



## *IR Strategy Series*

# The October Revolution on Wall Street

*Strategies for adapting to the changing research landscape*

## **Introduction**

The past twelve months have brought about a sea change for sell-side analysts and their research processes. Anger among individual investors after the collapse of many technology stocks, well-publicized corporate boardroom abuses and repeated disclosures that research reports from the top Wall Street firms were tainted by flagrant conflicts of interest have led to far-reaching reforms in how Wall Street covers common stocks. The Sarbanes-Oxley Act and new regulations from the Security and Exchange Commission (SEC) and the National Association of Securities Dealers (NASD) all aim to eliminate conflicts of interest arising from stock research that put investment banking profits ahead of investors' best interests.

The drive for structural reform on Wall Street reached a new level of urgency on October 24, 2002, when the SEC's enforcement chief, Stephen Cutler, and New York state attorney general Eliot Spitzer, joined forces to outline a plan to overhaul sell-side analysts' research processes, eliminate conflicts of interest arising from the "synergies" between banking and research, and provide retail investors with access to independent research reports. This culminated in the "Global Settlement" that was signed on April 28<sup>th</sup>, 2003 between the ten largest brokerage firms in the nation and a raft of regulators, including the SEC, NASD, NYSE, the New York Attorney General and other states, which included \$1.4 billion in fines and restitution.

Among the provisions of the settlement were:

- Brokerage firms must separate reporting structures for analysts and investment bankers;
- A significant portion of each analyst's compensation must be based on the quality and accuracy of the analyst's research;
- Solicitation of investment banking business by analysts is prohibited;
- Analysts are prohibited from participating in investment banking road shows;
- Analysts' contacts with investment bankers are limited so as to maintain the analyst's role as gatekeeper in the offering process, but to prevent the analyst from serving as marketer or cheerleader for investment banking transactions; and
- Policies and procedures must be designed to prevent bankers from influencing the contents of a research report to obtain or retain investment-banking business.

In addition, a number of self-regulatory organizations, such as the Association for Investment Management and Research (AIMR) and the National Investor Relations Institute (NIRI) have proposed guidelines that would expand the reach of the reforms to cover buy-side research, corporate issuers, investor relations executives and related professionals.

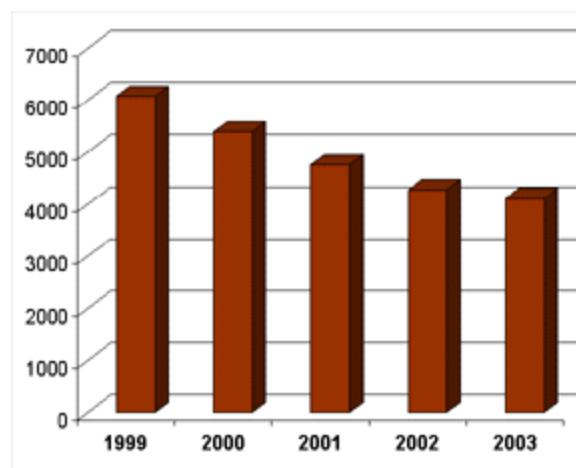
## **Reengineering Wall Street**

Taken together, these sweeping changes have redefined the role of research analysts. But more profoundly, they aim to reengineer the way in which Wall Street has conducted business for the

past decade or more. Following the Global Settlement, sell-side analysts will be definitively separated from the machinery of investment banking – which had heretofore subsidized their economic status as high-priced “loss leaders” for integrated broker-dealer organizations. This is having profound consequences, both intended and unintended, on established processes for analyzing stocks, disseminating material information to investors, and capital formation. Among the most important effects are:

- The number of sell-side analysts working at major brokerage firms has declined sharply, leading to many small- and mid-cap companies becoming Wall Street “orphans” with limited or no research coverage.
- There has been a corresponding increase in the number of independent or boutique research shops attempting to fill the void for high-quality, unbiased research.
- Investment banking assignments are no longer a guarantee to a firm establishing or maintaining research coverage.
- In an effort to restore their tarnished credibility and comply with new rating system standards, many sell-side analysts have been more prone to issue downgrades and “sell” recommendations on underperforming stocks.
- Some issuers have responded to this skeptical climate by cutting off access to analysts with an unfavorable view of their prospects.
- In desperation, a number of micro- and small-cap companies are turning to “paid research” in an attempt to generate interest in their stocks.

