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INDEPENDENT FINANCIAL RESEARCH: CHANGING THE WAY INVESTORS VIEW RESEARCH?

What if you gave a party and no one showed up? This is not a trick question; the "party" could well take the form of the global settlement reached by ten blue chip names—the major Wall Street investment firms—and New York Attorney General Eliot Spitzer, requiring that "independent" financial research be made available to retail customers for five years. What if few or no investors follow the guidance of the outside research, request such research, or even care that it is available? (The work of the independent analysts, in addition to the firms' in-house research products, must be made available to retail customers.)

What if the party took the form of the emergence of a truly independent financial research industry—now estimated at 300 firms and growing—and there were no money to fill the independents' punch bowl (that is, if customers continued to demand or expect "free research" from their brokers or investment bankers and declined to pay for research)? These are real concerns for a number of the new independents, most of whom still rely on "soft dollars," or direct fees paid for their research and analysis by institutions.

The terms of the Wall Street-Spitzer global settlement reached in 2003 require the outside, independent research for retail customers to be free of ties to compensation for investment banking or consulting. The ten investment firms must also make this "free" research available to their customers.

As the sideways stock market of the past few years continues to bump up and down, sliding this way and that, the public debate continues to be about the "lack of investor trust" in the market, investor "faith" in financial research, and the need for "safety" in determining one's investments. Billions of investor dollars are believed to remain on the sidelines in cash or debt instruments (or under the mattress) awaiting word that it is safe to go to Wall Street's equity party . . . again. So the stakes are high for Wall Street companies as they experiment with the future of research (assuming customers want the same).

The implications of "independent research" are also important for corporate managers and boards of directors. As the settlement ink was drying, large investment firms were curtailing and eliminating coverage of hundreds of public companies and laying off analysts. Today, one estimate projects that up to 60 percent of corporate issuers have no research coverage, and the gap between coverage and no coverage is widening.

Here is an overview of independent research issues currently in debate.

The research and investment banking settlement

For several months after Attorney General Spitzer and the investment firms' CEOs agreed to their global settlement of all charges regarding past problems with analyst behavior, the small independent financial analyst community anxiously awaited the details of the injunctive relief: what would happen to the $1.4 billion? Even as the settlement terms were announced, an important question emerged and continued to hang in the air: should investors—individual or institutional—expect the financial analyses, opinions, and recommendations provided to them as inducements to do business with an

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investment firm to be objective, unbiased, reliable as input for making investment decisions, and unrelated to the firm's investment banking or brokerage operations? The assumed answer is yes; the challenge is how to provide such services to retail customers under the settlement.

A second set of questions quickly emerged and is only now being answered: Who pays? Is there a place today for independent research that is not related to the relationship of brokerage to investment banking business? If research is no longer "free," how will analysts be compensated? The settlement created a pool of almost $500 million for five years' worth of independent research.

This arrangement is important for all players in the capital markets: brokers, bankers, analysts, regulators, exchanges, and investors. If analysis and recommendations cannot be trusted as a basis for making decisions, then trust could continue to be eroded in the idea of the market as a "safe" place for all types of investments. Hence the markets may not attract investment dollars, depriving corporations of much-needed capital and Wall Street firms of revenues.

The most important force for reform has not necessarily been Sarbanes-Oxley, Securities and Exchange Commission (SEC) implementing rules, or NASD or other regulatory initiatives. The pressure was—and is being—applied by the crusading Mr. Spitzer. He won a $1.4 billion settlement from New York's investment firms, with one-third to be allocated to generating independent research for their customers. The "how" of this aspect of the settlement took months to work out.

In a highly publicized series of moves, Mr. Spitzer (joined in due time by the SEC, NASD, and NYSE) zeroed in on the 1990s behaviors and practices of analysts working for investment firms, and the "abuses" that were found as some—underscore some, not all—financial analysts worked hand-in-hand with their firms' bankers to promote specific stocks or even whole industry sectors or genres of investments (for example, the high-flying, profitless Internet stocks that created bubbles on top of bubbles in the markets).

Settlement terms. The global settlement terms were unique and complex. Reduced here to a simplified explanation, the ten Wall Street investment firms agreed to set aside a total of $484 million for a five-year period to provide what will be presumed to be—and is intended to be—independent and objective advice on certain corporate issues separate from those covered by the firms' analysts. This research is to be provided to retail customers (and institutions, if they wish). While $484 million sounds like a lot of money, consider that the ten investment firms will be dividing this sum over five years, an average of "only" $10 million or so per firm per year. This will be the amount used to recruit and retain a corps of fee-based analysts to provide independent reports alongside the firms' own products.

