A VISION FOR THE FUTURE OF INDEPENDENT RESEARCH IN EUROPEAN EQUITY MARKETS

"Objective and unbiased investment research is a key component of this endeavour."
The Forum Group, September 2003.

The Independent Research Think Tank

February 2005

TABLE OF CONTENTS

CHAIRMAN'S INTRODUCTION

In today's market equity research is largely produced by integrated investment houses with significant vested interests that are often at odds with those of their external clients. It is in the nature of humans that such conflicts will ultimately impact upon peoples' thinking: however well the Chinese wall is structured and the codes of conduct are obeyed, these conflicts do not go away. It is our belief that independent research and the companies that produce it have an important role to play not just in keeping everybody honest and on their toes but, above all, to give voice to the contrarian's view that is otherwise unlikely to be heard. Independent research is an important element in the maintenance of integrity in the market place. We believe that its presence is also a key factor in maintaining confidence in sell-side research and so will also be of benefit to the integrated houses research departments in the long term.

At the same time independent research is hampered by the fact that non-independent research is heavily cross subsidised. As such it becomes difficult to establish an independent research company as a self-sustaining venture. The viability of such enterprises can thus only be achieved through a separate regulatory recognition of the issues at stake.

Europe, contrary to the U.S., has not (yet) institutionalised the provision of independent research. As a result, in the U.S. this sector is rapidly reaching maturity while Europe is being left behind. This fact is important for at least two reasons. First, it demonstrates that independent research has a role to play as long as it is recognised by those that set the market infrastructure. Second, if this difference between the U.S. and Europe remains there will be another field (besides rating agencies for mutual funds and credit rating agencies) where U.S. firms will be totally dominant over European firms. If both are seen in Europe as undesirable then it is vital that independent research is moved higher on the political agenda.

The document we have produced serves as a stimulus and input for a broader discussion to establish independent research as a sustainable business venture in Europe.

George Möller

1 EXECUTIVE SUMMARY

This report examines the role of independent equity research. There has never been any doubt that the large investment banks produce some excellent research, although quality varies substantially by analyst. Furthermore, over the last couple of years regulation and better market practice have led to increased monitoring, control and disclosure of investment banking conflicts. **Has this made independent research redundant? Does it still have an important role to play in a new cleaner world? Why is the independent research sector so small?**

To answer these questions we ran an anonymous survey of 31 investors with combined assets under management of EUR 1.9 trillion[1], enabling fund managers to speak freely on this issue. The survey covered a range of fund managers including hedge funds, pension funds, insurers and asset management businesses ranging from the small to very large. The response to the survey was unequivocal – independent research has value to add:

1. We asked the investors whether disclosure of investment banking conflicts was adequate **–** only 45% of investors said '*yes*' and the rest were doubtful or felt it varies. One US investor who answered '*yes*' said "*we are now more aware than ever of potential conflicts"* and a UK asset manager who also answered 'yes' wrote "*as far as I'm concerned, disclosure of a conflict of interest does not remove the conflict*." (See Chapter 5)

2. Only 29% of respondents felt that disclosure of trading conflicts was adequate. Many felt disclosure was too vague to be of much help – one investor indicated that they still "*have absolutely no idea of the bank's proprietary trading position! Thus the statement that they may or may not have a trading [position] is more of a legal disclaimer than anything else."* (See Chapter 5).

3. 84% of respondents indicated that a properly researched independent report would be valuable during an IPO and respondents rated the input of the independent analyst as more useful versus the input of the syndicate analyst by a ratio of 17 to 1 (see Chapter 4). However investors also frequently cited lack of access for non-syndicate analysts as a problem e.g. "*More independent due diligence would be welcome. There is a lack of independent research pre-IPO. Advisers appear to stop IPO companies from utilising independent brokers."*

SO INDEPENDENT RESEARCH IS USEFUL

A large majority of investors believed independent research had a role to play by providing opinions free of conflict from corporate banking and/or proprietary trading, particularly at times of new issues. In related discussions with investors it also became clear that independent research had a clear role to play in governance matters – commenting on the performance of company management before a drama becomes a crisis.

[1] Over half of respondents were UK based, but responses were also received from the US and Continental Europe. Over two thirds of assets represented are managed by houses from which the independent brokers drafting the report have not received business in the last three years.

While the survey focuses on institutional investors, the integrity of financial markets – of which the availability of independent research is one key element - is even more vital for retail investors.

> The Forum Group Report[2] indicated that *"independents represent a potentially valuable source of unbiased analysis and opinion."* Yet, as that report goes on to explain, the sell-side offering in Europe lacks critical mass: "*we have not yet seen material changes in the structure of the financial services industry, therefore currently the ability of independent stand-alone research firms to operate with full effect has not been proven, despite some successes*.[3]" Why?

This lack of critical mass can be partly explained by the investor survey:

1. For all the enthusiasm expressed about independent research, most institutions surveyed indicated that they allocated little, if any, of their commission budget to independent research. Some 42% made no specific allocation, and only 10% of respondents allocated over 10% of their business and not one allocated over 20% (see Chapter 4). We believe this will change, but slowly.

2. Investors' ever increasing focus on transaction costs continues to drive volume to the larger houses and new trading solutions – for instance, our survey showed 45% of respondents are already using electronic crossing and direct market access systems. This is hitting commission income at the small brokers (independent research houses using commission-sharing may not be impacted in the same way). Unbundling will help here.

3. More important and less fixable is the pricing of research and this nut will be harder to crack. It appears that large houses are often prepared to offer investors research at below cost or even for free.[4] The Forum Group also made this point. Unbundling may not solve this problem.

4. Finally, Europe has not seen any major initiative to match the US settlement. Regulators in Europe have not pursued the past sins so there is no money-pot.

As a result smaller independent minded brokers often make the decision to add proprietary trading or corporate brokership to their services (see Chapter 5). As a result they become potentially conflicted i.e. not independent. Our definition is:

> **INDEPENDENT RESEARCH DEFINITION:** Investment research produced by regulated companies, whether this is paid for by traditional broking commission, by commission-sharing arrangements or by research fees. It excludes:
>
> - research from houses who derive income from investment banking or
> - who derive income from corporate brokerage, or
> - who conduct research paid directly by the company covered, or
> - who derive income from equity proprietary trading or market making

[2] Forum Group Report, 4 September 2003, Section 6.1, Page 46.

[3] The Forum Group Report, Section 5.3, Page 27

[4] In the old days this cross-subsidy was often a specific funding amount – say 30% of the research budget was paid by corporate finance. These days it might be more subtle – for instance, a more benign overhead allocation.

CONCLUSION AND PROPOSAL

First, despite all the time, effort and money spent by regulators and investment banks on improving disclosure and controlling conflict (or "symptom treating") the survey shows that many large investors doubt that analyst bias has significantly disappeared. The clear message from the survey is that there is also a need for independent research alongside the output of integrated houses.

Second, for various reasons (including cross–subsidies[5] in the large integrated houses) the independent sector in Europe is currently small and fragmented.

We ask DG Internal Market to conduct a "Forum 2" Report, which focuses on one question: "the case for independent research and what initiatives and measures must be put in place to ensure that a strong independent research sector emerges in Europe?"

[5] One commentator pointed out that if an Investment Bank needs a strong position in research for its overall business model then the specific research department profit and loss account may be irrelevant. He indicated that removing an explicit transfer from other departments to research does not end cross subsidy if wider strategic goals mean that the bank is tolerant of low or no returns from the research department.

Summary Of The Second Section On The SME Problem

The SME ‘problem’ may be worth a mention too. There is a wide political consensus that a vibrant small company sector is important for European growth and that one essential element in this context is effective access to equity capital. Yet small listed companies are often orphaned i.e. struggle to get analyst coverage beyond the point of initial listing.

Our survey showed that only 19% of respondents were “fairly satisfied” with European mid and small cap research, 52% indicated it varied per market, 13% indicated it was a real problem – the remaining 16% of replies were inconclusive. Investors clearly indicate that there are gaps in coverage.

Still more striking was the survey’s results on how houses performed on SME coverage, shown in the table below:

Responses to survey question 18 – which houses produce the best SME research?				
Integrated Houses	Smaller Houses[6]	Difficult To Generalise	Other	Total
0	16	11	4	31
0%	52%	35%	13%	

Low turnover in such stocks often makes research coverage uneconomic – see section 7.2 where we discuss the economics of small cap coverage. Those sell-side research teams who continue to cover these stocks, especially in the sub EUR 500m market capitalization range, often justify these loss leader research efforts by extra income from investment banking, liquidity providing/market making, corporate broking or even research for pay (i.e. financed by the company covered).

We believe, and again this is an issue of market integrity, that a second source independent opinion should be available on these shares, alongside research produced by issuers or corporate brokers. This issue is clearly on the agenda of the exchanges.

[6] While the marginal cost of coverage is the same for large and small brokers, the latter may find any programmes to stimulate SME research makes more difference to their business as a whole. Also in these stocks local knowledge is sometimes more important than having the wide industry coverage from sectoral teams.

2 THE SCOPE OF THE REPORT

We present a vision for the future of independent research in the EU.

Context

Our report refers repeatedly to key policy work in this area, in particular the Forum Group Report.[7] We also regularly refer to work done in the UK such as the 'Myners Report' and the resulting FSA policy documents CP 176 and PS 04/23.

We assume that the Forum Group's work will be a key input into future EU policy discussions, and so we have tailored our work to build upon the discussion of independent research covered in its report. Where we feel that the ground has already been adequately covered by the Forum Group, we refer readers to the relevant section of its report. We thus concentrate our discussion on areas either not covered by it or where we would wish to offer another perspective. The independent sector only rates a specific mention in the last of the 31 recommendations - "*analysts in independent houses should be required to respect the Principles of this report*". Of course, but what else? Our report aims to expand on this one topic.[8]

The Myners Report is another crucial input into the debate on equity research in Europe, in particular on the way investors should best pay for that research. We include a specific section on Myners and CP176.