### **Wall Street’s “Orphans” Fewer companies with sell-side coverage**



It is indisputable that sell-side analysts play a critical role in the efficient functioning of equity markets. Stocks that have no coverage are likely to have less liquidity, greater volatility, a higher cost of equity capital and reduced access to the capital markets than stocks with adequate research coverage. However, it is equally indisputable that the economic model supporting high-quality stock research is broken. During this period in which Wall Street struggles to reinvent itself, companies will have to be more resourceful, better informed and more deeply engaged in the process of investor communication than ever before. In this paper, we sketch some of the most important features of the new landscape of equity research and suggest techniques that companies can adopt to get their stories heard

### **Bricking Up the “Chinese Wall”**

A few years ago, the process for gaining analyst coverage was relatively straightforward. First, a company had to identify a transaction – be it an initial public offering, follow-on offering or sizable acquisition – that would support a meaningful investment banking fee. Then the issuer would meet with the investment banking teams and analysts at the brokerage firms that were most highly regarded in the industry, as measured by *Institutional Investor* or other rankings. Following this “bake off,” the management would select the team that was most enthusiastic about their company’s prospects, and thirty days or so after the transaction closed, research was established -- nearly always with a gilt-edged “Buy” rating attached.

Following the Global Settlement, investment banks that explicitly tie research coverage to deal flow will risk censure, fines, customer lawsuits and scads of bad press. While broker-dealers may be more likely to cover companies where they have brought their institutional clients into the stock, it is quite possible that coverage may be established with a “sell” or “hold” opinion if the analyst in question does not share the bankers’ high opinion of the shares. Because analyst salaries must now be paid out of funds generated from retail brokerage accounts and institutional trading, neither of which is nearly as lucrative as investment banking fees, it is likely that the absolute number of analysts working for major brokerage firms will continue to decline.

More significantly, research by “bulge-bracket” firms is becoming concentrated on large-cap names that trade millions of shares each day. Given diminishing commission margins and the time-intensive process of conducting fundamental research, analysts will have no incentive to follow companies that cannot support their trading desks. These analysts will still specialize in a narrow range of industries and write in-depth research reports on a small number of companies that are distributed to an extensive network of institutional and retail clients of the brokerage firm. Even if the number of research analysts employed by the largest ten firms remains at the current levels of about 3,000 designated research analysts and 2,000 research associates,<sup>1</sup> the focus is likely to be almost exclusively on large-cap companies.

In addition to the Global Settlement, analysts must now abide by a much more detailed set of regulations of their professional conduct issued by the SEC and NASD. Regulation Analyst Certification (**Regulation AC**), which became effective in April 2003, requires that analysts certify that the opinions expressed in the research reports accurately reflect their own views, disclose any compensation received with specific recommendations or views, and require broker certification of public appearances made by research analysts.

The NASD’s series of reforms has increased regulation of research analysts and research reports so as to improve the objectivity of research and provide investors with more reliable information when making

investment decisions. These new rules incorporate the following main elements:<sup>2</sup>

- Require research analyst compensation to be independent of investment banking relationships;
- Prohibit submitting the research report to the subject company for approval;
- Restrict publishing reports and public appearances during designated public offering quiet periods;
- Prohibit publishing reports during “bake-off” period when banking deals are being negotiated; and
- Require registration, a qualification exam and continuing education for research analysts.

All of these new regulations have had the effect of making analysts less willing and less able to play the role of corporate cheerleader and consigliere that Jack Grubman and his imitators assumed at the height of the tech bubble. More importantly, sell-side analysts are struggling to reestablish their credibility as providers of untainted analysis to their institutional clients and brokerage sales force.

