

---

# **SELL-SIDE RESEARCH: THREE MODEST REFORM PROPOSALS**

The reasons why sell-side research has failed to deliver on its analytical promise and the measures needed to release that potential

**By**

**Michael Mainelli,  
Jamie Stevenson  
& Raj Thamotheram<sup>1</sup>**

**January 2009**

---

**Network for Sustainable Financial Markets**

[www.sustainablefinancialmarkets.net](http://www.sustainablefinancialmarkets.net)

---

<sup>1</sup> The authors are participants of the Network for Sustainable Financial Markets and are writing in their private capacity. Please send feedback to [jamieroger.stevenson@virgin.net](mailto:jamieroger.stevenson@virgin.net)

## CONTENTS

PAGE	
3	Executive Summary
5	The strengths of sell-side research: <ul style="list-style-type: none"><li>• Sizable funding</li><li>• Well-paid and educated professionals</li><li>• Focus on disseminating ideas</li><li>• Ideal platform to add significant insight and value to market analysis</li></ul>
5	The failures of sell-side research <ul style="list-style-type: none"><li>• Buy-side preference for opaque payment structure</li><li>• Pressures for a tainted, bland consensus</li></ul>
6	Conflicts of interest within integrated investment banks
7	Corporate management pressure on analysts
7	Dearth of "Main Street" experience amongst analysts
8	Flight from small cap to higher-fee large cap coverage
9	Neglect of extra-financial and sustainability issues
10	False signals between sell-side and corporate management
11	Three (struggling) initiatives to raise research quality: <ul style="list-style-type: none"><li>• Spitzer settlement in 2002</li><li>• Enhanced Analytics Initiative</li><li>• Voluntary unbundling</li></ul>
14	Three simple proposals for modest reform: <ul style="list-style-type: none"><li>• Full disclosure of research payment contracts</li><li>• Analysis of recommendation balance</li><li>• Naming-and-shaming of corporate 'freeze-out' tactics</li></ul>
16	A post-script on regulation and why a 'nudge' approach to tighter regulation is now required

### *About the authors*

- Jamie Stevenson is Teaching Fellow in Finance at Exeter University and former head of research at a sell-side firm.
- Michael Mainelli is Director of the City of London's leading commercial think tank, Z/Yen.
- Raj Thamotheram is a founder of the Enhanced Analytics Initiative and a Responsible Investment professional with experience of both asset owners and buy side.

This paper has been prepared by the authors as individuals and not as representatives of any entity or organization. Affiliations are given only for identification purposes.

Information about the NSFAM is available at [www.sustainablefinancialmarkets.net](http://www.sustainablefinancialmarkets.net).

## Executive Summary

Investment banks (“sell-side”) spend at several \$billion<sup>2</sup> per annum globally on equity research sold to investment clients (“buy-side”). Even after cutbacks in recent years, sell-side equity research remains a well-funded and high-profile activity. It ought therefore to be adding significant value to investors’ understanding of quoted companies. And, since sell-side analysts disseminate their research widely, it should also improve the all-round quality of market information. Yet despite these sizable resources and high rewards (unmatched in any other field of analytical research) and powerful advantages, sell-side research has been clearly and consistently shown to:

- Miss most of the major insights or turning points in company analysis<sup>3</sup>
- Err persistently towards Buy recommendations and stances supportive and uncritical of current company management policies and or management fads<sup>4</sup>
- Follow consensus (and company guidance) forecasts and views, rather than construct independent earnings models and opinions
- Prioritise daily client marketing contact over long term development of fundamental research
- As a consequence, focus on short to medium term valuation formulae at the expense of examining in depth the extra-financial and operating issues which impact the long term sustainability of business models and company performance

The reason for these failures can be traced to the lack of transparency in commercial relationships between sell-side and buy-side. This lack of transparency arises because:

- Buy-side institutions are loath to make open, direct and significant payments for specified research services
- Instead, they opt for a maze of commercial contracts - across the corporate, new issue and market-making functions as well as commission - which mask their true dealing costs whilst providing broad research cover to defend their decisions
- This reluctance to pay full dealing and research costs has shifted focus and power within investment banks towards corporate fee and proprietary trading income
- Which in turn has exacerbated the conflicts for equity analysts between research for clients and making a contribution to corporate and trading income

There have been three very different attempts to address these weaknesses. Each has had some positive impact but none have significantly altered the status quo.

The Spitzer settlement in December 2002<sup>5</sup> aimed to eliminate these conflicts of interest and create a level playing field in which buy-side could access sell-side research on a transparent basis. It has improved the system of research disclosures (to the displeasure of many analysts who complain about ‘red tape’) but failed to alter the preponderance of Buy recommendations and favourable research on each bank’s own corporate clients.

The launch of the Enhanced Analytics Initiative (EAI) in Europe in mid-2004 sought to encourage research beyond the limits of short term financials. Its radical idea of linking income (5% of participating institutions’ annual commission total) with a public ranking of sell-side competency in this new type of research started to attract significant research efforts from a dozen or more bulge bracket and other

---

<sup>2</sup> Global investment banking revenue estimates vary between US\$42bn and US\$83bn. Even if only 10% is spent on equities research, this amounts to between US\$4bn and US\$8bn annual global research spend.