Time Frame And Methodology

This report was compiled over a very short period between October and December 2004. This tight time frame has led to a report with very narrow parameters, focusing entirely on the potential of the independent research industry in Europe. The working group was small, consisting of Delta Lloyd Securities (team headed by Michael Sparkes), Independent Minds (team headed by Lucy Cottrell and Hans Plugge) and IRIS (team headed by Ronald Wuijster and Hemmo Hennes). This team produced the draft report, the survey and some of the ideas. IRIS collated the survey results.

The Investor Survey

This survey covers 31 institutions with combined assets under management of €1,936 billion, with a good range of fund types and sizes. The focus was to get a cross section in Continental Europe (assets surveyed €401bn), the UK (asset surveyed €1,505bn) plus a little feedback from a handful of US institutions (assets surveyed €30bn). While a survey of 31 institutions does not represent a statistically significant sample, it provided a forum for a number of serious institutions to tackle head on a few of the key issues and trends in European Equity markets.

---

[7] "Financial Analysts: Best practices in an integrated European financial market. Recommendations from the Forum Group to the European Commission services. 4 September 2003"

[8] "We are particularly grateful for the comments we received, but recognise that this informal consultative process was not exhaustive and that it will clearly have failed to obtain comments from all relevant sources. The consultations must continue." Page 4 of the Forum Group Report.

We summarise the findings on each question and also include some quotations which provide additional colour. The survey questions are shown in Appendix 2 and the survey results are recorded in the relevant sections of this report.

Investor Category					
Pension Fund	Insurance Company	Asset Management	Hedge Fund	Wealth Manager Private Bank	Other
4	3	17	3	3	1

Group Assets Under Management In Euros					
Up to €500m	€500m-€2.5bn	€2.5bn - €10bn	€10bn - €100bn	Over €100bn	Not Declared
3	5	6	10	6	1

European Equity Assets Under Management In Euros					
Up to €500m	€500m-€2.5bn	€2.5bn-€10bn	€10bn - €30bn	Over €30bn	Not Declared
5	8	8	2	4	4

The Committee

The whole project was overseen by an international Committee which challenged, refined, tightened the work and introduced new ideas. It was headed by George Möller, the CEO of Robeco. Appendix 1 lists the Committee Members.

Naturally not all the contents of the report can be ascribed to all members of the Committee. There were certainly differences of emphasis. However there was overwhelming support for the value of independent research, the need for a healthy debate on the topic and the attempts to create practical and affordable initiatives to breathe life into the sector.

The Follow Up

The IRIS team will organise a perception survey in 2005, gathering feedback from the various ‘stakeholders’ of (independent) investment research. This survey will include retail investors, institutional investors, specific government organisations and NGOs and the press. The survey will include questions about the value of research and, more specifically, of research independence.

At the same time as this report is presented IRIS will aim to show the results of the first annual measurement of a comparison between the investment results of independent research houses versus the traditional research model.

PART 1: INDEPENDENT RESEARCH

3 WHAT IS SPECIAL ABOUT INDEPENDENT RESEARCH?

In this chapter we examine the case for independent research. For instance, we look at a number of areas where these smaller, non-integrated providers should have a natural value-added. These include providing (1) an objective assessment of the attractiveness of new issues; (2) governance driven research, such as research which comments on the performance of company management; (3) wider research coverage of SME's (the latter being tackled in Chapter 7).

3.1 Independent Research Can Add Significant Value During New Issues

Firstly, independent research's greatest attraction is, strangely, 'what it is not': independent research is not compromised by serving more than one client constituency. This freedom from conflict enables the independent research segment to provide a check and balance. This explains why the SEC has ingeniously found a way to get the US industry to finance that independent voice.

This paper does not seek to argue that integrated houses will necessarily fail to deliver objective and unbiased investment research, although this has undoubtedly been the case in the past. **It is enough to accept the Forum Group's view that there are times when being completely objective may be a challenge**. According to the Forum Group Report "*new issues were found to be an area of particular concern to investors and to have high conflict potential*."[9] This topic is also discussed in depth in the chapter on "Conflict." The survey made clear that independent research has value to add here.

Survey Question 6: "What role, if any, can or should independent research reports play at the time of an IPO or issue?"

Of the 31 investors in the survey 2 respondents left this section blank, 1 hedge fund rarely participated in IPO's, a UK asset manager cited caveat emptor and one US asset manager felt the prospectus was for information and the sell-side research for amusement.[10] **The other 26 respondents – 84% – indicated that independent research had a useful role to play in a new issue process.**

In these responses the words *objective and unbiased* came up repeatedly. Investors wanted independents to offer "*a more realistic appraisal of the firm value and business plan*", produce "*an independent choice of the comparables*" and offer *"assistance … in confirming that pricing is appropriate for the issue concerned."* Overall there was a broad consensus that independent research houses could add value during new issues, providing that the analysts were given adequate access to company management.

[9] Forum Group Report, Executive Summary, page 6

[10] "If you have been around the block a bit and if you are in circumstances where sell side research is available during IPO processes, you can mostly look through the agenda, and have a laugh."

Survey Question 7: "In an IPO which is of more use (A) the opinion of the syndicate analyst (B) the opinion of the independent analyst (C) neither. Please can you give your reasons."			
Syndicate	Independent	Neither	NA or Both
1 3%	17 55%	8 26%	5 16%

17 respondents (55%) felt independent research was more useful while only one respondent answered that the syndicate analyst was more useful and that only due to preferential access: *"The syndicate analyst, although biased, gets more information."*

Of the remaining 13 respondents, 8 responded "neither" and a further 5 respondents gave a range of other answers. The reasons given by these 13 respondents are revealing**: lack of access for non syndicate analysts was cited by 6 respondents**; 3 respondents preferred their own analysis; 2 respondents felt that non-syndicate analysts might be influenced by sour grapes; 1 respondent felt independents did not make enough effort here; 1 respondent gave no reason.

We would like to highlight the replies of two respondents who tackled the access issue. Firstly, these are the comments of one large UK investor:

- Re question 6 the investor wrote "*Definitely worth reading. Any issuer that refuses to talk to independent analysts generally has something to hide. Key is getting corporates to give sufficient disclosure to non-syndicate analysts and investors; and people need to read the prospectus as well.*"
- Re question 7 the investor answered that "*neither*" analyst was useful, explaining that the "*independent would be more useful if they had access; when they are denied access then syndicate is the best of a bad job*."

A US investor reinforced this answer, pointing out the special US circumstances:

- Re question 6 – was there a role for independent research during issues - the investor wrote "*A critical role. As a US investor our information tends only to come through verbal communication with sponsoring institutions. This is clearly not objective, whereas independent research would be.*"
- Re question 7 the investor raised the access issue: "*Occasionally the input from the syndicate analyst is more valuable as they have more access to the company. In principle the best source would be an independent opinion with equal access to management*."

One of the very welcome suggestions of the Forum Group Report was that researchers from non-syndicate members should have access to meetings organised by the syndicate.

This is particularly relevant in the case of IPOs where an analyst cannot tap past knowledge: *"Companies should encourage and not restrict the attendance of analysts at financial information meetings organised in connection with an offering (for example by making attendance conditional on agreement not to publish or to submit research for review by the issuer), nor discriminate in terms of provision of information to analysts."*[11]

It is worth pointing out that the issuing companies themselves are mostly not in the driving seat on access – the lead manager or advising investment bank usually insists that non-syndicate analysts are not allowed near the company until after listing (and preferably until after the stabilisation period i.e. + 1 month).

We would like to offer one further suggestion to supplement the Forum Group recommendation shown above. In the case of an IPO price sensitive information is not a market issue - the company is not yet quoted. **There should be no reason why these non-syndicate analysts should not get access at the same point in time as syndicate analysts to create an informational level playing field.** It is worth bearing in mind that often in equity issues the large investors' meetings or roadshows happen very late i.e. within days of the moment when the investors must make a decision. In the case of an IPO, a non-syndicate analyst who is meeting the company for the first time will not have adequate time to produce a proper analysis of the correct valuation.

With the conditions mentioned above in place, we then believe the independent research analyst can offer a fund manager a useful, objective and well-informed insight into the attractiveness and pricing of the equity being issued.

Finally, we would like to make a more general point about analyst access. **While lack of proper access is clearly a major influence at the time of new issues, it can also be a day-to-day obstacle.**

As a rule, small firms still tend to get less favourable access although moves by the regulators to make information evenly available to all have greatly improved the situation. On one hand, it is true that a star analyst commands access just by dint of reputation and client list, even if the analyst is working at a small independent research house. On the other hand, companies not only favour "star" analysts but also tend to favour large houses (with or without the star analyst) purely because they believe, rightly or wrongly, that large houses have larger and more influential client bases i.e. by talking to one analyst from a large house you reach ten times the number of investors reachable by talking to an analyst from a small (independent) house. So it's not just the quality of the analyst that still causes bias, but also/largely the size of the "hinterland."

---

[11] Forum Group Report, Executive Summary, page 4

3.2 Research Which Comments On Company Management Performance

There are few outside observers whose knowledge and understanding of individual companies is as detailed as the sell-side equity analyst's. This is probably truer today than 20 years ago, since corporate consolidation and increasing demands from global investors have forced analysts to know an ever smaller number of companies in ever greater detail. It follows that few outsiders would be better placed to influence a company's governance by highlighting management and strategic weaknesses, and then getting investors and the share price to do the rest.