At the same time that the SEC, state regulators and brokerage firms were reaching a settlement, AIMR and NIRI were introducing guidelines that extended to buy-side research, corporate issuers, investor relations executives and related professionals and sought to significantly reduce a company’s ability to influence sell-side research reports. These guidelines attempted to address questionable tactics that some companies employed to secure favorable coverage, such as refusing to communicate with an analyst with a negative view of the company, declining to participate in buy-side meetings with arranged by the analyst or in investor conferences sponsored by the analyst’s firm, and shopping banking deals. While these guidelines do not have the force of law, companies that flout them may be singled out for embarrassment by the financial press.

### **The Rise of the Independent Analyst**

One aspect of the Global Settlement that created high expectations was the requirement that major broker dealers fund the creation of independent

research reports and supply them to their retail clients free of charge. Under the terms of the settlement, \$450 million will be paid out over five years for independent research and each of the firms involved in the settlement will be responsible for selecting as many as three additional reports from independent “third-party research analysts.”<sup>3</sup>

This inspired the hope that a new crop of independent research shops would arise to supplement the diminished firmament of Wall Street research stars. However, there were two significant flaws in the regulators’ scheme. First, successful independent analyst shops generate their revenues by selling proprietary research to institutional clients. Having these reports widely circulated through broker-dealer networks would dilute the value of their insights and destroy their business models. Second, the bulk of these research dollars will fund reports on the most liquid, large-cap names that already have extensive research coverage. Small- and mid-cap companies, where the flow of information is least efficient, will not benefit from these research dollars.

Not surprisingly, the prospect of \$450 million being distributed has inspired a mad scramble by individual firms and consortia to position themselves as worthy recipients of Wall Street’s indulgence dollars. Best Independent Research (BIR) is a consortium of six independent research firms (Callard Asset Management, Channel Trend, Columbine Capital Services, Ford Equity Research, Global Capital Institute and Market Profile Theorems) that was formed to compete for the third-party research opportunities.<sup>4</sup> BIR is made up of research firms that were completely free of investment banking and cover more than 500 stocks. However, the firms included in BIR rely upon computerized quantitative analysis techniques, eschewing interaction with corporate management. This data-crunching approach means that these firms generate little meaningful insight into a company’s strategy, competitive position, or market prospects.

Investorside Research Association (ISA) defines independent research in a different manner by declining to provide research to the sell-side and instead relying on revenue from providing research to buy-side institutional investors, hedge funds, and individual investors and from market making and

trading activities. ISA includes some of the oldest independent firms and many that are only a few years old, including American Technology Research, Argus Research, Avalon Research, Green Street Advisors, OTA-Off The Record Research, Schaeffer’s Investment Research, Triad Securities, Vista Research, Battle Road Research, GARP Research, Precursor Group, Sidoti & Co., Vickers Stock Research, Investars, BNY Jaywalk, Inc., McLean & Partners and Weiss Ratings. In addition, ISA intends to create individual and institutional investor certification designations for its participating firms’ reports.

### **Who Qualifies as Independent?**

Broadly defined, independent analysts consist of those firms that do not engage in investment banking services and do not generate fee-based research under agreements with covered companies. Based on this definition, there are slightly more than 140 independent research firms that rely primarily on revenues derived from selling research reports directly to institutional investors or the public at large. Diverging opinions complicate attempts to further narrow the definition to exclude firms that conduct trades, have asset management affiliations, or are willing to sell research to sell-side firms. Most of these firms are focused upon particular market niches, with only 30 of the 140 covering more than 500 stocks. Excluding the firms that fall under the “financial media” classification by only publishing research reports as part of a subscriber-based financial newsletter and analysts that do not meet the AMIR requirements, there are fewer than 60 independent research firms.