<sup>3</sup> Examples of significant missed turning points include widescale earnings manipulation in the 1980s, dotcom bubble in the 1990s, Enron and other off-balance sheet scams, BP’s safety exposure, dividend cuts in the early 1990s and now again in 2008/9, bank balance sheet failures etc

<sup>4</sup> *Are security analysts fashion victims? The Core Competence Case*, Ann-Christine Schulz and Alexander Nicolai, University of Oldenburg, 2008

<sup>5</sup> New York State Attorney General Eliot Spitzer agreed to drop cases against major Wall Street banks for fraudulent research in return for \$1.5bn fines and agreements to separate research functions more clearly from trading and corporate, and to make more transparent statements about conflicts of interest

leading banks. But the project struggled against the domination of fully bundled corporate, trading and commission packages and in late 2008, it merged into the Principles of Responsible Investment initiative leaving unanswered questions about how to keep pushing for change.<sup>6</sup> Ironically, the banking crisis of 2008 (itself a classic example of a fundamental event which ESG research would have been better placed to identify) has led to retrenchment by investment banks from research in general and from ESG research in particular.<sup>7</sup>

A similar fate awaits post-Spitzer initiatives in ‘unbundled’ research from non (or less) conflicted boutique broker-banks. The logic of quality research standing apart from corporate client and proprietary trading pressures is flawless. It has to be the logical way to raise equity research quality and independence. Yet few firms offering earmarked, unbundled research services have succeeded beyond the specialist boutique level.

The weight of existing relationships between buy-side and sell-side militates against such initiatives. It is arguable that only legally enforced separation of corporate, trading and broking functions (i.e. break-up of integrated investment banks) could achieve full transparency and independence in the supply of equity research. In the absence of political support for fundamental reform, the following three manageable steps would improve research quality:

- Full disclosure by sell-side and buy-side of all commission contracts
- Compulsory publication by sell-side of their recommendation balance (Buy/Hold/Sell) for (a) all covered stocks, and (b) corporate client stocks
- Naming and shaming of corporate managements who deny access to non-favourable analysts (‘analyst freeze-out’)

These are modest steps and simple to implement. They would not eradicate the failings of sell-side research at a stroke but they would at least make it harder for corporates and investment banks to conspire in neutering the analytical edge of equity research. And they might encourage buy-side to see their long term advantages in paying directly for less conflicted and more deeply questioning sell-side research. Given the persistent failures of the voluntary approach, such measures need to be supported by regulation or at least the imminent threat of it, in the absence of industry proposals with teeth.

---

<sup>6</sup> *What’s the future for ESG broker research*, Hugh Wheelan, responsible-investor.com, 22/12/08

<sup>7</sup> Sell side firms who closed their ESG units in 2008 include Citi, Deutsch Bank and JP Morgan.

## 1. The strengths of Sell-side research

Sell-side and credit research agencies have the potential to play a significant, positive role in enhancing the quality of equity market analysis and awareness.

In theory, these agencies are a hugely efficient centralised resource, motivated to gather and to share investment relevant information. Like their buy-side clients, sell-side and credit research analysts have powerful incentives to be right – perhaps even more so than the buy-side given the smaller job market in which they work and their higher profile. Even after recent cutbacks, sell-side analysts remain significantly better paid than those undertaking similar work in health, education, civil service, academia, politics, the media, mainstream corporate careers and even the law, accounting and consultancy.

Being associated with brokerages, sell-side researchers are motivated to be public, if not loud, about their opinions. In contrast the buy-side has much less to gain from sharing data with others and is motivated to keep information secret. Sell-side research is pushed through the financial system. Sell-side researchers have a large effect on market perceptions about particular stocks. In fact, one interpretation of a sell-side brokerage is that it is a research (or publicity) machine with a brokerage attached.

Theoretically, sell-side research makes a vital contribution to market efficiency: the collective intelligence of the market, aggregating divergent opinions into price setting. The sell-side provides shared learning about stock price formation that is widely available at low cost. And this learning is built upon a statistical framework of quantitative income, cash flow, balance sheet and financial ratio modelling which has grown exponentially in technical sophistication over the past two decades. The intellectual capacity of today's sell-side analyst to crunch complicated numbers and valuation formulae through fast, real time, interactive spreadsheets is light years ahead of the equivalent in the 1980s.

Similar advances have been made in the technical efficiency of corporate communication to investors and analysts. None of the insider benefits which were routinely exploited a quarter-century ago by market professionals are now so easily available. Tighter rules on parity of disclosure and instant electronic data communication have eliminated the low hanging fruit of old-fashioned insider dealing. Investor relations (IR) has grown up into a genuine professional skill. The processes of announcement, presentation, Q&A, conference calls, investor 'one-on-ones' etc have developed from sporadic initiatives into standardised, measurable and accountable units of IR activity. Managements will always use the tricks of spin, slant and data overload to push-and-pull analysts in their direction, but the latter can no longer complain that they lack the informational tools to execute their scrutinising and valuation tasks.

## 1. The failures of sell-side research

Yet sell-side research has manifestly failed to deliver on this potential. Bar a few brave outliers, most of its vast daily e-mail and printed output recycles published data and promotes bland, consensus views with a bias towards Buy recommendations and uncritical views on current management policy or current management fads<sup>8</sup>. Where critical views are expressed, they mostly follow a copycat cycle of clichéd invective (“lacking vision”, “poor investor relations”) for currently unfashionable companies. The underlying cause of this empty approach is the opaque and inadequate payment structure between sell-side and buy-side.

This in turn arises from the criteria under which investment funds (buy-side) are themselves evaluated and how these drive their research appetite and payment structure. Investors tend to evaluate buy-side performance over benchmark periods shorter than the life of a typical fund, e.g. quarterly for a 30 year pension fund. All buy-side positions are constantly subject to second-guessing ex post. This creates a defensive culture in buy-side firms and a ready market for sell-side research recommendations which can be used to support almost any position. A preponderance of Buy recommendations fills their need to justify poor investments – “I bought Vodafone and lost a lot on that position, but it was recommended by

---

<sup>8</sup> *Are security analysts fashion victims? The Core Competence Case*, Ann-Christine Schulz and Alexander Nicolai, University of Oldenburg, 2008

Mega-Broker’s investment researchers”. This buy-side need reinforces the internal pressure on sell-side analysts for positive recommendations to placate fee-paying corporate clients.

