optimally

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• Analysts optimize over the likelihood of obtaining a precise signal, solving  $\frac{\partial \Pi_A}{\partial \gamma} = 0$ 

• This gives  $\gamma = \frac{w_S - w_W}{c_I} + \frac{c_P}{c_I} \left(\rho_S - \rho_W\right) \left(P_H - P_L\right)^2$ 

▶ Investment banks maximize their profits by setting wages  $w_i$  optimally, solving  $\frac{\partial \Pi_B}{\partial w_i} = 0$  with  $\Pi_A = 0$ 

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• Analysts optimize over the likelihood of obtaining a precise signal, solving  $\frac{\partial \Pi_A}{\partial \gamma} = 0$ 

• This gives 
$$\gamma = \frac{w_S - w_W}{c_I} + \frac{c_P}{c_I} \left( \rho_S - \rho_W \right) \left( P_H - P_L \right)^2$$

- lnvestment banks maximize their profits by setting wages  $w_i$  optimally, solving  $\frac{\partial \Pi_B}{\partial w_i} = 0$  with  $\Pi_A = 0$
- This gives  $\gamma = \frac{2\pi 1}{c_I} \left( \rho_S \rho_W \right) V + \frac{c_P}{c_I} \left( \rho_S \rho_W \right) \left( P_H P_L \right)^2$

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- Setting these equal, we get  $w_S w_W = (2\pi 1) (\rho_S \rho_W) V$

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Analysts optimize over the likelihood of obtaining a precise signal, solving  $\frac{\partial \Pi_A}{\partial \gamma} = 0$ 

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$$\gamma = \frac{w_S - w_W}{c_I} + \frac{c_P}{c_I} \left( \rho_S - \rho_W \right) \left( P_H - P_L \right)^2$$

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- ► This gives  $\gamma = \frac{2\pi 1}{c_I} \left(\rho_S \rho_W\right) V + \frac{c_P}{c_I} \left(\rho_S \rho_W\right) \left(P_H P_L\right)^2$
- ▶ Setting these equal, we get  $w_S w_W = (2\pi 1) (\rho_S \rho_W) V$

• And then 
$$\gamma^* = \frac{\rho_S - \rho_W}{c_I} \left( (2\pi - 1) V + c_P \left( P_H - P_L \right)^2 \right)$$

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Analysts optimize over the likelihood of obtaining a precise signal, solving  $\frac{\partial \Pi_A}{\partial \gamma} = 0$ 

• This gives 
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• More uncertainty  $P_H - P_L$  and loss to reputation  $c_P$  increases the strong analysts

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- More uncertainty  $P_H P_L$  and loss to reputation  $c_P$  increases the strong analysts
- Larger difference in ability  $\rho_S \rho_W$  increases the strong analysts

Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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- More uncertainty  $P_H P_L$  and loss to reputation  $c_P$  increases the strong analysts
- Larger difference in ability  $\rho_S \rho_W$  increases the strong analysts
- ► Larger additional business V increases the strong analysts

Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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- ▶ Higher costs of becoming strong, reduces the strong analysts

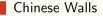
Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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Problem and model assumptions

Unregulated analysts



Disclosure of wages



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Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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### Remuneration

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Problem and assumptions	No regulation	Chinese Walls ○●○	Disclosure 0000	Summary 0000
Remuneration				

Chinese walls refers to a situation where analysts cannot be rewarded for bringing in additional business

Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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Remuneration				

Chinese walls refers to a situation where analysts cannot be rewarded for bringing in additional business, but only for the quality of their forecasts

Problem and assumptions	No regulation	Chinese Walls ○●○	Disclosure 0000	Summary 0000
Remuneration				

- Chinese walls refers to a situation where analysts cannot be rewarded for bringing in additional business, but only for the quality of their forecasts
- Suppose the remuneration is a base wage

Problem and assumptions	No regulation	Chinese Walls ○●○	Disclosure 0000	Summary 0000
Remuneration				

- Chinese walls refers to a situation where analysts cannot be rewarded for bringing in additional business, but only for the quality of their forecasts
- Suppose the remuneration is a base wage, adjusted by the forecast error

Problem and assumptions	No regulation	Chinese Walls ○●○	Disclosure 0000	Summary 0000
Remuneration				

- Chinese walls refers to a situation where analysts cannot be rewarded for bringing in additional business, but only for the quality of their forecasts
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$$\blacktriangleright w_i = \frac{w_0}{E_i \left[ \left( \hat{P} - P_j \right)^2 \right]}$$