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An "independent consultant" (IC) was recommended to each of the ten firms by public officials. Once retained, the IC will seek out, retain, and manage independent research providers (IRPs) who have no income or conflicts related to the research work contracted for resulting from consulting, brokerage commissions, or investment banking fees. How investors view the IRP research and advice will be an important factor in the IRP's continuance as a contract researcher. Firms could be dropped for certain conditions, including the quality and usefulness of their analyses, as evaluated by public customers. The IRP's stock recommendations would be aligned with the investor's basic question: should I ... *buy, sell, or hold?*

Today, when retail customers of one of the ten investment firms receive an internal report or recommendation, they are informed that a separate, "independent" report (prepared by the IRP) is also available. This practice will continue for four more years, within budgets established by each firm as a proportion of the $484 million settlement.

Immediate challenges: (1) Where does a large investment firm find an IC acceptable to the regulators and prosecutors; and (2) where does the IC find a corps of expe-

rienced, qualified, independent financial analysts who can be relied on by investors? We are getting some answers as the first year of the settlement operations ends.

Independent researchers gather

The Investorside Research Association,[1] the major trade group of larger independent-research providers, conducted its Second Annual Independent Research Conference in New York City in April 2005 to explore issues surrounding independent research and the first year of research under the settlement. (Members must certify they are free of conflicts due to compensation by companies in research-for-hire, investment banking fees, or corporate consulting. Investorside allows the member firms to use its certification.)

The news was mixed, but prospects for the future appear bright for those who see the independent research glass as "half full." "Soft dollar" concerns were a part of many speakers' presentations. One of the knotty questions most independent member firms were dealing with was how to generate subscription revenues for their research reports and payment (in general) for equity or debt research that is *not* compensated for directly by brokerage or banking customers. For example, in the environment of falling trading prices, increased competition for stock trading, and unbundling of transactions, less than two cents of a five-cent per share transaction would be directly related to the execution; the balance would be for "soft costs," especially the provision of research. But if this division or allocation were made clear to the brokerage customer, what would the effect be? A response of "don't need the research" would have a chilling effect on the independents.

For years, major brokerages covered their in-house research costs through (at first) higher, fixed rates for trades, and later, after deregulation of trading costs, within transaction costs even as their income fell in a hotly competitive environment. (The addition of discount brokers such as Charles Schwab and electronic exchanges has driven costs downward over the past decade.) The worsening finances of analysis was taken up by the investment bankers, who relied on some of their firms' analysts—especially the new media superstars—to help land deals and mergers and acquisitions or banking customers. Those analysts who performed in these assignments were well rewarded for relaxing or even abandoning objectivity and independence. Scandal, then, became an accident waiting to happen.

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When the Wall Street global settlement was first announced, some members of the new Investorside Research Association reacted negatively, pointing out that the problem of investors wanting "free research" would not be properly addressed if the ten investment firms were providing "free" independent research for the next five years. The resistance was temporary; the competition for both IC/IRP contracts and the opening vistas for paid research with "soft dollars" helped to expand the independent research marketplace.

Many questions, evolving answers

The key questions for independent analysts today remain: How do we get paid for research? Do we offer customers trading (by operating a brokerage in-house or through partnerships) or not? Do we need to sit on a distribution platform to draw attention and generate revenues? (Member consensus seemed to be "yes": it is very helpful to be on a popular platform with multiple offerings for investors.)

A panel comprised of Stanton Green of Vista Research, Mike McCauley of Pulse Trading, Michael Plunkett of Instinet, Peter Sidoti of Sidoti & Co., and Scott Cleland of Precursor Research explored the contentious "soft dollar" issue and the paths open to independent firms to generate life-sustaining revenues. In the five-cent per share trade example offered, today there may be three cents or more available to cover research costs; what happens if the transaction cost gets squeezed down to two cents per share? Will the "soft dollar" component then be a halfpenny? What kind of quality research would be available at that level?

Peter Sidoti pointed out the pressure on the independents, where 20 analysts may be covering 400 names, and institutional clients may expect varying and different services. The subscription model may be lim-

iting (in his view), requiring an arrangement of some kind for trading revenues.

Mike McCauley stressed that buy-side (investor) managers are under pressure to lower costs and are heading toward "free execution," which could eliminate the spread for research. Margins are lowering for everyone: sell-side houses, buy-side managers, traditional investment banking analysts, and the new independent researchers.

Michael Plunkett told the gathering of independent colleagues that "if the research is valuable, people will pay for it. The client will figure out what it is worth, especially if the research adds to performance for the client's portfolio." (Today, 140 broker-dealers have partnered with Instinet as a preferred platform.)