Investors also evaluate buy-side performance in terms of fees, typically excluding brokerage costs. Therefore, the buy-side strongly prefers that its costs somehow find their way into brokerage costs. Not surprisingly, a variety of costs has found its way into brokerage fees, such as ‘softing’. This has accentuated the resistance within sell-side research to the concept of ‘unbundling’ (see section 9 below).

This emphasis on controlling reported costs by buy-side firms tends also to reduce their own in-house research resource and increase their reliance on the sell-side research which is circulated to them (and all other brokerage clients) ‘free’. Already concerned to avoid significant quarterly under-performance risks, such buy-side clients are naturally prone to converge around the consensus of this corporate-filtered, uncritical and dealing-biased research. This convergent behaviour in turn creates and exacerbates bubbles.

## 1. Conflicts of interest within integrated investment banks

The steady dismantling in the US of the provisions of the Glass-Steagall Act (resulting in its final repeal in 1999) and the UK’s Big Bang in 1986 have created today’s global integrated investment bank model. Its inherent conflicts of interest are almost too obvious and well documented to bear repeating. No amount of internal compliance rules and Chinese Walls can airbrush out of reality the inconvenient truth that executives operating for the same ultimate paymaster in the triple functions of corporate advisory, proprietary trading and equities research cannot ever act in a truly independent manner for their client. And, to misquote Jane Austen, it is a truth universally acknowledged that a banker in possession of a good corporate client (or indeed a trader in possession of a sizable long or short position) must be in want of a co-operative research analyst.<sup>9</sup> In short, the dice are loaded against independence and integrity in the equity research division.

The analysts in sell-side and credit research agencies are fully aware that they work in a conflicted business model and that, since the demise of equities commission rates in the wake of de-regulation, their own funding depends on corporate and trading income. Spitzer (see section 9 below) may have broken the direct, formal link between corporate income and research rewards, but the invisible link is more powerful than ever. For most normal people, this inevitably leads to self-censorship, a process which is generally insidious and rarely explicit. It does not take more than the occasional analyst to be made “an example of” – i.e. who says something negative about an important client, doesn’t retract/apologise and who then is “let go” – for the message to get through to most analysts. Why risk a highly paid position for a concept of integrity which the system neither recognises nor values? This informal system of self-imposed control augmented with the occasional action *pour encourager les autres* is thus highly effective.

Within the investment banking system, the power hierarchy is clear – research analysts are not the top dog. Some of these top dogs (eg M&A deal makers) react very badly to upset corporate clients. Other top dogs (eg proprietary traders, sales staff) dislike market efficiency – a former corporate governance analyst at one bank was criticised internally for making available governance scores to buy-side clients who didn’t pay as much as hedge funds for the same data. The problem is even worse in CRAs since unless the client likes the report, they may not pay for it. Conflicts of interest become entrenched and no amount of Chinese Walls, commitments to internal integrity and internal processes such as whistle blowing can reverse their negative impact. The disinclination of sell-side analysts to identify laggard companies – as opposed to leaders – in any field exemplifies this mind-set. The fact that most analysts do not see this as important shows how institutionalised individuals can become in the goldfish bowl of investment banking.

---

<sup>9</sup> “It is a truth universally acknowledged that a single leman in possession of a good fortune must be in want of a wife.” Opening lines of *Pride and Prejudice*, Jane Austen (1821).

#### 4. Corporate management pressure on analysts

US academics have shown that US executives have been able to secure more favourable research ratings for their companies from investment banks by bestowing professional favours on Wall Street analysts. The study, carried out by Michael Clement of University of Texas and James Westphal of University of Michigan, found that by offering analysts favours, ranging from recommending them for a job to agreeing to speak to their clients, executives sharply reduced the chances of a downgrade in the aftermath of poor results or a controversial deal. The research, carried out on some 1,800 equity analysts and hundreds of executives, suggests that radical regulatory reforms of recent years have failed to eradicate conflicts of interest on Wall Street. Analysts' representatives said that accepting favours such as those described in the study - which also include putting analysts in touch with executives at other companies and advising on personal matters - was unethical. However, according to the study nearly four out of six Wall Street analysts admitted receiving favours from company executives. The frequency of favours increased in line with the shortfall between the company's earnings and market expectations - a crucial determinant of analysts' stock ratings.<sup>10</sup>

The converse to such charm offensives by corporate managements towards analysts is, of course, the "stick" of punishing critical analysts with a reduction or even cessation in contact, information flow and response to questions. This is the corporate version of the standard device regularly and (till they lose office and popularity) successfully deployed by government ministers and spin-doctors to manipulate journalists.<sup>11</sup> This "freeze-out" of an inconvenient analyst stops one step short of the less frequently used nuclear option of a formal complaint by the company to his paymasters. Ironically, the former lower level option is the more insidious and usually more effective one. Subject to the all-important proviso that no corporate fee is at risk (see section 3 above), being the subject of a formal complaint from a covered company can be turned by a confident analyst into an honourable war wound signifying valour. The less glamorous inconvenience of losing regular contact for those minor but vital daily details of data feedback is more likely to wear down the analyst's resistance and what is left of his independent spirit.

#### 5. Dearth of "Main Street" experience amongst analysts

Excess trust in efficient market theory was one of the (if not the) defining self-deceptions in the run-up to the 2008 crisis. It is now more than ever clear that markets do not tend systemically towards an equilibrium around an efficiently filtered discounting of all known and knowable information. Instead, they fluctuate violently around massive mis-readings of fundamental trends at macro and company levels. Animal spirits play their part but equally deficiencies in the market professionals' analytical toolkit contribute to the market's errors of judgement and pricing.

