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THE FUTURE OF SECURITIES ANALYSIS

The global settlement reached with major Wall Street investment banking and brokerages by the Securities and Exchange Commission (SEC) and the New York Attorney General in April 2003 had the objectives of settling the issue of separating the research function from investment banking and trading, and reassuring investors they could rely on the "independent" research to be offered in the future by the ten firms involved in the settlement. Some observers noted that the settlement closed the boom era of the 1990s and cleared the way for a new era in research.

For the first time, the details of the settlement touched off a lively debate over the future of "paid" and "free" financial research and the expected effects of the agreed-to changes on the corporate community, as well as on professional analysts.

Important questions are being raised about the future directions of traditional securities analysis. For example: What will happen now to the research function (and individual staff researchers) at large, "name" investment banking and brokerage houses? Will far fewer companies be covered by an individual analyst? Can a Chinese wall really be erected (as in past eras) to separate research and banking, to conform to the terms of the global settlement? Will there be a larger market for "independent" researchers with *no* ties to bankers or brokers, who offer their research reports as a stand-alone service, to be paid for by investors?

Corporate finance executives have much riding on the answers. And we will only know the answers over time, as practice follows the principles agreed to and new laws and regulations governing analyst behavior. For example, securities analysts that have traditionally covered a company could now decide to drop coverage (since companies may decide that there are "no profits" in research). There could be far fewer analysts—or perhaps no analysts—issuing reports on some companies in the months ahead. *The Wall Street Journal* reported there are 6,384 publicly traded companies traded on NASDAQ and NYSE, and 4,189 have analyst coverage; however, almost half (44 percent) of NASDAQ companies have no coverage, and 14 percent are covered by just one firm today.

CFOs and investor relations departments may have to resort to paying for research (i.e., agreeing to retain researchers for hire to issue reports). Issuers will have to expand their direct communication with investors to maintain a level of interest in their companies in the absence of public research.

Importance of the global settlement

The $1.4 billion global agreement was intended by prosecutors and regulators to change attitudes and behavior at the large broker and investment banking firms and to generally spur major reforms in the ways that all financial analysts do their work, publish results, insulate themselves from banking and brokerage, and are compensated.

New York State Attorney General Eliot Spitzer began the probe into analyst behavior in June 2001 with an investigation into the rating practices of just one firm—Merrill Lynch. Merrill Lynch turned over many documents. The firm settled in May 2002, paid a $ 100 million fine, and promised significant reforms, including severing the link between analysts and investment banking.

The continuing (and expanding) investigations had an effect on pending legislation: In July 2002, the comprehensive package of measures known as the Sarbanes-Oxley Act was passed by the Congress and signed into law by President George Bush. The Sarbanes-Oxley Act contained additional measures intended to reform certain practices in financial analysis. (Title V addressed analyst conflicts of interest, created firewalls with investment bankers, and expanded disclosure requirements for analysts.)

Also, in December 2002, the National Association of Securities Dealers (NASD) and the New

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York Stock Exchange (NYSE) proposed additional analyst rules to further insulate analyst compensation from investment bank pressures, prevent the issuance of "booster shot" research reports, and require a final research report be issued when an analyst terminates coverage of an issuer.

Among the terms of the settlement are:

- Three firms admitted to fraud; seven others were charged with lesser violations of federal and state securities laws (such as failure to disclose conflicts, or issuing reports with unwarranted claims);
- Investment bankers are prohibited from setting analyst compensation and analyst pay will be based on quality and accuracy;
- Analysts cannot participate in road shows or sales presentations;
- The process for issuance of shares in IPOs to customers will be reformed;
- Each of the 10 firms will have to publish every one of their analysts' ratings on every stock covered; reports to be published within 90 days of the end of each quarter (this is intended to provide investors with a means of comparing ratings);
- Each of the firms will have to provide three "independent" research opinions for any research that is provided to a customer ($432 million is earmarked for this);
- This "independent research" will be monitored by an SEC-approved consultant to the banking or trading firm; and
- Each firm will have its monitor report on compliance with the agreement.