Slide 14 of 22

Problem and assumptions	No regulation	Chinese Walls ○●○	Disclosure 0000	Summary 0000
Remuneration				

- Chinese walls refers to a situation where analysts cannot be rewarded for bringing in additional business, but only for the quality of their forecasts
- Suppose the remuneration is a base wage, adjusted by the forecast error

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$$w_i = \frac{w_0}{E_i \left[ \left( \hat{P} - P_j \right)^2 \right]} = \frac{w_0}{(1 - \rho_i)(P_H - P_L)^2}$$

Problem and assumptions	No regulation	Chinese Walls ○●○	Disclosure 0000	Summary 0000
Pomunoration				

- Chinese walls refers to a situation where analysts cannot be rewarded for bringing in additional business, but only for the quality of their forecasts
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$$w_i = \frac{w_0}{E_i [(\hat{P} - P_j)^2]} = \frac{w_0}{(1 - \rho_i)(P_H - P_L)^2}$$
  
• This gives  $w_S - w_W = \frac{w_0}{(P_H - P_L)^2} \left(\frac{1}{1 - \rho_S} - \frac{1}{1 - \rho_W}\right)$ 

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Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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$$Set w_0 = (2\pi - 1) \left( 1 - \rho_S \right) \left( 1 - \rho_W \right) V \left( P_H - P_L \right)$$$$

Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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Remuneration				

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• Set  $w_0 = (2\pi - 1) (1 - \rho_S) (1 - \rho_W) V (P_H - P_L)$ , then  $w_S - w_W = (2\pi - 1) (\rho_S - \rho_W) V$ 

Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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• This gives  $\gamma^{**} = \gamma^*$ 

Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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Remuneration				

- Chinese walls refers to a situation where analysts cannot be rewarded for bringing in additional business, but only for the quality of their forecasts
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Problem and assumptions	No regulation	Chinese Walls ○○●	Disclosure 0000	Summary 0000

### Ineffective Chinese Walls

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Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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Ineffective Chinese	Walls			

With Chinese Walls the quality of analysts does not improve

Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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Ineffective Chines	e Walls			

- ▶ With Chinese Walls the quality of analysts does not improve
- ▶ Investment banks recover their optimal solution by setting base wages accordingly

Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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## Ineffective Chinese Walls

- ▶ With Chinese Walls the quality of analysts does not improve
- Investment banks recover their optimal solution by setting base wages accordingly
- ► The remuneration differences are the same as before

Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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Ineffective Chines	e Walls			

- With Chinese Walls the quality of analysts does not improve
- Investment banks recover their optimal solution by setting base wages accordingly
- The remuneration differences are the same as before and hence the incentives to analysts are identical

Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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Ineffective Chines	e Walls			

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Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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Problem and model assumptions

Unregulated analysts

Chinese Walls

Disclosure of wages



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Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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#### Fraction of strong analysts

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Problem and assumptions	No regulation	Chinese Walls 000	Disclosure ○●○○	Summary 0000
Fraction of strong	analysts			

▶ We assume that investment banks and analysts know if the analyst is strong

Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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Fraction of strong	analysts			

We assume that investment banks and analysts know if the analyst is strong
 We also assume that the additional business is only attracted if the high forecast is made by a strong analyst

Problem and assumptions	No regulation	Chinese Walls 000	Disclosure 0●00	Summary 0000
Fraction of strong	analysts			

- ▶ We assume that investment banks and analysts know if the analyst is strong
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- As weak analysts do not add value, we set  $w_W = 0$

Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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- Analyst profits:  $\Pi_A = \gamma w_S \frac{1}{2}c_I\gamma^2 c_P E\left[\left(\hat{P} P_j\right)^2\right]$

Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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- This is maximized at  $\gamma = \frac{w_S}{c_I} + \frac{c_P}{c_I} \left(\rho_S \rho_W\right) \left(P_H P_L\right)^2$

Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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Problem and assumptions	No regulation	Chinese Walls 000	Disclosure 00●0	Summary 0000

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Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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Optimal wages				



Investment bank only gets additional revenue if the analyst is strong

Problem and assumptions	No regulation	Chinese Walls	Disclosure 00●0	Summary 0000
Optimal wages				

Investment bank only gets additional revenue if the analyst is strong and predicts the high value