No system is foolproof against corporate misdeeds, self-deception and cover-up on the scale of those perpetrated in the global banking sector and debt markets over the first decade of the new millennium. Yet it is arguable that a greater depth of experience and operational knowledge amongst professional analysts at the centre of equity market valuation could have improved awareness – as well as providing critical feedback to corporate managements as to what was (un)acceptable to shareholders.

These two qualities – depth of experience and operational knowledge – do not feature on the tick-lists of investment bank recruiters in the 21<sup>st</sup> century. Their selection system is more rigorous, fair and competitive than at any time in the history of banking. Sell-side firms attract the brightest and the best (first and upper second class) honours graduates and MBAs from the leading universities and business schools across the US, UK and Europe. They train them in the disciplines of CFA and other financial analysis courses to high levels of spreadsheet modelling and ratio crunching ability. Intellectual and analytical rigour are paramount and have played their part in raising technical standards of equity

---

<sup>10</sup> "Study reveals cosy relations between chiefs and analysts", *Financial Times*, Francesco Guerrera, Ben White and David Wighton (27 July 2007)

<sup>11</sup> Immortalised in the telephone reply to former New Statesman editor John Kampfner from Tony Blair's communications director Alistair Campbell, "Shut up and take this down, if you want any more from where this is coming from."

research since the 'amateur' 1980s. Yet few analysts can claim any operational or hands-on experience outside these narrow confines of tracking the reported and forecast financial performance of their sector companies. And that sector choice itself tends to be a serendipity outcome from the first postgraduate year rather than a reflection of special interest or knowledge.

This focus on excellence in financial modelling at the expense of hands-on operational insight generates two negative side-effects. It reinforces the disinclination amongst analysts to examine extra-financial issues such as environmental impacts or corporate governance (see section 7 below) which affect the long-term sustainability of a company's business model. And when an analyst's excellence in pure financial modelling and valuation is endorsed by high status survey recognition (II, Extel) and the pursuit of headhunters, it often isolates him on a pedestal of self-belief and resistance to queries and ideas emanating from outside the bubble of financial market numbers and gossip.

Such a mindset becomes suspicious of new approaches to investment analysis and loyal to the apparently proven formula of crunching the income, cash flow, balance sheet and valuation numbers. Doing things differently risks being seen as unprofessional if not illegal. Whether this risk is in the heads of practitioners or 'real' doesn't matter - it has the same effect. Work on building a new theory of investment is only just starting and the component parts<sup>12</sup> have yet to be linked in a coherent way. There are, however, encouraging moves by CFA Institute<sup>13</sup> and EFFAS<sup>14</sup> and but it is early days. It would need a significant change in buy-side demands to shift sell-side research analysts out of their existing comfort zone of excess reliance upon financial modelling. The time investment required for sell-side to embrace fully the extra-financial issues would be seen as an unjustifiable risk unless endorsed by a widescale buy-side shift towards measures such as the Enhanced Analytics Initiative (see section 9 below).

## 6. Flight from small cap to higher-fee large cap coverage

Before addressing the neglect of extra-financial issues and the struggles of EAI to correct this, it is worth noting another negative side-effect from the pressure on sell-side research to justify its costs to its investment banking paymaster. According to Reuters Research, there was a 13 percent increase in the number of US companies that lost sell-side coverage completely between 2002 and 2004. Anecdotally, the growing struggles in recent years of many quoted UK companies in the £100m-£300m market cap range to attract coverage beyond the one committed appointed broker analyst and desultory interest from a couple of smaller sell-side firms illustrates this same point. As the senior editor of CFO.com notes: *"...analysts who work for the sell-side research units of large brokers and investment banks are heading en masse for the economic shelter of large-cap companies. The reason for the exodus? Large-caps boast heavily-traded stocks — and their whopping fees — as well as the potential for profitable investment-banking business."*<sup>15</sup> Such harsh economics will be accentuated through the credit crisis.

---

<sup>12</sup> See for example, Keith Ambachtsheer work on "Integrative Investment Theory", Andrew Lo's work on "Adaptive Markets Hypothesis", Woody Brock's work on "Endogenous Risk", Avinash Persaud on new risk thinking.

<sup>13</sup> The CFA Institute has always had a focus on personal ethics, although this personalised approach may have hindered focus on the systemic faults. CFA has broadened its focus to include corporate governance analysis and has further expanded this by considering compensation and ESG analysis: <http://www.cfainstitute.org/centre/topics/governance/>

<sup>14</sup> The EFFAS has set up a commission on ESG which is seeking to define key indicators and also produce a training programme: <http://www.effas-esg.com/>

<sup>15</sup> The Flight of the Sell-side Analyst, Marie Leone, [www.cfo.com](http://www.cfo.com) (8 July 2004)

## 7. Neglect of extra-financial and sustainability issues

We have alluded at various points in this paper to the minimal attention directed by sell-side analysts towards ‘extra-financial’ or Environmental Social & Governance (ESG) issues. This term refers to the range of forces outside the company’s immediate operations which are unlikely to influence its three-year earnings and cash flow forecasts (i.e. the daily working tools of an equity analyst) but which will drive its long term performance and even existence. With few exceptions, sell-side researchers do not generally pay due attention to the extra financial performance of the companies.

This observation was endorsed in a recent study of banking sector sell-side analysts, whose authors conclude<sup>16</sup>: *“Corporate governance reporting (mandatory under listing rules under UK ‘comply or explain’) was usually unread because governance in UK banking was generally trusted by the analysts. Social and environmental reporting was universally considered irrelevant and incapable of influencing a financial forecast. It was rarely read by analysts and any suggestion that the environmental reporting might contain disclosure germane to the description of secondary (i.e. loan book) environmental risk was dismissed.”* This systemic blind spot in the coverage of commercial research providers has a double impact on the capacity of fund managers to address these long term fundamental issues in their investment decisions.