However, despite the reforms and procedural tightening which has ensued from the post-Internet bloodbath and Eliot Spitzer's crusade, this report will argue that there are still many influences, overt and subtle, which will continue to blunt the criticisms and undermine the independence of all but the most robust and well-established analysts.

In Corporate Governance one area of particular focus is the performance of management, both individually and collectively. Yet commenting on a company's management team is always sensitive. The large integrated houses can often be reluctant to publish research notes which comment specifically on individuals.

In practice an analyst at an integrated house will regularly make critical comments about a specific company manager but do this verbally while briefing the in-house sales desk or when talking to his/her client call list i.e. the inner circle of fund managers which the analyst services regularly. Retail clients and smaller institutions may therefore miss this vital analytical input.

This can effectively create two tiers of client – those clients privy to these asides and those relying on the written research (so outside the loop).

We believe that insights on management can be very helpful to an investor. Of course, comments on individual managers are not always necessary. For instance, in cases where the problem is an unsuccessful strategy the analysts can make hard hitting comments without mentioning personalities, and this is probably better.

On the other hand, there are also cases where the strategy is good but the leadership and execution is poor. For instance, this can occur when a strong long-serving CEO steps down and a successor struggles to cope with a management structure which is still dependent on charismatic leadership and not on collegiate decision-making. Even very stable companies with fantastic franchises can experience a significant deterioration in effectiveness during such a management transition period. The related investment risk may merit the attention of all investors in the stock.

Currently we observe that the press is the main debating forum for company management issues, along with a few activist fund managers at AGM's and shareholder activism organisations. This really is a lost opportunity. As mentioned earlier, analysts' highly focused approach means they may have even more to offer to the debate than a journalist with a more generalist mandate.

On independent houses' value-added in SME research see Chapter 7.

3.3 Is the Independent Research Sector Adding Measurable Value Now?

There is some evidence that the answer is “yes”. We start first with one caveat.

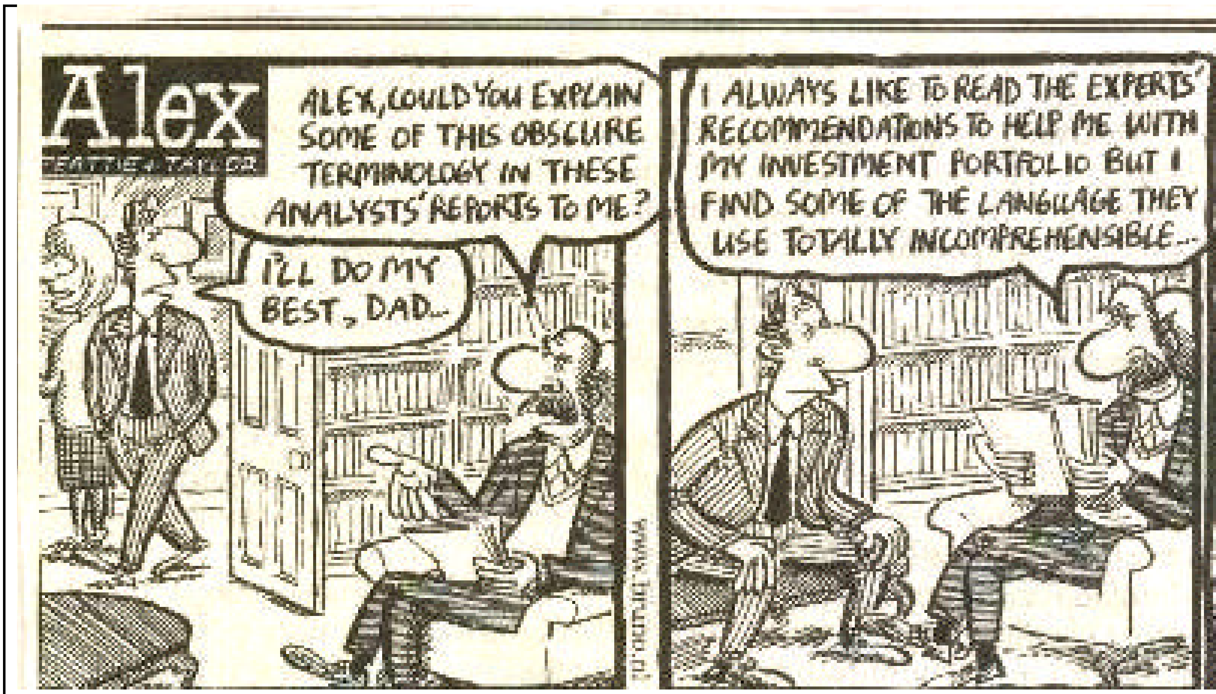
We will argue in section 3.4 below that good recommendations are just one component of what an analyst offers an institutional investor and that a very accurate and knowledgeable analyst can offer value even if his or her recommendation track record is poor. For the retail investor, of course, recommendations are crucial.

That said there has been a US study of comparative performance - “Comparing the Stock Recommendation Performance of Investment Banks and Independent Research Firms.” This has received some press attention in the US. The study was produced by Brad Barber of the University of California at Davis, Reuven Lehavy of the University of Michigan Business School and Brett Trueman of UCLA. We show the abstract below:

> Abstract: This study compares the profitability of security recommendations issued by investment banks and independent research firms. During the February 1996 - June 2003 period, the average daily abnormal return to independent research firm buy recommendations exceeds that of the investment banks by 3.1 basis points, or almost 8 percentage points annualized. In contrast, investment bank hold and sell recommendations outperform those of independent research firms by 1.8 basis points daily, or 4 1/2 percentage points annualized. Investment bank buy recommendation underperformance is concentrated in the subperiod subsequent to the NASDAQ market peak (March 10, 2000), where it averages 6.9 basis points per day, or slightly more than 17 percent annualized. More strikingly, during this period those investment bank buy recommendations outstanding subsequent to equity offerings underperform those of independent research firms by 8.7 basis points (almost 22 percent annualized). Taken as a whole, these results suggest that at least part of the underperformance of investment bank buy recommendations is due to a reluctance to downgrade stocks whose prospects dimmed during the early 2000's bear market, as claimed in the SEC's Global Analyst Research Settlement. Additional analyses find that the underperformance of investment bank buy recommendations extends not only to the ten investment banks sanctioned in the research settlement but to the non-sanctioned investment banks as well.

It is well documented that there have been far too many buys and far too few sells in the average broker’s recommendation lists. It is self-evident (assuming a market- or sector- relative rating system) that only half of the companies can be above the median. While index weightings may influence the exact point where you draw the line between an outperformer and an underperformer, still it is clear that brokers have been far too ‘buy’ focused. This cannot be attributed to bias or the fear of aggravating corporates alone – it is down to a factor often referred to as ‘the natural optimism of most analysts’.

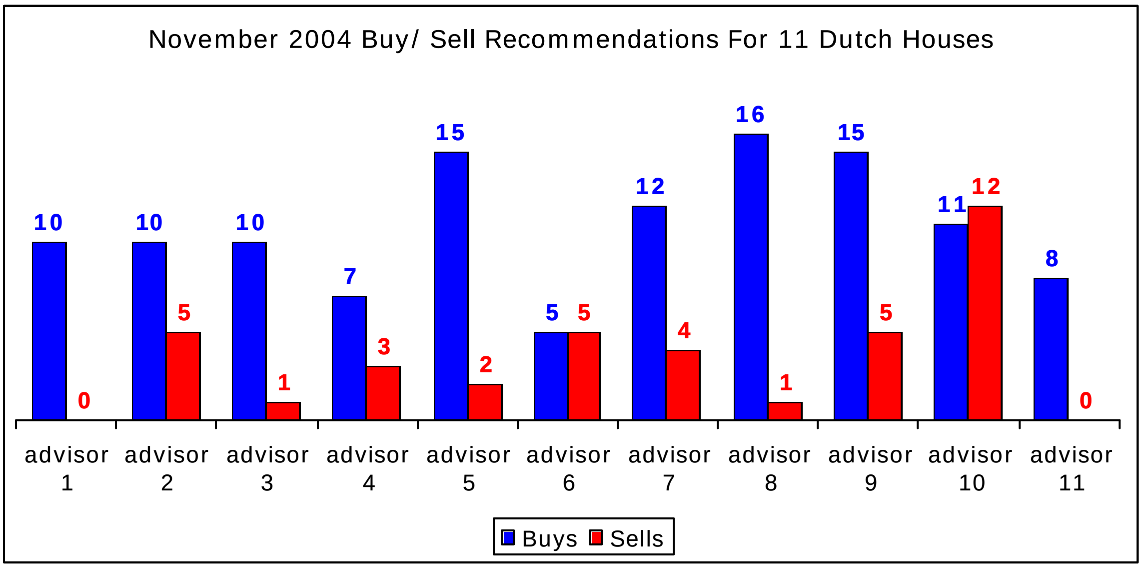
The bad old days were best summarised by this Alex Cartoon[12]:



The broking industry is certainly working hard to tackle this issue and much progress has been made in measuring the buy/sell/hold ratios. However it seems to be hard to crack this buy bias.

[12] Alex Cartoon (Peattie and Taylor) in the Telegraph and reproduced with their permission

For instance, we show below a recent overview from a Dutch investors' magazine,[13] which showed the main local brokers' recommendations on the Dutch AEX stocks. The names of the various banks and brokers have been replaced by numbers to avoid making examples. Everything else is as per the article.