Problem and assumptions	No regulation	Chinese Walls	Disclosure 00●0	Summary 0000
Optimal wages				

Investment bank only gets additional revenue if the analyst is strong and predicts the high value and wage is only paid to the strong analyst

Problem and assumptions	No regulation	Chinese Walls	Disclosure 00●0	Summary 0000

- Investment bank only gets additional revenue if the analyst is strong and predicts the high value and wage is only paid to the strong analyst
- $\Pi_B = \gamma \left( \left( \rho_S \left( 2\pi 1 \right) + (1 \pi) \right) V w_S \right)$

Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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Investment bank only gets additional revenue if the analyst is strong and predicts the high value and wage is only paid to the strong analyst

• 
$$\Pi_B = \gamma \left( \left( \rho_S \left( 2\pi - 1 \right) + (1 - \pi) \right) V - w_S \right)$$

• The optimal wage gives us  $\gamma^{***} = \frac{\rho_S(2\pi-1)+(1-\pi)}{c_I}V + \frac{c_P}{c_I}(\rho_S - \rho_W)(P_H - P_L)^2$ 

Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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- We easily see that  $\gamma^{***} > \gamma^{**}$

Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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Problem and assumptions	No regulation	Chinese Walls	Disclosure 000●	Summary 0000

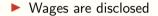
# Increasing analyst quality

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# Increasing analyst quality



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Problem and assumptions	No regulation	Chinese Walls	Disclosure 000●	Summary 0000

#### ► Wages are disclosed

 $\Rightarrow$  Companies can identify the type of analyst

Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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- Wages are disclosed
- $\Rightarrow$  Companies can identify the type of analyst
- $\Rightarrow$  Route additional business only to strong analysts

Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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- Wages are disclosed
- $\Rightarrow$  Companies can identify the type of analyst
- $\Rightarrow$  Route additional business only to strong analysts
- $\Rightarrow$  Erasing the value of weak analysts to the investment bank

Problem and assumptions	No regulation	Chinese Walls 000	Disclosure 000●	Summary 0000

- Wages are disclosed
- $\Rightarrow$  Companies can identify the type of analyst
- $\Rightarrow$  Route additional business only to strong analysts
- $\Rightarrow$  Erasing the value of weak analysts to the investment bank
- $\Rightarrow$  Allowing it to set their wages to zero

Problem and assumptions	No regulation	Chinese Walls 000	Disclosure 000●	Summary 0000

- Wages are disclosed
- $\Rightarrow$  Companies can identify the type of analyst
- $\Rightarrow$  Route additional business only to strong analysts
- $\Rightarrow$  Erasing the value of weak analysts to the investment bank
- $\Rightarrow$  Allowing it to set their wages to zero
- $\Rightarrow$  Increasing the wage differential between weak and strong analysts

Problem and assumptions	No regulation	Chinese Walls 000	Disclosure 000●	Summary 0000

- Wages are disclosed
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- $\Rightarrow$  Erasing the value of weak analysts to the investment bank
- $\Rightarrow$  Allowing it to set their wages to zero
- $\Rightarrow$  Increasing the wage differential between weak and strong analysts
- $\Rightarrow$  Increases the incentives to become strong

Problem and assumptions	No regulation	Chinese Walls 000	Disclosure 000●	Summary 0000

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- $\Rightarrow$  Increases the incentives to become strong

Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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Problem and model assumptions

Unregulated analysts

Chinese Walls

Disclosure of wages



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Chapter 10: Regulation of financial analysts Theoretical Foundations of Investment Banking

Financial analysts can help to gain additional investment banking business by providing positive assessments of companies

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- Regulation seeks to improve the quality of these assessments by focussing remuneration only on these assessments

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Problem and assumptions	No regulation	Chinese Walls	Disclosure 0000	Summary 00●0

Measures to increase the quality of analyst coverage have focussed on the separation of analysts from other business lines

Problem and assumptions	No regulation	Chinese Walls	Disclosure	Summary
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- Measures to increase the quality of analyst coverage have focussed on the separation of analysts from other business lines
- These results suggest they are not effective as investment banks can adjust their remuneration schedules

Problem and assumptions	No regulation	Chinese Walls 000	Disclosure 0000	Summary 00●0

- Measures to increase the quality of analyst coverage have focussed on the separation of analysts from other business lines
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Problem and assumptions	No regulation	Chinese Walls 000	Disclosure 0000	Summary 00●0

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