Firstly, the neglect of extra-financial issues in the mainstream of commercial sell-side research has a ‘permissive’ effect in skewing the market consensus away from the long term fundamentals. This acts as a disincentive to contrarian behaviour, as and when the buy-side may consider taking a bet against their benchmarks and the herd. The absence of credible external data or research to back them up implies an extended period of exposure to risk as it takes time (often several years) for the market to understand the true implications of that extra-financial insight. Companies (and whole sectors) can mask serious underlying problems for several years before being forced to acknowledge the impact in their reported numbers. The unlucky demise of some bearish analysts during the lead up to the 2000 dot.com bubble showed how hard it can be to sustain a contrarian stance against the herd in the absence of a serious mainstream body of extra-financial research.

In that instance, it would only have required three or four major sell-side firms to set aside research resource into the exaggerated economics of valuations based on “£X,000 per subscriber” to cap the bubble early and thus defuse and dilute the subsequent volatility. The relevant research work would have been detailed, onerous and time-consuming. In order to pinpoint and “prove” the bubble’s over-valuation of dot.com stocks, researchers would have needed to look beyond individual companies towards the whole “new economy” and construct a model aggregating the “value per subscriber” for the sub-sector. Such research was eminently do-able but would have taken many analysts away from daily client contact for a couple of months or more.

Secondly, the vast majority of buy-side firms do not have the internal capacity and resources to operate complex comparative models of the kind that sell-side houses do. Thus, only a few of the biggest buy-side firms have the ability to do in-depth primary investigation, comparing ESG performance of different companies in the same sector, and then bring it into a systematic model. In the same way the buy-side pay the sell-side to produce earnings estimates, so most buy-side firms need a similar service on the importance of ESG performance.

---

16 Analysts’ perspectives on the materiality of voluntary narratives in annual reports. Dr David Campbell, & Richard Slack, ACCA (November 2008)

## 8. False signals between sell-side and corporate management

The exchange between sell-side and corporate management is a two-way street. It is not just confined to the kinds of carrot-and-stick pressure applied by the latter to the former, as described in 5 above. The approach of sell-side analysts sends signals back to management about equity market priorities and likely reactions. The broad perception amongst CEOs and CFOs is that mainstream analysts rarely initiate discussions of corporate responsibility or governance nor of environmental and safety issues, except when these are seen as posing specific and immediate threats to financials and value (e.g. the US refinery problems of BP in 2006). With buy-side analysts having only an hour with senior management, it is perhaps understandable that priorities have to be tightly set. But the top half dozen sell-side analysts in any sector have greater access to management, extending up to two days per visit and a week for overseas trips. Their inclination to deal with extra-financial issues only en passant or not at all during such visits gives a clear, and negative, signal to corporate management.

There are several anecdotal examples of this. As noted commentators Michael Jensen and Robert Fuller say: *“Enron in its heyday owned significant assets, made true innovations in its field and had a promising future. Its peak valuation required the company to grow extremely vigorously....To its detriment, it took up the challenge. The company expanded into areas in which it had no specific assets, expertise or experience... Had management not met Wall Street's predictions with its own hubris, the result could have been different.”*<sup>17</sup> Few CEOs are spared the pressure: *“The investment community has no sense of social responsibility. And when I say ‘no’, I can’t use smaller words than that.”* The fact that this was said by Chuck Prince is particularly telling.<sup>18</sup>

The question has also been considered by Duke University economists who found CFOs had a strong propensity to trade off productive expenditure (see below) in order to “meet the number”.

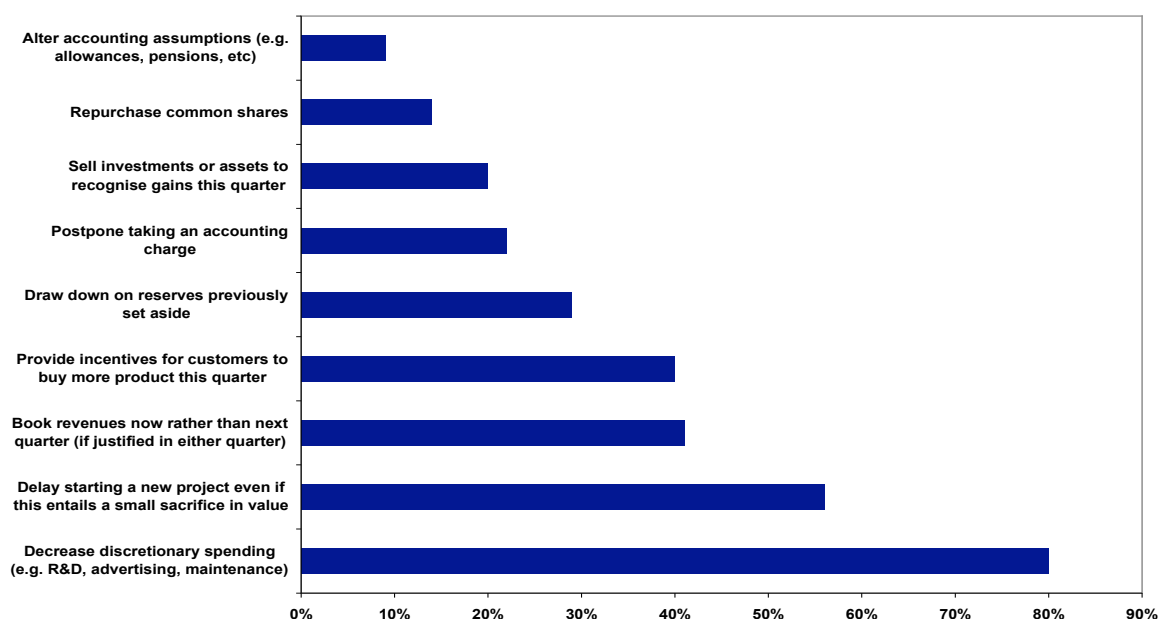


Figure 1: Taken from Graham, John R., Harvey, Campbell R. and Rajgopal, Shivaram, "Value Destruction and Financial Reporting Decisions" (September 6, 2006).