Contracts with three research firms required

One of the critical elements of the SEC/Attorney General settlement is the requirement for the 10 firms to contract with at least three independent research firms to provide unbiased research to the brokerage firm's customers over a period of five years. Each firm will also hire an independent consultant, who will be approved by regulators, with final authority to procure this independent research from qualified independent providers.

In February 2003, SEC adopted Regulation AC—Analyst Certification—requiring that any research report disseminated by a broker, dealer, or associated person will include certifications by the research analyst that the views expressed reflect the analyst's personal views and disclose if the analyst was paid for recommendation or views. (This information would also have to be disclosed when an analyst makes a public appearance to promote research.)

As of May 2003, both the SEC and the attorney general's office continue to investigate individuals at the various banking and trading firms, especially those who supervised analysts and investment bankers. Thousands of pages of documents are being released as part of the settlement, which will be used by lawyers to pursue the firms.

NEW YORK STATE ATTORNEY GENERAL ELIOT SPITZER BEGAN THE PROBE INTO ANALYST BEHAVIOR IN JUNE 2001.

But, will the settlement result in dramatic change in analyst or investment banker behavior; in the dominant, ultra-competitive Wall Street culture; in the way securities analysts are compensated and rewarded; or in investor attitudes toward research? Obviously, only time will provide the answers. Short term, there are some alternatives to traditional financial analysis that are worth examining as backup or substitute measures.

Independent, objective research

The key words for triggering intense debate about the future of securities analysis are "independent," "objective," and "untainted." In the wake of the dramatic revelations concerning a handful of researchers who allegedly slanted their research to help their firm's bankers and traders, it often appeared that the entire corps of sell-side researchers were being accused of issuing biased reports. That is obviously a great exaggeration of the truth; many analysts have issued fair, accurate, objective, and unbiased research reports regarding publicly traded companies and stand behind the analysis and ratings they assign to public securities.

Unfortunately, analysts as a group are in danger of being stigmatized by the revelations of improper behavior by the few. There is also lingering investor doubt that Wall Street research practices can be reformed.

Early in 2003, editor Ben Wright of *The Washington Post* wrote that veteran analysts doubted investors would really benefit from changes taking place in research."True, analysts put more disclosure of potential conflicts in research reports and issue more 'sell' ratings," the *Post* reported, but one broker at a top Wall Street firm told the newspaper that it will be still be hard for analysts to ignore the temptation to issue bullish reports when [these] generate investment banking deals—unless firms are forced to stop publishing research altogether."

ANALYST COMPENSATION

One of the "distortions" cited in the SEC-NY AG investigation were the handsome compensation packages of well-known analysts. In the 1960s, the New York Society of Security Analysts reported that base salaries for starting analysts were $5,000 to $10,000, with established members earning $10,000 to $18,000. (The average American worker pay was $100 weekly in 1963 and by 1968, median family income was $8,000 per year.)

The number of talented analysts is likely to shrink once reforms are agreed to and the global settlement goes into effect, the *Post* speculated.

NIRI guidelines on paid-for research

As some companies that do not have *any* analyst coverage explore the idea of paying for research coverage, the National Investor Relations Institute (with 5,000+ members representing more than 2,500 public companies), issued guidelines for "paid-for research" in January 2002, which were further refined in March 2003. The NIRI guidelines are:

- Paid-for research should be fully disclosed in the research document (e.g., notice that the company paid for the research);
- Research should only be written by a qualified analyst;
- Compensation for preparing the research should be in cash (not stock, options, or warrants); and
- Research reports should not contain any recommendation to acquire the stock or set future price targets.

NIRI President and CEO Louis Thompson, Jr. said the organization recognizes that some companies will face increasing difficulty in maintaining sell-side coverage, and some investor relations offices (IROs) will have to focus their efforts now on communicating directly with investors.

Those who use paid-for research reports for public distribution should be cautious about *who* they select to write the reports and avoid conflicts of interests and negative perceptions. NIRI's foremost recommendation is that companies lacking research coverage should communicate directly with their investors. "Investors need clear and credible information from companies," Mr. Thompson advised his members. "They want research based on independent thinking and without conflicts. These requirements are critical to restoring investor confidence."

