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STAY TUNED TO... Independent, Objective Financial Research

By Hank Boerner

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Stay Tuned . . . to the coming "multiple views" on companies covered by the sell side. The terms of the historic $1.4 billion settlement reached by New York State Attorney General Eliot Spitzer and 10 major brokerage houses includes $432.5 million to fund independent research and $80 million to promote investor education.

Each firm is required to retain an independent consultant to select at least three independent research providers, who will develop separate, objective research on covered public companies that will be made available free to its customers (only for those companies covered by the brokerage or banking firm). Contract researchers will not be allowed to perform investment banking or brokerage services in direct competition with the firm hiring them. (JP Morgan has

hired Laura Unger, former SEC commissioner, who will now select its IRPs.)

One of the objectives is to increase coverage of some covered companies. In theory, a covered company could have a report issued by Morgan Stanley, Bear Stearns or Goldman Sachs, and three or more *other* reports or ratings could be issued by the contract independent researchers serving each of these major houses. While highly improbable, there could be 30 reports issued for one covered company if each of the 10 houses approved research on the company by their respective suppliers. At the same time, nothing in the settlement orders or suggests that the major houses expand coverage to public companies *not* covered by their research, nor is there a requirement to have three research providers per covered company.

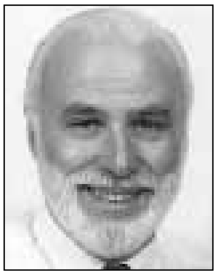
There will be more research available, but not necessarily *more coverage* of companies by the 10 houses in the settlement. If these houses drop coverage — as Citigroup did in May, eliminating coverage of 100 companies and laying off eight analysts — IROs could be seriously challenged in attracting new analyst coverage. The major houses have agreed to support the "independent research initiative" for five years. Compliance reports will be provided to the regulators.

Stay Tuned . . . to the fine print. The "utility" of the IRPs' research to customers — including ratings and price targets, as well as the use of this research by customers — will be gauged and reported to regulators. If customers don't use the independent research, then what? What if the cost is deemed to outweigh the benefits? If researchers' compensation is not based on investment banking revenues, what will the determinants be? And, finally, where do the independent monitors now find the needed number of research houses?

Stay Tuned . . . to the rise of independent researchers. Before the settlement, creating a totally independent research organization could be quite challenging. Who would pay for research, which was provided "free" to sell-side firms and broker customers? How would the research function be supported, if not by investment banking fees and brokerage commissions?

There have always been well-known, independent research organizations that sold their services to investors — Morningstar, Standard & Poor's and Value Line, for instance. These are now being joined by start-up entrepreneurial organizations.

One of the new independents is The Precursor Group in Washington, D.C., founded as an employee-owned company in June 2000 by former Legg Mason telecomm analyst Scott Cleland. As Cleland and his colleagues established their firm, they invited other independents, such as long-established Argus Research, to join in the formation of a new trade association: Investorside Research Association, founded in July 2002. (Cleland, who is now CEO of both his own firm and the trade association, concedes that some association members will now seek relationships with the 10 houses involved in the settlement.) Like other members, The Precursor Group does no money management, proprietary trading, stock picking or investment banking.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Stay Tuned . . . to the "certification movement." There are now 21 independent research organizations that are "certified" members, including Howard Schilit's Center for Financial Research and Analysis, Investars, Vickers, BNY Jaywalk, Sidoti & Co, and Sanford Bernstein (part of the large Alliance Capital organization). Members are certified for providing researchers to individual investors, institutions or both.

By defining acceptable independent research as having no association with investment banking, Cleland (who caused quite a buzz with his views when he addressed the opening session of the NIRI annual conference last month) believes that the settlement is a good first step in discouraging investment banks from misleading investors in the future by suggesting that their research is independent or objective when it is not. But simply separating research and investment banking will not establish "independent research" in the large investment banking houses.

Stay Tuned . . . finally, to research for sale. In the absence of any coverage, some companies are now responding to pitches from "independent researchers" to sponsor — i.e., pay for — their research coverage. The practice is highly controversial. NIRI issued an *Executive Alert* on paid research in January 2002, then refined the guidelines in March 2003.

NIRI advises that paid-for research should always be fully disclosed in the research document and written only by a qualified analyst; that compensation for preparing the research should be in cash only; and that the research report should not contain recommendations.

NIRI President & CEO Lou Thompson's "foremost recommendation" to companies without coverage that are considering paying for research is to communicate directly with investors. "Investors need clear and credible information from companies, and research based on independent thinking and without conflicts," Thompson pointed out in a recent *Executive Alert*. "These are critical to restoring investor confidence." IRU

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