<sup>17</sup> Joseph Fuller and Michael Jensen: "End the Myth-Making and Return to True Analysis," The Financial Times (22 January 2002)

<sup>18</sup> \*Business Leadership in Society", M Blowfield & B K Googins, The Centre for Corporate Citizenship, Boston College, October 2006

## 9. Three (struggling) initiatives to raise research quality

Our exposure here of the flaws in sell-side research is neither original nor controversial. Few participants on either buy-side or sell-side disagree with the broad observations about conflicts of interest and lack of transparency in the payment structure. Defenders of the existing system used to rely instead on the pragmatic argument that with the gradual waning of Glass-Steagall and introduction of Big Bang the global economy had enjoyed a quarter-century of unprecedented and almost uninterrupted growth in wealth and GDP from 1982 to 2007. If it ain't that broke, why fix it?

The credit crunch of 2008 took the wind out of that argument's sails but articulate proponents can still be found for the plausible pragmatic line that in a free market economy money attracts quality. Thus the bulge bracket banks – with all their flaws - will continue to enjoy the most brilliant concentration of analytical brainpower and only their integrated model can afford to fund that brainpower from its mix of corporate, trading and commission income.

Three attempts over the past decade to challenge that domination of the integrated model are worth highlighting:

- The Spitzer settlement of 2002
- The Enhanced Analytics Initiative
- Unbundling initiatives by independent research houses

### *The Spitzer settlement*

Elliot Spitzer, then Attorney General for New York state, agreed in December 2002 to drop a series of indictments for fraudulent misuse of research against several of Wall Street's top sell-side firms such as Merrill Lynch and Citigroup in return for fines totalling \$1.4billion and agreements to separate and ring-fence their research activities from the corporate, trading and other functions of the investment banks. Spitzer justified his decision to drop the indictments (which were supported by unequivocal evidence of research deception by Wall Street analysts to protect corporate clients) on the grounds that his main objective was to resolve the banks' conflicts of interest. But as Robert Kuttner prophetically wrote in Business Week at the time,

*“Will the settlement do that? By requiring analyst compensation to be based solely on analyst performance, and by erecting a management wall between research and investment banking, the deal does make it much harder for research analysts to illegally promote stocks that their investment banker colleagues are underwriting. However, the other major element, the promise to stop spinning IPOs, is voluntary for now. An official regulatory ban awaits SEC rules.*

*The nub of the problem is that Wall Street and its regulators remain far too clubby. Self-regulation is delegated to the NASD, the stock exchanges, and the accounting profession, which lack the appetite to go after the conflicts that enrich their brethren. The opportunities for insiders to profit from conflicts of interest are pervasive.”<sup>19</sup>*

The Spitzer settlement led to furious activity by investment banks to be seen to be strengthening their Chinese Walls. These included a series of moves to tighten up disclosure in research publications on:

- Any actual or potential corporate income interest which the bank held in any of the companies covered by the research note
- The historic timing and performance of stocks against their recommendations
- The balance of the firm's stock recommendations between Buy, Hold and Sell.

That these changes had made some impact is evidenced by that most reliable of indicators – the rumbling of complaints by analysts against 'red tape'. Procedures are undoubtedly tighter than a decade ago and analysts more circumspect and careful in their handling of data and recommendations. Yet the preponderance of Buy recommendations (running at four to five times Sell recommendations) is unchanged, as is the favoured treatment of corporate stocks. The disclaimers on corporate involvement

---

<sup>19</sup> Robert Kuttner, Business Week, (May 2003)

are of the lengthy catch-all variety which reveal little insight. Every research note into almost every company carries a similar disclaimer as to the possibility that it might provide revenue to the bank's corporate division.

Spitzer and its descendants may have tightened up investment bank procedures but they have not shifted the balance of power away from the corporate and trading divisions of the bulge bracket firms. Even the credit crisis has not achieved that since, although some names have disappeared and the investment bank model has suffered the mother of all PR disasters, the show will roll on under new ownership (part Fed, part Bank of America, part HM Treasury, part sovereign wealth funds) and, as the resurgence of many Lehman mover-and-shakers under the Nomura label illustrated, the same internal dynamics will re-assert itself over independence and integrity in research.

### ***Enhanced Analytics Initiative***

The EAI is a voluntary initiative which was started in mid-2004 by European pension funds and fund managers. It aimed to encourage the sell-side to invest in quality, long-term research which would consider material extra-financial issues. The Initiative set up two incentives for research providers to compile better and more detailed analysis of extra financial issues *within* mainstream research. These were a commitment to allocate 5% of broker commissions to those brokers who did good ESG work, and publicity for the best performers by naming and acclaiming the winners (and using this winning list to concentrate the payment so making it meaningful). Over a four year period, EAI grew to include twenty members and acted as the catalyst for several sell-side firms developing in-house ESG capacity.<sup>20</sup>

EAI was a highly innovative and, in its own terms, successful project. The project has now merged with the PRI whose much greater funds – \$15 trillion – expand the potential impact, provided they make use of the following lessons from the experience of implementing the EAI.

Sell-side reaction to EAI showed that:

- There is weak engagement of analysts in North America, Australia and Emerging Markets, the former being most important given most global firms have their HQ there. The global reach of even bulge bracket firms is found wanting when seeking to spread awareness of corporate governance and extra-financial issues against the grain of local worldviews.
- Sell-side firms found it easier to write specialist SRI/ESG research notes for new clients than to integrate the insights into the mainstream notes which have much more market impact.
- Sell-side firms found it easier to comment on climate change than corporate governance. Similarly coverage of the financial sector was very weak and shown minimal grasp of the corporate governance and risk issues leading up the credit crisis.