At only two of the eleven advisors is there anything like parity between buy ideas and sell ideas - advisor 6 and advisor 10. Advisor 6 is IRIS, an independent research institute, owned by a fund manager and a big bank on a joint basis. Advisor 10 is a broker with no equity trading book and no corporate advice function. This suggests it may be easier for independents to pick sells even in the new more critical environment although this is by no means a statistically significant sample.

3.4 What Makes Good Research For Institutional Clients?

This question is not just important for the purposes of the discussion on independent research but also to evaluate how analysts should be remunerated. We do not claim to have the perfect answer to this big question but have endeavoured to reach a "working definition" of good research for the purposes of this discussion on how to preserve and promote research in the EU. We offer this definition:

Good research for institutional clients provides the information, analysis and/or ideas to assist a fund manager in reaching the right investment decisions.

It is obvious that investors find different things useful, depending on their own investment approach and their fund's investment process. For some fund managers the recommendation and the balance of factors by which the analyst reaches that recommendation is crucial; for other fund managers the information and industry background may prove more useful. Our survey highlighted four key research inputs:

[13] Beleggers Belangen, 5th November 2004, p32-33,' 'Overzicht Beleggingsadviezen'. It is not explicit whether these are relative or absolute recommendations or versus the sector or market.

- **Money-Making Recommendations**

Many fund managers are looking for analysts to draw their attention to good ideas, and argue the case in a balanced and persuasive manner. We call this *good stock-picker value-added.*

- **Information About Companies**

It can be extremely useful for a fund manager looking at a potential investment for the first time to talk to an analyst who knows the company well. The analyst can provide context through an explanation of the history of the company, its divisions, its business model, its competitors and even an opinion on those running the company. We call this the *background knowledge* value-added. (Some fund managers would see the investment banking relationships as a help here – giving the inside track on a company while falling short of inside information.)

- **Sub Contraction Of Information Filtering**

Sometimes the fund manager, confronted with a massive wall of information, is looking for an analyst to summarise the facts with accuracy and clarity. Imagine you run a diversified Pan-European equity portfolio for a pension fund and its the 15th of August. It is possible that 10 of the companies held in the portfolio are reporting half-yearly results that day. Imagine each company produces a 20 page press release, which takes 45 minutes to read properly, and each company is holding a 60 minute conference call. Clearly, it becomes vital for a fund manager to subcontract part of this work to a buy-side or sell-side analyst. This filtering can only be trusted if the analyst knows the context – what the market expects and what has been said in the past- so that analyst can make a sensible assessment of how that might influence forecasts. We call this value-added task *information filtering*.

- **Sub Contraction Of Model Building**

Some fund managers find it very helpful to use analysts to prepare detailed models and estimates. The production of detailed projections with divisional assumptions and with the profit and loss account flowing through automatically to balance sheet and cash flow forecasts can take time, especially when annual reports come out accompanied by accounting changes. A fund manager will often rely on the buy-side or sell-side analyst to do this model-building work and then ask for his/her assumptions to be inputted. We call this the *numbers modelling* element.

In some cases specific work is actually commissioned for a fee and meant for that client alone, and there are rules on that not later being used for others, although often the base work is leveraged in subsequent research.

> Each of these four value-added inputs is produced by an individual or a small team – so good research is research produced by a good analyst. This last seemingly obvious point forms a key part of our discussion about the future of independent research. One survey respondent was asked whether large or small firms provided better small cap coverage – the answer given was that: *"it really depends on the analyst and how dedicated they are."*

On top of these four components, a group called EAI highlight that there is a growing recognition amongst pension funds and fund managers that the management of extra financial or intangible issues by companies is essential for their long-term performance. Such issues typically include corporate governance, human capital management, value creation or destruction during mergers and acquisitions, or global environmental challenges such as climate change. To date, brokers have had little – if any – incentive to focus on these issues. The Enhanced Analytics Initiative (EAI), which was launched in November 2004, comprises a group of institutional investors and fund managers who have decided to allocate individually a minimum of 5% of their respective brokerage commission to sell-side research houses (or others) who are deemed effective, with the help of an independent evaluator, at analysing material extra-financial issues and intangibles.

Remuneration: Our discussion of the role of independent research does not attempt to address the important issue of analysts' remuneration. However one side comment may be useful - that a system which linked analysts' remuneration to the success of the recommendations should leave scope to reward the other value-added services described above. This seems also to be view of the Forum Group: *"In order to reinforce the objectivity of analysts, the Group suggests that, in determining analysts' remuneration, firms should consider the performance of their recommendations, in addition to all other relevant considerations, such as the quality or originality of the content of their research reports*".[14]

In fact, it is not uncommon to hear a fund manager talk about an analyst in these terms: *"Joe Bloggs knows more about the chemicals industry than any other analyst because he used to work in the business. I like to talk to him at least once a month but don't ever follow his advice because the guy is a contrary-indicator*." An analysts' remuneration based purely on recommendation success would leave Joe Bloggs out in the cold. Of course, if research is unbundled – paid for in fees – the investors will attribute a monetary value to each analyst's work and this will provide far greater clarity.

Conclusion:

- Good research is research produced by good analysts
- The value-added can take several different forms

3.5 What Makes Good Research For Retail Clients?

Demographic pressures, legitimate expectations of retirees and lower expected investment returns (to say nothing of the political imperative abroad in almost all developed countries) makes it increasingly important that individuals accept (at least partial) responsibility for the financial planning of their retirement. They need to understand and become accustomed to the fact that this means saving and that saving means investment.

[14] Forum Group Report, Section 5.8, Page 36

Some may like fixed interest investments or property, but it is likely that all will have some equity component to their savings plans. If they have equity investments it is in the interests of everyone in a society that the investments are made prudently, with the benefit of decent quality advice. A market in which all the core company research came from integrated houses would lack the 'check and balance' provided by good independent houses.

As we have indicated in Section 3.4, the recommendation on a research report can be less or more important for institutional investor – this class of investor may instead look for the description of the activities, trends and developments and the full financial analysis of the company in the report.

For the retail investor the situation is totally different. The average retail investor considers a recommendation to buy or to sell a stock as something that requires action. He or she will take a recommendation from a financial advisor very seriously and may well trade based just on the words "buy" or "sell".

Retail investors are also more interested in the colourful and appealing elements of a story about a company (e.g. Unilever sold more ice cream this year because of the hot summer) than the full details. Therefore it is the analyst's responsibility to incorporate into the recommendation elements of the story that the retail investor would not naturally consider. That is, to elevate the retail investor to an institutional analytical level the analyst needs, next to the common fundamental material, to take into account the technical position of a company's stock, some elements of quantitative analysis and the trends within the company's sector.

Institutional investors know that some research reports may be biased. The retail investor trusts the advisor and will almost always assume that the recommendation is in his or her best interest.

The retail investor has problems understanding that the majority of investment research uses a relative approach. That is to say: a buy rating doesn't necessarily mean that the analyst expects the stock to go up in absolute terms if the stock market crashes. Once the investor understands the relative game it is even harder to explain to him/her why the majority of the ratings are buys but he/she will continue to assume that the financial institution is the expert and will act in his/her best interest.

The IRIS team's experience was this: "*Within IRIS we have found out that the tone of voice used for the retail investor needs to be different from the institutional tone we were brought up with. We now try to explain complex structures in the language of a business newspaper and indeed that involves some extra effort in presenting our cases. Institutional research is usually too complex for retail investors to read although the situation may be improving slightly given the increasing use of graphs, figures and pictures.*"

Finally, the time scale may differ, as IRIS points out: *"Retail investors need recommendations that are valid for the longer term. Unlike institutional investors they are not able to reconsider their positions every day. Retail investors need to have the risk characteristics of a stock recommendation, or better a portfolio of recommendations, taken into account in the investment recommendation."*

3.6 Is there a need to preserve the volume of research?

The Forum Group Report cites “the need to maintain the flow of research” as a reason to avoid dramatic changes in the industry. We quote three passages from that report which make that point.

- Forum Group Report, Chairman’s Introduction, Page 4: “*A majority within our Group felt that best practice in the research industry should be encouraged to evolve rather than be legislated abruptly, and that change should be tempered by practical considerations, especially the need to maintain the flow of research in the European marketplace and also the need not to disadvantage European practitioners in a global context*.”
- Forum Group Report,[15] page 27: “*The Group doubts whether compulsory legal separation of research would be universally appropriate in Europe. While firms would naturally want to analyse the costs and benefits of such a model, the Group believes that it would be likely to reduce the amount of research available.*”
- Forum Group Report[16], page 27: “*If bundling and/or investment banking subsidies were to be discontinued (and if more stringent rules on softing were adopted, further reducing fund managers’ budgets for spending on research), there is a danger that the volume of independent research produced might not immediately compensate for the reduced research output from integrated houses. This could also detrimentally reduce the level of information available to the retail market*.”

We would take issue with the *need to preserve flow* argument. While certain parts of the market such as “small cap” may be inadequately researched, overall we suspect a bit less volume of research would not hinder fund managers in their investment process.

There is a famous story from the 1990’s. The manager of European research at one of the successful investment banks had carelessly left a pile of research on his desk. This should not have been visible as the pack had been sent by an analyst whom he was considering hiring. This analyst was well-known in the European market, was commercially successful and did well in the research surveys. The manager had obviously looked at the pack because on the corner he had jotted a small note with his impressions – “dull but a lot of it.” This small anecdote pretty much summarises what you hear from successful institutional fund managers. Fund managers are deluged with research and can read only a small portion of the material sent.

Some fund managers have been known to mutter that there is far too much research and that much of it is of dubious quality.