Out of this universe, there are fewer than a dozen research shops – including B. Riley & Company, Fulcrum Global Partners, and Sidoti & Company – that regularly cover small-cap names that are at the greatest risk of being Wall Street orphans and also submit earnings estimates to First Call. So while the rise of independent analysts is an important trend, it is not yet sufficient to compensate for the consolidation of coverage at the major firms.

### **Role of Boutique and Regional Firms**

Analysts with mid-tier, regional and boutique sell-side firms will continue to play an important role in providing coverage for companies in their regions and in specialized niches. While these firms have thus far

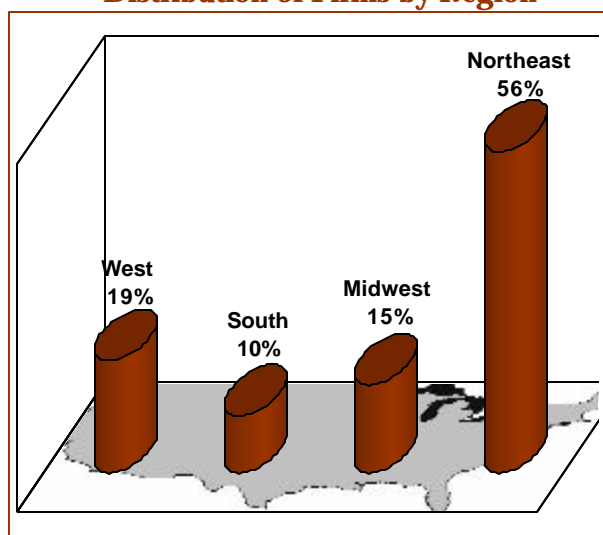
been spared the close scrutiny of the federal regulators, many have suffered from the downturn of stock trading and equity issuance during a three-year bear market.

# Sample of Research Firms — Sorted by Size and Services

		Investment Banking	Retail Network	Trading	Institutional Clients	Asset Management	Fee Based
<b>Top-Tier</b>							
ABN AMRO	ING						
Banc of America	JP Morgan Chase						
Bear Stearns	Lehman Brothers						
CIBC	Merrill Lynch	✓	✓	✓	✓	✓	
CITI Group	Morgan Stanley						
CSFB	RBC						
Deutsche Bank	UBS Warburg						
Goldman Sachs							
<b>Mid-Tier</b>							
A. G. Edwards	Raymond James						
Edward Jones	Robert W. Baird	✓	✓	✓	✓	✓	
Fahnestock	Wachovia						
Jefferies & Co.	William Blair						
Legg Mason	US Bancorp						
<b>Boutiques</b>							
AHH	HD Brous						
BMI	JMP						
Craig-Hallum	KBW						
D. A. Davidson	Leerink Swann	✓	✓	✓	✓	✓	
Davenport & Co.	Moors & Cabot						
Dougherty	Roth Capital						
FBW	SG Cowen						
Fox-Pitt, Kelton	Stephens						
GKM	Thomas Weisel						
<b>Independent--With Trading</b>							
Argus Research	Fulcrum Global						
Avalon Research	Precursor Group			✓	✓		
B. Riley & Co.	Roffman Miller						
C. L. King	Sidoti & Co.						
<b>Independent--With Buy-Side</b>							
David J. Greene	ThinkEquity			✓	✓	✓	
PNC Advisors	Value Line						
Sanford C. Bernstein	WP&G						
<b>Independent--Without Trading</b>							
Callard	Ford Research				✓		
Channel Trend	MPT						
Columbine							
<b>Independent--With Fees</b>							
J. M. Dutton	S&P				✓		✓
RedChip	Taglich						

A succession of mergers and acquisitions since 2000 has decreased the number of regional and boutique firms by over 25%, to approximately 700 in 2003. Interestingly enough, during the same time frame, the number of designated research analysts and associates working at these firms increased about 17% to 7,000<sup>1</sup> as many of the top research analysts laid off by Wall Street giants were snapped up by the boutiques and regional firms.