From the buy-side firms who did not join EAI and did not do something comparable on an independent basis, it became clear that:

- The gap between funds' espousal of long term responsible research and their giving a financial commitment to reward such research is large and widespread
- Fear of internal debate and tension in part explains buy-side firms' reluctance to make formal commission allocations to specified kinds of extra-financial research
- This is accentuated by the dispersal of decision-making over sell-side research to many individual fund managers, which tends to endorse existing favoured practice
- This leads to the chicken-and-egg argument that ESG related research lacks the quality to justify taking 5% of the commission budget – which in turn deprives it of the extra funding which would help to deliver that quality
- It is hard to innovate in such a regime dominated by suspicion of new, untried methods and preferring a known formula

From those buy-side firms who did join EAI and try to support this initiative, it became clear that:

- It is hard to take a leadership position when the rest of the market, especially clients and investment consultants more or less ignore a voluntary initiative – eventually energy fades and senior management attention drifts. Whilst it may be true that “we cannot have sustainable

---

<sup>20</sup> Other key drivers have been the voting surveys like Institutional Investor and Thomson Extel (which define bonuses)

retirement income without sustainable financial markets”,<sup>21</sup> pension executives do not have, as part of their day to day priorities, the task of looking after the long term health of the economy as a whole.

- Although firms made the commitment to join, there were questions from sell-side participants about whether the commitment was actually translated into practice. It would not be surprising if the factors referred to in the above paragraph were not also, to some degree, present amongst EAI members since the commitment to join comes from the CEO/CIO and the implementation mechanism for commission happens far below him or her.

In summary, it is certain that a project like EAI can act as the catalyst for innovation. PRI is the right body to oversee scaling up this process of change but to achieve this, PRI members will need to do more than they currently have committed to do with regards to encouraging sell side research on material ESG aspects of corporate performance – i.e. they will need to allocate credible amounts, be transparent about this with brokers, institute benchmarking process which will drive amounts upwards, and prioritise within their evaluation process, the "mainstreaming" of ESG analysis and not niche report production.

Post crisis one would hope this learning and leadership will happen but to ensure it does, we have proposed regulator nudges (see section 10) which will shift the culture of interactions between buy and sell side in a way which makes it rational for buy side and asset owners to want to show leadership.

### ***Voluntary unbundling***

The debate around Spitzer and conflicts of interest did generate an upsurge of interest in the concept of “unbundled” research and a series of start-ups. These were based either on well known sector analysts marketing exclusively specialist research or on enterprising boutique brokers latching on to the independence & integrity argument as an ideal marketing tool to sell their agency services (trading as well as research) against the more opaque product of the integrated investment banks.

Several firms in both these categories have flourished during the 2003-07 bull run in equity markets but not on a broad enough scale to make a dent in the domination of research from the integrated houses. Despite the intuitive arguments in favour of such independent research during the radical re-shaping of values which has occurred through the credit crisis, there is little evidence to suggest that these unbundled sell-side boutiques are likely to hold up better during the downswing of the cycle.

---

<sup>21</sup> Quote from Keith Ambachtsheer in *Pension funds could show the way*, Pauline Skypala, Financial Times, (4 January 2009)

## 10. Three simple proposals for modest reform

- *Full disclosure of research payment contracts*
- *Analysis of recommendation balance*
- *Name-and-shaming of corporate “freeze-out” tactics*

Two radical measures could eradicate most of the flaws in sell-side research which have been identified in this report. First, the buy-side could fund the creation of a wholly independent financial analyst profession. Excellent advances have been achieved over the past decade by the Chartered Financial Analyst (CFA) Institute in this direction, but this remains a voluntary regime largely funded by the sell-side. Second, the integrated structure of the sell-side could be forcibly unbundled via legal break-up of the corporate, trading and investment advisory functions.

The latter is frankly too radical a measure for politicians and regulators in the USA or Europe<sup>22</sup>. Today, such change is described as “too risky” given financial markets. And when markets are doing well, such change is “patently unnecessary”. Sell-side break-up combined with the creation of an independent analyst profession, accountable to the buy-side, may be the only route towards root-and-branch reform of current research constraints and distortions. Yet in the absence of what is needed, there are three much simpler and easier-to-implement measures which could at least reduce the scope for undermining analyst independence.

### ***10.1 Detailed and standardised disclosure by buy-side to clients (and their agents) of financial relationships with the sell-side:***

Currently, the buy-side is effectively paying for research using client money and there are serious questions to be asked in terms of value for money. As recently stated by respected commentators Integrity Research: “*the buy-side's reliance on sell-side firms for access to company management seems to us to be rather suspect part of the value proposition of their research offering. Not only is it unclear how one can argue that management access is actually research, but it is also surprising that large buy-side firms continue to pay for a ‘concierge service’.* Large buy-side firms should be able to get access to most company management teams they want to meet, thereby eliminating the need to pay so much to the sell-side to arrange these meetings.”<sup>23</sup>

Moreover: “*Numerous studies in recent years have shown that the value of traditional research reports has been on the wane, while other factors, including direct analyst service and management access are becoming the core source of value for the buy-side. However, the continued production of research reports by most sell-side and alternative research providers suggests that many have not understood this dramatic shift in perceived value.*”

Put simply, clients have a right to know how their money is spent. Hence regulators should require all buy-side firms report to their clients: what goes to research/company access/trading and how it spread between sell-side firms. In addition, buy-side should disclose any related business arrangements with sell-side firms (eg stock lending, prop trading etc). As with the sell-side, associations representing buy-side should be given an opportunity to develop a standardised and appropriate framework but if this cannot be done in due time, the regulators should make clear they will define such a framework for the sector.