Investorside: new association for the independents

Creating a market for totally independent research—independent, that is, of ties to established brokerage or investment banking houses, with output sold purely as research—has been challenging for the growing body of unaffiliated research outfits.

Some firms have formed an association to certify independent houses. Scott Cleland is Chairman of Investorside Research Association, as well as CEO of The Precursor Group (both are based in Washington, DC). He formed Precursor Group in June 2000 as an independent, employee-owned research service company that does no investment banking, money management, proprietary trading, or stock picking. Mr. Cleland also set out to organize similar firms in an association; Investorside was organized by Mr. Cleland and John Eade of Argus Research in July 2002. Today, 21 independent research organizations are "certified" members, including CFRA and Sanford Bernstein (part of the Alliance money management organization).

Speaking of the SEC's and the New York Attorney General's global settlement with the major Wall Street houses, Mr. Cleland praised the prosecutors and regulators for formally defining "independent research" for the first time, "as having no association with investment banking." The settlement, he noted, "if fully enforced, could help grow a more investor-aligned investment research industry." The choice of the trade association's name was deliberate: to be on the "investor's side."

"By defining acceptable independent research as having no association with banking, the global settlement is a good first step in discouraging Wall Street investment banks from misleading investors in the future... by suggesting that research is independent or objective," he explained.

However, he noted, just separating research and investment banking does not mean that research is "independent." Additional steps are needed; the SEC's definition of independent research is now aligned with Investorside's definition. The association has been certifying that independent firms provide no banking or consulting services; are paid by investors, not companies; and are in good standing with regulatory agencies.

Investorside Research Association's Code of Ethics was adopted to restore investor trust in the capital markets system through research that is financially aligned with investor interests; members agree to:

- Maintain the highest standards of integrity and professionalism;
- Promote truth and fair representation in investment research; and
- Serve investors forthrightly.

Mr. Cleland noted,"Investment bank-sponsored research has been thoroughly discredited ... its wings were clipped by Sarbanes-Oxley and recent SEC regulations. The SROs failed in regulating research. For 10 years research was misrepresented and misadvertised, and the exchanges did nothing to discourage these practices.

"Members of Investorside have created a 'Good Housekeeping' type of seal that will assure institutional, pension, and individual investors that members' research is independent, objective, and can be trusted. Out of the ashes we hope to rebuild a reputable, investor-aligned research industry.

"The disappointment is that the attorney general/SEC settlement treats the symptoms, but not the source of the problem. Here is the challenge: 95 percent of the research market has been performed by investment banking firms, and only 5 percent by truly independent organizations. I'm afraid that the global settlement could devalue research further by perpetuating the myth that research is not profitable, and should be given away. The government is encouraging the distribution of free research.

"Government negotiators should have encouraged real competition to Wall Street banks and brokerages and not turned the independent competitors into suppliers to the Wall Street investment bankers. Why would existing independent researchers risk their business by having it distributed free to the rest of the world? Why would we reinforce the idea that research is free... and suitable only for promoting investment banking?

"We believe we have a superior idea... you can make money performing research ... you can do it in a transparent way, separate of commissions ... .Future demand will be key ... .Investors are best served by companies working for them and their interests. We will soon see just how serious government is about protecting the nation's 85 million investors... while Wall Street is still driving this bus."

Traditionalists: Graham and Dodd and their disciples

In examining the possible future state of research, some of us will be revisiting "the bible," *Security Analysis by* Benjamin Graham and David Dodd. The book has been the investment bible and the basis of fundamental research since the first edition was published in 1934. (The book was published in part to revive interest in equity investment after the 1929 crash. Sound familiar?)

Graham and Dodd's concept of security analysis placed an emphasis on determining future value, and provided the conceptual framework of security analysis for generations of researchers and investors to follow.

Benjamin Graham taught at Columbia University and first introduced "investments" as a class in 1929. He was an important mentor to Warren Buffett (his student), who later joined his firm. Graham was a founder of the New York Society of Security Analysis (he died in 1976 at age 82.)

The title of the book—*Security Analysis*—became the generic name for a major financial discipline.

Each of the editions has been important source books for members of the Financial Analysts Federation and Institute of Certified Financial Analysts. •