[15] Section 5.3, Management of conflicts of interest within integrated firms
[16] Ditto

4 HOW DO INVESTORS PAY FOR RESEARCH TODAY?

In this chapter we give some background on the economics of today's research market looking at how investors pay for research, new dealing technologies and the debate on 'unbundling'. The survey showed that research was still mainly paid for by traditional commissions, broker lists were now fairly stable or contracting a bit, there was occasional conflict between dealers and fund managers about where business should go, and few firms had a policy of allocating a meaningful part of commission to the independent sector. We explain how the combination of these factors (investor enthusiasm not translating into commission cash and competitive pressures from investment banking cross subsidies which result in high salaries and cheap research) makes life tough for the real independent research provider.

4.1 How Do Investors Pay For Research At Present?

Survey Question 8: *"At present, how do you pay for broker research? (A) Traditional broking commissions (B) Cash fees paid from our own P&L (C) All our brokers are paid by commissions but we have introduced a system whereby a few large brokers get all the flow. These large brokers then pay fees to the smaller brokers (commission sharing). (D) A mixture of the above (please specify) If you are currently planning to make changes, can you explain what system you plan to adopt."*

Traditional Commissions	Cash fees paid from your own P&L	Commission sharing arrangements	Mixture
26 84%	-	-	5 16%

The survey shows 84% of respondents still paid for research exclusively by bundled commissions, although one of these did pay fees for macro research. One large UK firm (over £100 billion AUM) was reviewing this situation and another mid sized US firm was considering a commission sharing arrangement. The five respondents already using a mixture can be analysed as follows:

- Two very large UK asset managers were already using some alternatives – in both cases also paying some fees from their own P&L. In one case the percentage was not specified, in the other 10% of research was paid this way. (Both respondents were also making use of new dealing technologies.)
- A large UK pension fund had some fee based arrangements.
- One large hedge fund said it paid for research 95% via commissions and the other 5% was split between fees and commission sharing. (This fund also makes extensive use of new dealing technologies.)
- Another large hedge fund was also experimenting with fee arrangements.

We then asked whether broker lists were expanding or contracting - the conclusion here is that broker lists are generally stable or contracting.

Survey Question 12: *"Is the number of brokers you deal with expanding or contracting? (A) Expanding – if so, are small brokers being added? (B) Stable (C) Contracting – if so, are small brokers being cut off?"*			
Expanding	Stable	Contracting	No Comment
4 13%	14 45%	11 35%	2 6%

We asked about allocation of business to independent research:

Survey Question 14: *"Do you currently allocate a portion of the research budget (commission or fees) to independent research and if so, on average how much? (A) No (B) Less than 3% of total commissions/fees (C) More than 3% but less than 10% of total commissions/fees (D) 10-20% of total commissions/fees (E) Over 20% (F) I have no idea"*					
No	Below 3%	3-10%	10-20%	Over 20%	No Comment
13 42%	5 16%	5 16%	3 10%	0 0%	5 16%

The conclusion is that it is not common practice to specifically allocate independent research houses in Europe a meaningful percentage of business. 42% made no specific allocation and only 10% of respondents allocated over 10% with no respondent allocating over 20% of business to independents.

We then addressed potential conflicts on where business flow was directed and found more far harmony than we expected:

Survey Question 13: *"Is there a difference between the brokers that the fund managers want to reward and the brokers that the dealing teams feel provide best execution? (A) Not an issue (B) A source of occasional conflict (C) A source of regular conflict (if possible, explain)?"*			
No Conflict	Occasional	Regular Conflict	Not Discussed
16 52%	11 35%	2 6%	2 6%

In the 16 firms where there was "no conflict" this was either because they had (presumably) found a system that worked or the conflict did not arise because the fund managers did the dealing.

Various comments were made by investors who did experience internal conflicts. One investor suggested that the conflict was natural: *"the best research providers cannot always provide the best dealing, and vice versa."* Another investor put it more strongly*: "availability of flow, willingness of broker to commit capital, and low fee structure are rarely found in the same houses as the best research."* A third investor suggested this was more of an issue *"where liquidity/volumes are very important."*

A US investor put it down to the weakest link theory: *"I think that is always an issue…. Of course a reliable and good analyst or salesman can easily come in combination with a crooked or bad trader in one house. That is a problem. I think that in that case the chain is as strong as the weakest link, and I will tell the analyst or salesman about the problem. If there is nothing we can do, I tell them it will be hard for us to pay them."*

4.2 The Changing Face Of Execution

At the time of *Big Bang* the norm for order execution was still the traditional agency brokerage route.[17] With commission levels no longer fixed the rates started to come down but the excellent volumes in the bull market soothed the pain. However, brokers also started to deal frequently with clients as principal (dealing 'net'), taking the stock on their trading book. Block trading quickly became important.[18] The American banks were especially strong in this area. It was not until the mid 1990's that program trading – a variant of block trading - became the norm for big asset shifts.[19] Given the nature of this business the large brokers that can commit substantial capital to the business are in reality the only ones that are equipped to provide program trading services.

The way fund managers handled orders also shifted dramatically in the 1990's. In the old days, a fund manager usually passed the order himself to the broker, often in direct response to a research idea. Increasingly fund management houses divided into three categories – the buy-side analysts, the portfolio manager and the dealers. Fund managers and analysts would select who they wished to reward for ideas – through a "tiger token" voting system - but the dealers would chose where to direct a particular order. There was certainly a perception that the big houses looked after these dealing contacts better – both in terms of sales trading newsflow and by occasional facilitation i.e. taking the block or the last part of it on 'the book'. Capital and best execution often became synonymous. **The pressure is now on institutions to minimise transaction costs, not just by a reduction in the commission rate but also by trying to minimise market impact and to assess the opportunity cost.**

---

[17] An agency order is given to the broker to execute in the market on a best efforts basis, with or without price limits. The broker charges a commission of a certain number of basis points.

[18] A block trade is an off-exchange transaction, usually quite large in size, between two sophisticated parties at a single, negotiated price, even if the price is slightly discounted from the current market. Typically, a brokerage firm is a party to the block trade with one of its customers, but the firm can also be used to bring two customers together in what is referred to as an "agency" block trade.

[19] The advantage for the institution is that the trade is done instantly at a given price so transaction costs are transparent and known upfront. The disadvantage is that because the trade is done in one transaction the broker instantly has to put a price on market risk and market impact. The sell–side trader will tend to be cautious and try to build a certain safety margin into the bid or offer price for the program trade, thereby increasing the transaction costs. This is particularly true if less liquid stocks are a part of the program trade.

It is now recognised that moving the price or dealing at the right or wrong moment makes even more difference than the broker's commission rate. Transaction Cost Analysis (TCA) services are being widely used to measure these various impacts.[20] (Brokers are sometimes required to have the systems in place to actually provide the data for this measurement.)

Last year fund manager Marcus Hooper commented on how the Myners Report in the UK (of which more later) had increased the focus on transaction costs and the investment consultants had jumped on the bandwagon: "*Consultants are absolutely delighted about the heightened interest in transaction cost analysis. They have been trying for years to sell better ways of picking fund managers, and this gem of a marketing opportunity has been thrown into their laps. Investors can now select asset managers based on transaction costs, an entirely new aspect*." [21]

Over the years the large integrated broker houses have invested heavily in trading platforms. These new systems are not only used by their own traders but have also been made available to the buy-side who get direct access to the markets (DMA) through these platforms i.e. without going through a sell-side trader.

The percentage of trading volume executed this way is still limited but growing fast. According to recent research from Needham based TowerGroup (1/10/2004) the number in the US in 2000 was 11%, but is forecast to rise to 38% by the end of 2006. Instead of paying full commission the buy-side will pay a relatively small charge to the broker for using the system. This way the buy side reduces transaction costs and the broker keeps a business relationship with the client.

So far these new trading systems have had more impact in the US but it is clear that Europe is following. It is normal to see a period where institutions experiment with these new platforms before going live and we are probably at this stage in Europe. However, once advanced trading starts seriously, as in the US, it is bound to accelerate quickly.

In question 9 of our survey we asked the (mainly) European respondents about usage of these trading options:

Survey Question 9: "*With more and more focus on transaction cost analysis, is an increasing part of your firm's European equity business going through electronic crossing systems or direct market access terminals? (A) No (B) While only a small part of our flow goes via these systems at present, we see the % rising (C) These systems already handle a meaningful part of our order flow..*"

No	A small percentage at present but rising	Already a meaningful part of order flow	No Comment
16 52%	10 32%	4 13%	1 3%

[20] TCA services use computer programs that compare trade information of a specific transaction to wider market data.

[21] The Impact of the Myners Report on Global Investors, Marcus Hooper, MD Duvacy Ltd, 2003 AIMR

The conclusion is 32% of the respondents were trying out these new dealing systems, using them for a small part of the flow, but with usage now building up. 13% of investors were already made extensive use of these dealing options. 52% of investors polled had not yet dabbled with them.

So, in summary, we found that while the majority of trading volumes are still executed through a broker in the more traditional way, the proportion of total trading volumes on which full commission is paid has declined and is certain to decline further.

4.3 The Debate On Unbundling

In 2000, the UK's Chancellor of the Exchequer appointed Paul Myners to carry out a review of institutional investment in the UK. His final report[22], published in March 2001, proved particularly controversial on one topic: *"He concluded that there was an incentive for fund managers to direct business to brokers to obtain additional services, rather than the most favourable trade execution terms for their customers, and that this represented an unacceptable market distortion."*[23]

The Myners review has kick-started a major debate on how fund managers should pay for equity research. As one investor commented: "*although only 2 out of the 201 pages in the report address commission payments, commission payments have been the main focus of attention.*" [24] Following Myners, the FSA took the topic forward with the publication in April 2003 of a detailed policy document, CP176. The debate has not been confined to the UK and it has proved controversial wherever it has been discussed. For instance, the Forum Group struggled to find a common position amongst its members.[25]

Myners' first concern was visibility. He argued that current practices made it extremely hard for a trustee to see the full costs of fund management. While management fees are transparent, he felt dealing commissions are not - it was not clear either how much commission is charged to the funds in total, or how much of that commission is being used to buy services in addition to trade execution.