### ***10.2 Universal reporting framework for percentage of buy/sell/hold***

One consequence of the Spitzer deal is that all sell-side firms now report, in some way, on the independence of their recommendations. At present, most brokers simply give the percentage of investment banking clients in each of the categories they monitor (generally buy, sell and hold). The only way to confirm, at least statistically, that their research and investment banking divisions are indeed independent of each other is to see if the proportion of investment banking clients in each category is about the same. Comparison between brokers, on the other hand, is not always possible, and even when it

---

<sup>22</sup> *A Tame Regulator for the SEC*, Robert Kutner, [www.prospect.org](http://www.prospect.org), (18 December 2008)

<sup>23</sup> *The Changing Value of Investment Research*, Integrity Research, (29 July 2007)

is, this information is never explicitly presented and requires some amount of calculation. What would be much more useful to the readership of these reports would be a common standard to bring some uniformity, and hence better comparability to their disclosures. Morgan Stanley comes closest to this recommendation, in that it provides the number of companies in each category for companies covered as well as investment banking clients, and is the only broker to show explicitly the contrast between the buy:hold:sell numbers for all companies and those for investment banking clients. There should also be a historical track record: currently brokers provide only the latest statistics. ***Since this is likely not to be quick or easy for brokers to agree on an entirely voluntary basis to do what they would prefer did not happen – i.e. easy comparisons - regulators in key markets should jointly give brokers a reasonable time period in which to deliver an acceptable reporting framework, or face an imposed one***<sup>24</sup>.

### ***10.3 Analyst freeze-outs***

One of the many things that now out-going SEC Chairman Christopher Cox indicated that his agency's staff would look into and fully intended to 'tackle' was the problem of company's freezing out analysts that wrote negatively about the company, a goal which remains unmet. As David Weild IV, a former official at Nasdaq, notes, analyst freeze-outs remain "*the rule rather than the exception*."<sup>25</sup> Such freeze-outs have a negative impact on the firm's ability to deliver access to senior management, something which the buy-side are increasingly wanting. It also reduces the analyst's knowledge of sensitive news.

***Regulators should require all research firms, as a condition of their license to operate, to report companies which do this. Firms that do not report such freeze-outs should be fined.*** Such action would soon expose company management who take these decisions to scrutiny from board directors, media and investor scrutiny: bullying is harder in the open. In advance of such regulation, investor trade associations could play the same role but as always with voluntary whistle blowing initiatives, they will not be adequate in all countries and in all situations, so hence the need for regulatory action. What, for example, would a trade association do if it had to embarrass one of its own powerful members?

---

<sup>24</sup> The precedent has been set in recent Government/Finance sector discussion in many countries. For example, according to Bloomberg, the Federal Reserve gave U.S. futures exchanges less than a week to present written plans on how they would make the \$55 trillion credit swaps market less risky (28 October 2008).

<sup>25</sup> Coming Distractions, John Goff, [www.cfo.com](http://www.cfo.com) (1 April 2006)

## 11. Post-Script on the real purpose of regulation

Regulation cannot change culture by itself but it can trigger governance changes within organisations and between clients/suppliers. What is needed is a ‘nudge’ approach to regulation which triggers new behaviours.<sup>26</sup>

For instance, promoting disclosure of comparable buy:hold:sell ratios would cause management to be interested in their relative performance on this issue and to monitor this indicator over time. As part of a balanced scorecard approach, it could lead to greater introspection and accountability than there has been to-date, not least because clients, and potentially regulators could ask outliers to explain. And it provokes a TQM improvement approach by harnessing market forces. For example, the average buy:hold:sell ratio is about 49:39:12<sup>27</sup>. It is unclear why any house should think there are more buying opportunities than selling, and it is even more unclear why *all* houses should think this. Transparency and competition could well bring the ratio to more what it should be if long-term investment is the primary purpose of markets – namely more holds and equivalent numbers of buy and sell.

This is just one example of how well crafted regulation can result in behaviour and culture change. That change has to be grounded in a new way of working which has many dimensions including: a different, more discerning type of board director; design of compensation which places greater focus on the longer term and on risk; stronger human capital management culture<sup>28</sup> – put simply, a greater focus on an integrated approach to sustainable financial markets.<sup>29</sup> The ideological ‘voluntary only approach’ has been singularly ineffective in general and particularly so in terms of the market failures in investment research supply.<sup>30</sup> So too has old style punitive regulation. It is high time we learnt to use regulation more effectively and more quickly. Given the future role of Cass Sunstein in regulatory cost-benefit analysis in the US<sup>31</sup>, there are grounds for optimism that these three proposals could soon be put into effect, especially if asset owners and opinion-shapers make clear their support and regulators take a longer-term and systemic approach to evaluating costs and benefits and learn the lessons of regulatory capture.

---

<sup>26</sup> <http://www.nudges.org/>

<sup>27</sup> Unpublished analysis, Shaunak Meweda, AXA IM (2008)

<sup>28</sup> It is almost unimaginable that McKinsey reports – accurately in the authors’ experience – that banks face a talent shortage! Given the compensation packages paid, this highlights the huge weaknesses at the core of the sector’s approach to sustainable value creation: *A Talent Shortage for European Banks*, McKinsey & Co Quarterly, July 2008

<sup>29</sup> [www.sustainablefinancialmarkets.net](http://www.sustainablefinancialmarkets.net)

<sup>30</sup> Self-Regulation Means No Regulation, William Buitter, Financial Times (10 April 2008)

<sup>31</sup> *The Sunstein Appointment: More Here Than Meets the Eye*, [www.progressivereform.org](http://www.progressivereform.org), (9 January 2009)