**Distribution of Firms by Region**



The smaller regional and boutique firms compete by focusing investment banking and research efforts on narrow industry groups, smaller emerging growth companies and niche geographic markets, which have been largely ignored by top-tier brokerage firms. By selling their research directly to institutional investors and hedge fund managers and generating trade commissions, these regional and boutique firms continue to provide an important source of high-quality, reliable research. While these firms have escaped the full brunt of the Global Settlement, they are also in the process of reforming their research and investment banking processes so as to comply with SEC and NASD regulations. Some of them may also seek to provide “third-party research” for the top-tier brokerage firms.

### **What Does the Buy-Side Want?**

In all the discussion of how to reform research practices, the requirements of buy-side professionals

have been largely ignored. The assumption of the regulators appears to be that these professional investors (who effectively fund the majority of stock research) are sophisticated enough so as not to require any special protection. Yet it is fair to say that there has been a quiet revolution in how the buy side thinks about and consumes research coverage.

A recent survey by The Greenwich Associates revealed that in the wake of budgetary constraints institutional investors are realigning their priorities and cutting costs in a number of ways, including directing more business to electronic brokerage systems, hiring more in-house analysts and employing cost-benefit ratios for research and trading expertise. *Institutional Investor* magazine also recently reported<sup>5</sup> that buy-side firms are toughening the voting systems that are used to rate research reports and determine where trading commission dollars will be directed. While buy-side equity analysts will continue to use a diverse array of stock selection and portfolio management techniques -- including top-down industry analysis, quantitative screens, relative valuations, and bottom-up hands-on interaction with the management of targeted companies -- the cost-cutting initiatives are undermining Wall Street’s ability to support enormous research staffs, while creating opportunities for boutiques, regional brokerages and independent research firms.

Recent surveys of buy-side professionals conducted by the Tuck School of Business at Dartmouth and Connecticut-based Greenwich Associates provide insight into their relationships with the sell-side and independent research communities. The consensus of both surveys reveals that buy-side professionals rate the following aspects of existing relationships with the research community as most valuable:

- Detailed research reports;
- Accuracy of research reports;
- Announcement of downgrades;
- Research report updates;
- Informative discussions with sell-side analysts; and
- Meetings with company management.

The surveys also revealed the growing use of independent research services by buy-side professionals. The Dartmouth survey reflects an evolving attitude with only 47% of respondents citing independent research is more reliable than sell-side research; however, more than 60% of the respondents feel usage of independent research services will increase in direct relationship to improvements in the quality of the services.

## The Quest for Coverage

The quest to obtain adequate research coverage has always been one of the most important and most challenging components of every investor relations program. And it's getting tougher every day. IR professionals need to be aware of the implications of new regulations for corporate disclosure practices and rethink existing strategies for investor communications, analyst targeting and investor outreach. In order to effectively tell their story and gain the highest sustainable fair market value for their stock, companies should:

- 1. Develop direct channels of communication with the buy side.** Once upon a time, a company could effectively transmit information to investors by having in-depth, regular briefings with a handful of sell-side analysts working for the top Wall Street firms. These analysts would write thoughtful reports and then transmit the "story" to hundreds of institutional clients who would set the price for the stock through buy and sell decisions. This strategy is no longer viable, due to the diminished credibility of Wall Street analysts, the dwindling number of analysts, and the regulatory restrictions imposed by Reg FD and Sarbanes Oxley. Today, companies must be able to communicate effectively with dozens or even hundreds of buy-side firms that control their valuation destiny, and these firms are even more receptive than in previous years. According to The Greenwich Associates survey, in 2002, the average annual number of contacts that the buy-side had with management increased to over 11 times, up from just over eight times in 2001. However, IR professionals should continue to develop relationships with analysts at large Wall Street firms, even if they have a low chance for being

picked up for coverage. Establishing relationships can lead to inclusion in industry overviews and be an excellent opportunity for exchange of competitive intelligence with some of the most informed followers of your industry.