Myners' second concern was motive. He felt that the current payment system could encourage certain trading patterns, driven more by the asset management company's profit and loss account than the needs of the portfolio. For instance, the order might be directed towards the 'wrong broker' (i.e. not necessarily the broker offering the most effective execution) to pay for news services like Bloomberg. Myners also felt that there was an incentive to favour sell-side research (financed by the fund's transaction costs) rather than buy-side research where the asset management house would foot the bill. 'Churning' was also raised as a concern.

[22] "Institutional Investment in the United Kingdom: A Review." HM Treasury (hereafter 'Myners Report')
[23] Financial Services Authority, CP176, page 3
[24] The Impact of the Myners Report on Global Investors, Marcus Hooper, MD Duvacy Ltd, 2003 AIMR
[25] The Forum Group Report, Chairman's Introduction (page 5)

Myners' recommendations were:

"Clients' interests would be better served if they required fund managers to absorb the cost of any commissions paid, treating these commissions as a cost of the business of fund management, as they surely are. ….. Fund managers would choose which services to buy and which to provide themselves."[26]

"The review recommends that it is good practice for institutional investment management mandates to incorporate a management fee inclusive of any external research, information or transaction services acquired or used by the fund manager rather than these costs being passed on to the client."[27]

We will not attempt to argue out the pros and cons of 'unbundling' in this document, although we believe it could simplify life for some independents research providers. We did include a question on this topic in our survey:

Survey Question 10: *"Is your firm in favour of "unbundling" of research? (A) Yes, we are in support of unbundling, (B) We are neutral, (C) We are opposed, and if so, please specify why (D) This topic has not been discussed*

In Favour	Neutral	Opposed	No Comment
6	11	6	8
19%	35%	19%	26%

The outcome was not conclusive – 2 comments may be worth quoting nonetheless:

- From a pension fund who is opposed: *"this unbundling system cannot be made to work in one country. It would need to be agreed on a global basis to work. Also – we currently get to see all sorts of research and can decide on a case by case basis which we think is most relevant, if we were restricted to buying in research from one or two houses which we had to decide at the beginning of the year – it would be more difficult to follow the cut & thrust of analytical debate."*
- From a US asset manager who voted 'neutral': *"There are clearly industry profitability issues at stake here as in an unbundled world. We would need to see a mechanism put in place which would allow us to benefit from unbundled independent research without damaging either our clients or our shareholders' interests."*
- Those who are positive tended to save their comments for questions on why fees would change broker behaviour.

We then posed the question (question 11) about what changes in behaviour might occur if research was remunerated by fees not flow - **the outcome was decisive:**

- 61% expected a change in behaviour
- only 13% expected no change
- the rest were undecided.

[26] Myners report, page 11, item 61.
[27] Myners report, Recommendations on fund managers, page 22.

Survey Question 11: *"Would you expect the broker's behaviour to change if remunerated by fees as opposed to commissions on turnover? If so, please explain?"*		
Behaviour Would Change	Wouldn't Change	No Comment/Position
19 61%	4 13%	8 26%

While, as indicated above, the survey outcome is clear, there was quite some variety in the explanatory comments, for instance:

- A big UK asset manager answered: *"Yes – analysts will see pay cuts, so the quality of the people (and product) will fall."*
- A pension fund wrote: *"Answer: Yes. Experience suggests an improved FM/Broker relationship, with broker giving client a service more in line with needs/requirements"*
- One US investor echoed the thoughts of several about less churn: *"Yes, a longer term approach to investing & recommendations would be more likely."*
- Another US investor thought the income certainty could make analysts less driven: *"The reality of the financial jungle is that they will probably lack the direct, day to day incentive of commission to give you the best service and execution, if they already know what they are going to make, if their actions on a daily basis have no effect on these so-called fees. That may then mean that they will be more assertive on the trading side."*
- A large UK asset manager, who did not expect behaviour to change, explained why: *"[We] would not expect behaviour to change in isolation as it will still be necessary to prove correct over relatively short time periods. If a large section of the market were fee remunerated then behaviour could well change to longer term advice."*

4.4 The Issue Of Commission Sharing

In a CSA, the executing broker agrees that part of the dealing commission it earns will be redirected to one or more third parties, nominated by the fund manager, as payment for research services, that they have provided to the manager.

This enables a research house to get paid without winning the execution business. However CSA's do rely either on the client actively making an arrangement with a large broker to reimburse smaller ones for research or for the small broker to do deals with the large houses. Currently the FSA view seems to be that CSA's could be a good market driven compromise.

Two questions raised by the FSA in PS04/23 were: (a) the *"potential risks to market efficiency if a widespread use of CSAs resulted in order flow being concentrated in the hands of a small group of large brokers*", (b) potential "*specific obligations on the volume or value of business the fund manager would put through the broker."*

4.5 Why Has Independent Research Sector Not Reached A Critical Mass?

Given all the enthusiasm expressed in the surveys about the value of independent research – in Section 3.1 it is clear that investors like it - it may seem strange that these same investors make only such a modest allocation when it comes to actually paying for research – see Section 4.1. **It is clear that one obstacle is the need to reduce transaction costs and the new options available to achieve this – see Section 4.2. This means that small brokers – those who service the investors best on SME – get squeezed.**

The other major issue is cross subsidies. **As explained in the Executive Summary, the integrated investment banks can fund research not only from commissions but also from revenue earned in other investment banking or proprietary trading revenue streams.**

- **Firstly, this extra funding enables the large houses to pay top dollar to recruit the cream of the analytical community.**
- **Secondly it enables, and may encourage, the integrated broker to offer research at a price below what could be sustained by a stand-alone research operation.**

The impact of these cross subsidies has been dramatic in the period following Big Bang and we explain some of the history in the Appendix 3: The Recent Evolution Of EU Equity Research. This wage inflation and price deflation is a major reason why this apparently exciting sector has not emerged from its chrysalis.

As a result the European independent research sector is not yet a generally credible employer for the top analysts, despite a few early enthusiasts; yet talented analysts are the 'raw material' of good research. Surely the independent sector would win on lifestyle? In many ways that is true – it offers real freedom of speech, which good analysts love, as well as certain of the normal benefits of working at a smaller company, such as less bureaucracy.

However what an analyst most seeks is the buzz of working with a core of outstanding, thought-provoking people – an intellectual critical mass. An independent firm thus needs to be more than a vehicle for an individual maverick (who likes to work alone) – it must collect several big thinkers to make the creative buzz. This sector must become a more mainstream recruiter and for that to happen the economics must change. There is also an issue of human capital – is it healthy for all those coming into the industry to be trained at integrated houses or should some diversity of training be welcomed?

On the issue of cross subsidies the proponents of the status quo argue:

- It is outside the remit of regulators to interfere with brokers' business models.
- Some conflicts have been removed and others are being managed/monitored.
- The disclosure of conflicts has massively improved.
- Change might disadvantage European players in a global market.
- Some feel we are now in the situation "if it ain't broke, don't fix it."
- Most big companies – in any industry- enjoy synergies between divisions.
- Interference would tax success.

The arguments made by those who support changes are:

- Cross-subsidisation means that there is not a level-playing field in research in the EU today.
- Conflicts will provide an ever-present subtle pressure on an analyst, for as long as research capability remains a factor in how corporates select their investment banks.
- While conflict management is certainly improving, the remaining potential abuses are less visible for regulators to spot and for investors to discount - for instance, what an analyst omits to say or do.
- In the case of disclosure of interests on the trading book the fund manager would need to know whether the investment bank is long or short and in what size at the point when a salesman/analyst gives advice. This is not practical.
- It is now unusual to allow professional advisors to advise multiple constituencies. The 1990's saw large scandals in professions where advisors have been allowed to handle conflicts – investment banking and audit/ consultancy - but not in professions with single client concepts like the law firms.

5 CONFLICT – PROBLEM SOLVED?

> **" Follow the money"**
> Bob Woodward's Watergate informant, "All The President's Men", 1976.

> This chapter shows the results of the survey – that investors continue to be concerned about investment banking and trading book conflicts. Some feel disclosure is useless, some feel it is useful. However, either way, the message is that there is a difference between disclosure and the removal of conflict.

5.1 Distinguishing Between Conflict And 'Crime'

We wish to make a distinction between conflict - 'a potential temptation to sin' – and what happens if that conflict is abused – the actual sin or 'mischief'. We have tried to look at the potential conflicts that exist, what mischief is likely to be created if the conflict is abused, and how might independent research offer some remedy.

5.2 Distinguishing Between Biased Advice And Bad Advice

We feel it is important to make a distinction between biased advice and bad advice. For instance, an analyst could have written research which concluded that the internet stocks were still cheap at the height of the internet bubble. Investors may have followed the analyst's advice and lost a significant percentage of their investment. If this advice reflected the analyst's own view then it did not mislead the investor. It was bad advice given in good faith.

> One "mischief" to be addressed occurs when research is published which deliberately does not reflect the opinion of its author(s) and as a result misleads an investor. This could be either by what the research includes, implies, or, just as important, by what it omits.

5.3 Corporate Clients And The Risk Of Misleading Investors

It is widely accepted that investment banking business links can put the analyst in a position of conflict. This is not just an Anglo-Saxon and investment bank problem – in the past across Europe the house bank has tended to be seen as partisan with much pressure for the analysts to toe the line on recommendations. For example, the German banks had very substantial stakes in some companies too.