Another panel—comprised of Scott Cleland of Precursor Research, Daniel Peris of Federated Investors, Michael Mayhew of Integrity Research Associates, Chris Adams of Delaware Investments, and Sean McMahon of BNY Jaywalk—looked at the future of independent research. Of interest to both independent researchers and corporate finance managers, Michael Mayhew offered these projections:

- More transparency is coming to the capital markets, which will affect independent research providers as well as their customer base (sell-side bankers and brokers and buy-side money managers). Unbundling of costs will be more visible to the customer. "Execution vs. research" in the transaction will be a point of discussion and negotiation for investors.
- Sell-side research will see a 40 percent or more decline over the next three years. As an example, Lehman Brothers, whose analysts cover up to 1,400 issues, may be at the 350 point in five years. (Not good news for the managers of 1,000 companies no longer followed by this well-known and respected banking house.)
- The buy-side (institutional investors) will build more in-house research capabilities. More IRPs could be retained by mutual funds, pension funds, and other management firms under pressure to cut costs.
- The Independent Research Provider (IRP) community will continue to grow over the next five years, but not all boats will rise. The more unique and valuable the research, the stronger the provider may be.
- More industry consolidation is on the way for Wall Street. The sell-side will reduce, and in some cases abandon, financial analysis for customers. That will put pressure on small- and mid-sized asset managers who have been getting "free" research. And independents will be squeezed; there is a question of just how many firms can be supported in the future, and today's 300+ estimated firms could shrink to a dozen or so major providers, once the "soft dollar" questions are resolved.

MORE TRANSPARENCY IS COMING TO THE CAPITAL MARKETS, WHICH WILL AFFECT INDEPENDENT RESEARCH PROVIDERS AS WELL AS THEIR CUSTOMER BASE.

Questions for Wall Street and corporate America

The questions to be answered over the next four years by the ten major investment firms include: Is independent research making a difference with my retail customers? With any institutional prospect or customer? Does the availability of out-of-house research create incentive to "do better" by in-house analysts?

Questions for corporate finance executives who have oversight of investor relations include: What happens when one of the ten investment firms, or any other analyst now covering my company, drops coverage? (The issues not covered by Morgan Stanley, Merrill Lynch, et al., do not have to be covered by an independent.) What if *no* analyst will cover my company (a possibility, given the fact that paid-for research is frowned on and will not be a part of the global settlement process)?

Perhaps as a sign that independent research has earned its rightful place in the galaxy of financial analysis and the recommendations that flow toward investors, *Institutional Investor* magazine last year sampled "voters" in its "All-America Research Team" initiative. Among the firms suggested by money management and buy-side analyst readers were such firms as Fulcrum Global Partners, Sanford C. Bernstein & Co. (a unit of Alliance), Prudential Equity Group, Precursor Group, and Green Street Advisors. Name recognition is building for

independents. Among the first in the Investorside trade group voting: Argus; American Technology Research; BNY Jaywalk (now part of the Bank of New York); the Center for Financial Research and Analysis; William O'Neil & Co.; AltaVista Independent Research; Precursor; Sidoti & Co., LLC; Weiss Ratings; and Vickers Stock Research. Many are becoming household names among key investors.

Last words

Charles Gasparino, author of *Blood on the Street,*[2] the very thorough narrative of the "financial analyst scandals" that led to the global settlement, is now a business/finance editor for *Newsweek* magazine. Mr. Gasparino views much of the analysis of the boom years—from 1996 through 2000 especially—as a situation in which Wall Street clearly demonstrated just how lax the rules were for analysis, and how deliberate some of the worst practices were (such as converting financial analysis to a tool for increasing business for investment bankers)."One of the greatest frauds in the past 50 years occurred," he notes, "and even though many people knew that much research was a 'scam,' investors either ignored this or were financially inept."

Mr. Gasparino advises the new corps of independent researchers to be vigilant, avoid conflicts, work to keep Wall Street interests "honest," and be truly independent. Then, they may prosper and the markets may return to a more robust state. His summary of 1990s events will become part of history: "The sensational inside story of how Wall Street analysts duped a generation of investors." Hyperbole to some, but a characterization that still stings for investors and some corporate finance managers. ■

NOTES

1 Investorside Research Association is a not-for-profit trade association of independent research providers (IRPs) that has certified almost 75 member firms. Additonal information is available online at www.investorside.org.

2 Gasparino, C, *Blood on the Street* (New York: Simon & Schuster, 2004).