- 2. Identify and target mid-tier, regional and boutique brokerage firms for research coverage.** Research analysts with many smaller brokerage firms are becoming more proactive in seeking out less well known or undervalued investment stories so as to differentiate themselves with institutional clients. Many of these firms focus on narrow industry niches and have more flexibility as to the market cap of companies they can cover. They may also employ "special situation" analysts who focus on turnarounds or complex stories. While these firms do not have the massive retail sales forces of the major Wall Street houses, they often have developed a following among buy-side analysts who cover a particular industry, invest in small-cap stocks, or pursue a specific investment style. In targeting these firms, it should be recognized that even post-reform the prospect of an investment banking deal may be a decisive factor in a firm's initiation of coverage. However, with over 700 firms today, this target group represents the best opportunity for finding coverage for companies with a market cap of less than one billion dollars. Because of the frequent turnover and greater flexibility of analysts at regional and boutique firms, it is important to have an in-depth knowledge of the firms' current staffing trends, research mandates and affinity for particular industries or valuation models so as to identify the best candidates for coverage.
- 3. Identify and target independent research firms.** Independent research firms are becoming a more visible and more influential force within the investment community, particularly for small- and mid-cap stocks. Because their buy and sell recommendations are not driven to corporate finance deals, their credibility may be higher with institutional

investors and hedge funds. While the \$450 million dollar incentive package will encourage more firms to enter the market, most of this money will be spent on procuring supplemental research of companies already under coverage by the larger brokerage firms. As a relatively new industry, the cast of independent research firms is changing quickly and there is enormous variation in the quality and the format of the research they produce. Companies should focus on those firms that have a solid following among institutional investors, conduct in-depth company and industry research, and post earning estimates and recommendations to First Call on at least a quarterly basis. Fee-based research should be viewed as a last resort in order to gain circulation for corporate information, since the investment conclusions are likely to be ignored by professional investors and may even call management's credibility and judgment into question.

**4. Become your own analyst.** As the pool of qualified analysts diminishes, companies will have to take responsibility for doing much of the essential analytical work that was formerly done by Wall Street. This includes clearly articulating an investment thesis that is grounded in financial performance data, informed by market realities and closely aligned with business strategy. Companies can make it easier for time-challenged investment professionals to take an interest in their story by publishing high-quality corporate profiles or fact books, including detailed discussions of business strategies and competitive landscape in filings and investor presentations, and offering downloadable financial models on their websites that investors can then test with their own assumptions about future growth and margin trends. Perhaps the most important result of the recent Wall Street reforms is that responsibility for setting investor expectations and crafting the corporate story has been set squarely back where it belongs – with the company itself. Living up to this responsibility will require a greater investment in investor relations resources, more highly developed skill sets from IR professionals and a corporate culture of transparency and true partnership with the suppliers of equity capital.

## Summary

Just as abuses in corporate boardrooms brought about regulatory intervention with the Sarbanes-Oxley Act, disclosure of widespread conflicts of interest and misrepresentation in published research reports are driving sweeping reforms of the brokerage industry. The changes are intended to overhaul sell-side analysts' research processes, eliminate conflicts of interest that distorted research recommendations, provide retail investors with access to independent research reports, and address grievances of a growing investor revolt. These changes are transforming established practices for gaining research coverage and raising capital on Wall Street, creating significant opportunities for independent research firms and raising new challenges for IR professionals, who will need to rethink the way in which they target and interact with analysts and devise new strategies to reach the broader investment community.

<sup>1</sup> Directory of Investment Research 2003, Volume I – Research Firms, Thomson Financial

<sup>2</sup> "NASD and NYSE Rulemaking, Proposed Rule Changes," Securities and Exchange Commission, December 31, 2002. Available on <http://sec.gov/rules/sro>

<sup>3</sup> "Wall Street to Reform Analyst Conflicts," Josh Long, Best Independent Research, December 2002.

<sup>4</sup> "Research Revolution," Lewis Brahan, Business Week, December 2002.

<sup>5</sup> "Buy Side Toughens Research Voting Process," Sarah Gordon, Institutional Investor, March 2003.



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