Investors who relied on the recommendation at face value – here the retail investor was particularly vulnerable - could easily have been misled. Many institutional investors have applied a healthy dose of cynicism and one regularly heard the phrases: "*surprise, surprise – XYZ bank thinks it's a buy*." (These investors were not actually misled by the advice and no mischief occurred.)

Several changes have occurred: a) better disclosure of corporate links, b) syndicate banks generally avoiding written recommendations at the time of an issue. In question 4 of our survey we asked whether the disclosure was now adequate.

Survey Question 4: "Integrated investment banks now disclose banking relationships in their research. As a result an investor reading the research is aware of the potential conflicts of interest. In your view, is the current level of disclosure adequate to enable you (as an investor) to adjust for any potential bias: (A) Disclosure is adequate (B) It varies (if so, please comment below) (C) Disclosure is not adequate (If so, how could this be improved?)"

Adequate	It Varies	Not Adequate	Inconclusive
14 45%	7 23%	9 29%	1 3%

The responses look well spread. However of the 14 respondents who answered that disclosure was adequate, 3 chose to make additional comments suggesting their view was 'forewarned is forearmed' and 1 other investor did not care either way:

- US asset manager: "*We are now more aware than ever of potential conflicts.*"
- US asset manager: "*But even without disclosure you know that investment banks have agendas, so some of the disclosure stuff seems a bit overdone to me. Why go through all the motions and discuss the exact formulations for hours with teams of legal experts if no thinking person is going to read it.*"
- UK asset manager: "*As far as I'm concerned, disclosure of a conflict of interest does not remove the conflict. Integrated houses have two fundamental drivers, both of which are inimical to fund managers – they have a vested interest in encouraging trading and in maintaining relationships with their corporate clients. Fund managers should be aware of this whatever the level of disclosure.*"
- UK asset manager: "*... we carry out our own research anyway.*"

Overall 17 of the 31 respondents added comments. Common themes were the vagueness of the disclaimers *"they all use the same line: might seek or does business with company"* and a general perception of ongoing conflict. One UK asset manager wrote: *"One always has to assume that investment bank research will ultimately be driven by corporate finance objectives. Having said this, more "sell" notes seem to have appeared over the last few years."*

It may be that better regulation and practice now protect analysts from feeling any pressure from the corporate side, **but the survey makes clear that a significant proportion of investors remain unconvinced.** That said some years back no-one would have answered "adequate" so the regulators have certainly made progress.

In some cases the conflicts are more subtle, as pointed out by one pension fund:

"We would certainly give much more credence to research from houses that are not involved in the IPO. I suppose one might still be wary of research from big houses not involved in the IPO, but who might hope to have some relationship in the future with the issuer, or who might have IPO business to do in another stock in the same sector. With privatisation issues – which are the bulk of the business in Europe - clearly the banks would not want to alienate a government issuer, who is likely to have more IPO business in future. I view with particular cynicism the tendency of some issuers to include just about every investment bank in their issues – this is tantamount to censorship of the analyst community."

One final point - the fact that analysts in Europe continue to take part in marketing efforts and pitches to corporates, despite the ban in the US, seems strangely lax[28].

The remedy – independent research?

5.4 Trading Books And The Risk Of Misleading Investors

Here disclosure is much more of a problem because the information is actually no help at all in assessing which way an analyst or salesman could potentially be biased. The survey shows investors are often unhappy with disclosure here:

Survey Question 5: "Integrated investment banks now disclose that the bank may or may not have a proprietary trading position in the researched share. In your view, is the current level of disclosure adequate to enable you (as an investor) to adjust for any potential bias: (A) Disclosure is adequate (B) It varies (if so, please comment below) (C) Disclosure is not adequate (If so, how could this be improved?)"

Adequate	It Varies	Not Adequate	Inconclusive
9 29%	6 19%	14 45%	2 6%

A majority of investors remained concerned about conflicts and felt that the disclosures were not specific enough to be much help – one investor indicated that they still *"have absolutely no idea of the bank's proprietary trading position! Thus the statement that they may or may not have a trading [position] is more of a legal disclaimer than anything else."*

One fund manager who answered that disclosure was adequate stated: *"Further disclosure at this level would not really help. EG if a fund manager read a report saying the IIB had a big short position it would not help her/him to decide on the validity of the investment thesis being put forward by the analyst. Put it another way: more disclosure does not force an unbiased analysis. Analysis from the sell-side will always be biased if the provider does not have a co-incidence of interests with the user."*

[28] Forum Group P26 "The Group believes that analysts should continue to be allowed to make this valuable contribution to the identification, solicitation and execution of investment banking business, provided that research objectivity is not compromised".

In conclusion, 45% of investors surveyed believe that the disclosure of trading positions was inadequate and a further 19% indicate that it is variable. Only 29% of respondents felt that disclosure was adequate. Of course in the past far fewer would have answered "adequate" so here too there has been progress.

The remedy – a strict segregation of activities?

5.5 Corporate Broking (And Pre Briefing)

Corporate broking is strongly endorsed by the Forum Group as a key solution to poor coverage of the SME sector: *"… the Group still considers the corporate broker formula extremely valuable to both the issuer and the investor, so long as investors understand the relationship that exists between the corporate and the corporate broker, and so long as the research provider's role is appropriately disclosed."*

Corporate broking is to date a largely UK phenomenon. One of the traditional limbs of the service offered by the bank in a brokership deal is for the analyst to provide regular research coverage of the company, notably by writing up and commenting on major company results and other important events. This is an unwritten rule. In small cap stocks the house broker is particularly influential as the perception is that the analyst has 'Caesar's ear' and the mere fact that a bank is "house" (i.e. broker) to a company attracts a market perception that it is a market leader in trading its shares. This perception can naturally become self-fulfilling.

The corporate brokerage relationship involves, by its nature, significant potential conflict. Much of this mirrors the investment banking conflicts. However, one of the most startling elements in the analyst's role is to preview the results: that is, to see them and discuss them with the company the day before their release to the market. This can serve two purposes. First, the company's board benefits from a private reaction to its results, which readies it for the questions, praises and protests from investors, analysts and press the following day. Second, the privileged analyst has had the opportunity to crunch the numbers and collect his/her thoughts for the release of the results the following morning.

As soon as they are published, the analyst is permitted to inform the market of his/her considered views on them. This of course gives the analyst a substantial competitive advantage, whose only justification seems to be that an informed view may help reduce initial share price volatility as traders give knee-jerk reactions to headline figures flashing across their screens.

This competitive advantage is particularly significant if a set of results is accompanied by a long press release or is complicated to understand because of restatements or changes in consolidation. The analyst can write his/her results note even before the news goes live although it is regarded as gentlemanly not to publish it too quickly. However clients, salesmen and traders can have access to instant informed view – this is potentially a significant market distortion.

The remedy: (a) At least one independent provider should cover these small cap stocks. (b) Stop the pre-briefing.

6 LESSONS FROM AMERICA

“AMERICA was thus clearly top nation”
W.C. Sellar and R.J. Yeatman “1066 And All That”

In any discussion of the funding of independent research, the US Global Research Settlement will clearly come up in the conversation. In the US major steps have been taken to encourage independent research and we include here, and in Appendix 4, a brief description of those developments.

In April 2004 the SEC settled enforcement actions against 10 Wall Street firms and 2 analysts arising from an investigation of analyst conflicts of interest. The agreement that was reached totals more than $1.4 billion in penalties, restitution and monies to be used for investor education. This splits into “a retrospective relief fund for investors of $875m, payments for independent research will total $432.5m, $80m for investor education”. There was also a voluntary agreement restricting allocations of securities in "hot" IPOs.

The NASD Chairman Robert R. Glauber argued that the Global Research Settlement would improve the business position of the US by producing a real clean-up and showing the industry bodies had real teeth: *"It underscores that the industry's highest duty is to investors. It makes plain that cleaning up research and IPO practices is not just good ethics -- it's good business. And it demonstrates NASD's determination to investigate and sanction practices that harm investors and the integrity of the markets."*

<u>The plan for Independent Research was summarised on the SEC website as follows:</u>

- For a five-year period, each of the firms will be required to contract with no fewer than three independent research firms and will make available the independent research to the firm's customers.
- Firms will notify customers of the availability of independent research on customer account statements, on the first page of research reports, and on the firm's website.
- An independent consultant for each firm will have final authority to procure independent research, and will report annually to regulators concerning the research procured.
- Payments for independent research will total $432.5m.

The announcement of the settlement caused a frenzy of sorts, creating an environment where entrepreneurs could build some momentum. This can be illustrated by an anecdotal example[29]. A company called Soleil raised a total of $16m in funding, including a $6m second round: the founder said that "this new round of funding will permit us to extend our lead in the rapidly developing marketplace for conflict free equities research."

---

[29] Copyright Business Wire, October 30, 2003

"We have watched Soleil develop over several quarters and have evaluated many companies in the independent research space," said one VC investor. "We believe Soleil has an exciting new model that is very scalable. They also have a valuable first mover advantage and an extremely talented and experienced management team." Launched in June 2003, by mid 2004 Soleil had already won a slice of the Morgan Stanley independent research award.

How Is The Money To Be Allocated

Firm	Amount	Consultant	Providers
Merrill Lynch	$75m	Bridget Macaskill	BNY Jaywalk and Morningstar
Morgan Stanley	$75m	Arthur Ainsberg	Alpha Equity Research, Argus Research, The Buckingham Research Group, Fulcrum Global Partners, IPOfinancial.com, Soleil Securities Group, S&P and Zacks Investment Research
Citigroup SSB	$75m	‘Bud’ Morten	Morningstar, S&P, Argus Research, and Renaissance Capital. Thomson overview.
Goldman Sachs	$50m.	Henry Frantzen	Morningstar, Renaissance Capital and S&P.
CSFB	$50m.	Patricia Chadwick.	BNY Jaywalk, Renaissance Capital and S&P.
Bears Stearns	$25m.	Michael J. Downey	BNY Jaywalk
Lehman	$25m.	Mark Fichtel	BNY Jaywalk
J.P. Morgan	$25m.	Laura Unger	BOE Securities of Philadelphia, Morningstar and Renaissance Capital
UBS	$25m.	Michael A. Dritz.	BNY Jaywalk
Piper Jaffrey	$7.5m.	Thomas Brakke	Morningstar, S&P, Renaissance Capital, and Buckingham Research.

Many issues remain at this early stage of evolution. Firstly, the quality of independents is ‘variable’ and IR consultants are particularly wary of research-for-hire, often labelled as independent. Secondly, the chosen independents or platform providers are often parts of large companies – McGraw-Hill (S&P) and Bank of New York (BNY Jaywalk). Thirdly, the industry has been disrupted by the discussions about the removal of soft dollar business. Yet, for all these concerns, the fact remains that the Global Research Settlement funding will provide some serious winners who can plan and expand their businesses in a way that would make their European peers envious.

PART 2 – SME'S AND THE ROLE OF INDEPENDENT RESEARCH

7 PROVIDING RESEARCH COVERAGE ON SME'S

Why is the coverage of European small and mid cap stocks important? The answer – the stock market is one effective option for young growth companies to finance themselves and so a vibrant and viable small cap quoted sector is to be encouraged. In this chapter we examine why these stocks are orphaned and the gaps left. We also ask if and why smaller (often independent) brokers provide a better service in this sector. Finally we look at how coverage might be improved and discuss our SME Independent fund proposal.

7.1 Why Are SME Stocks Orphaned?

A vibrant and viable small cap quoted sector is a major asset in fostering the growth of small companies and this is an important driver of economic growth. This sector should really be booming. However, the reality is that we see an increase in the so-called "orphan effect", where small companies find they cannot get proper analyst coverage. An article in CFO.com on the 8th of July 2004 highlighted the problem in the US: *"According to Reuters Research, there's been a 13 percent increase in the number of companies that lost sell-side coverage completely since 2002. The researchers calculate that 666 companies of the 4,075 in its database had been "orphaned" by sell-side analysts as of January 2004. Two years ago, only 85 companies were left without analyst coverage."*

The Forum Group Report highlights the same issue in Europe:

"The maintenance of adequate provision of research covering small and medium-sized enterprises (SMEs) was an area of particular focus for the Group. It merits specific consideration because trading volumes in the secondary market are, in certain instances, insufficient to justify, in economic terms, the on-going costs of research coverage of SMEs.

Traditionally, in several European countries (and especially the UK), SMEs have received coverage from their corporate broker or from a local investment bank in the context of a stock market and/or debt market relationship with either or both of these.

However, in many cases, only one or two firms might cover a particular SME. The reduction of the number of analysts and reduced trading volumes in small and medium cap stocks, a result of tougher market conditions, have affected the research coverage of SME issuers."[30]

[30] Forum Group report Section 4.6. See also EFFAS website http://www.effas.com/pdf/effas_PM03.pdf

Finally, our survey showed that this poor coverage is also an issue for investors: **a mere 19% of respondents described themselves as '*fairly satisfied*' with coverage.** 52% of investors surveyed indicated that they found that the quality of small and mid cap research varied by market and a further 13% saw coverage as a real problem.

Survey Question 16: *"Are you satisfied with the amount and quality of research on small and mid cap stocks? (A) Fairly satisfied (B) In some markets it is good but in some markets it is inadequate (C) This is a real problem."*

Fairly Satisfied	Varies By Market	Real Problem	Other
6 19%	16 52%	4 13%	5 16%

In question 17 of the survey we asked if the greatest gaps were in the sub €500m sector. The response rate on this question was quite low but a handful of respondents added comments, generally indicating the smaller the company the worse the research coverage. One Continental European investor wrote: *"Of course. Very little coverage and when there is coverage it is often of poor quality."* A UK investor wrote: *"Research coverage becomes quite limited at a relatively high market cap and down. Say E1.5b".*

Two investors made the link with the economics of small coverage:

- *"The smaller the company the less commission it can generate and the less it will be covered. Is this a bad thing? It may be that it is in a very long view but proper coverage costs money and who should pay? The pensioners? The owners of the asset management business? The sell-side? None of the above?"*
- *"We tend to focus on larger caps but the amount and quality of research on smaller companies by the larger firms has diminished somewhat (probably due to the downturn in the market)."*

7.2 When Does Small Cap Coverage Become Unprofitable?

In preparing this report one investor whom we consulted suggested that we show a simple model to illustrate the economics of small cap coverage. We followed this suggestion and show our assumptions in a blue font and green background. It would be possible to run a much wider test along this simple methodology using salary variants, a much larger sample of stocks and different commission rates.

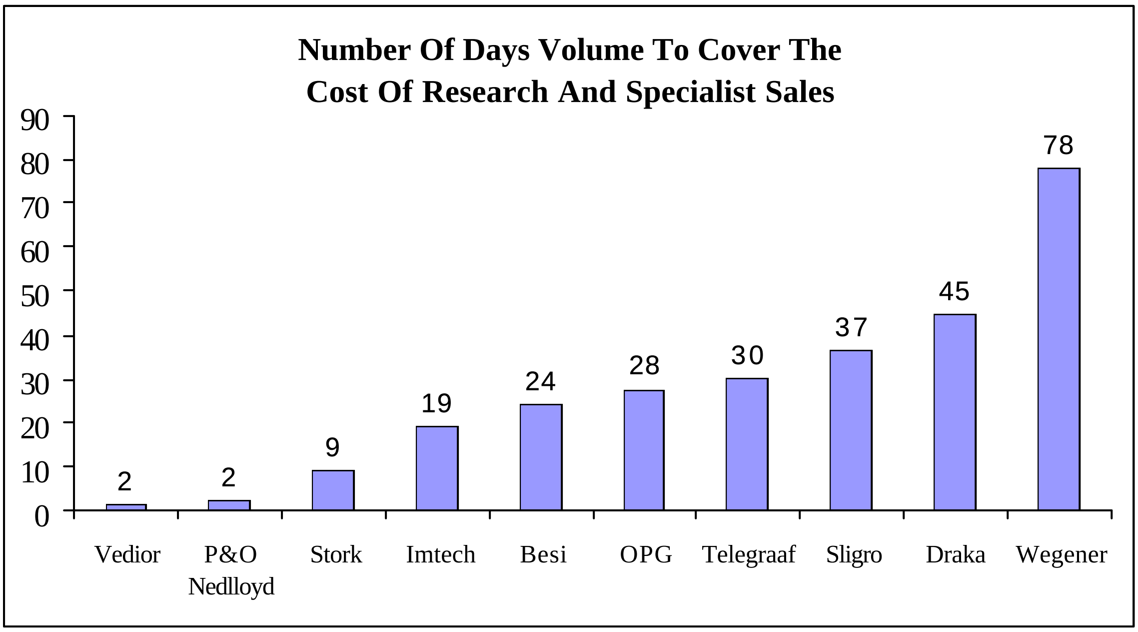
- In this model the first assumption is that an analyst's salary is £75,000 – this is probably low end, certainly in London.
- We then assume a sales person (on the same salary in this example) spends 25% of his/her time on the stocks covered by the analyst.
- To this basic salary we add a 20% mark up for other staff-related costs such as pensions to work out the full employee cost.
- To that number we add an additional 40% for indirect costs such as news services, property costs, travel etc.

The stocks covered by the analyst must bring in commissions of €225,000 to breakeven on this cost. **If the analyst covers 10 stocks that means ca €22,500 per stock.** At first sight, this looks like a modest target.

Analyst Costs	**Sterling**	**Euros**
Cost of An Analyst	75,000	107,143
Cost Of 25% Of A Sales Person's Time	18,750	26,786
Basic Salary Cost	93,750	133,929
Mark Up For Pensions, NI, Health etc	20%	
	18,750	26,786
Total Staff Cost	112,500	160,714
Mark-Up For All Other Costs	40%	
	45,000	64,286
Full Cost	157,500	225,000
Mid Cap Stocks Followed		10
Cost per Stock in Euros		22,500

Let's say commission rates are 0.2% (20bp) including trading costs of 5bp and back office of 1bp. This leaves 14bp to pay for research. This means the stocks covered must generate orders worth €16.1m euros to breakeven.

We took some sample Dutch stocks looking at average price and average daily volume to work out how many days volume that represented. In the case of Vedior breakeven is equivalent to only two day's turnover. This means that, working an order on the normal '1/3rd of the volume' basis, the firm could breakeven on coverage within 6 working days. This is easily achieved. For a share like Besi it would take the full market volume for 24 days to cover cost. Again, working 1/3rd of the volume, you would need to be active for 72 days a year which is less likely. Below the Besi volume level it gets really uneconomic.



2004 data to mid December

7.3 The Survey Suggests Small Houses Provide Better SME Coverage

The mathematics explains why it is not likely that these smaller stocks would be material for a large investment bank and this explains the orphaning process described in section 7.1. It is no surprise that where there is coverage it is generally from smaller houses, as illustrated in our survey. **Over half of respondents indicated that small brokers have more to offer in the small/mid cap sector although another 35% indicated that it is hard to generalise, several citing the individual analyst as a factor. Strikingly, not one respondent suggested that integrated houses offered a better service here.**

Survey Question 18: *"In markets or sectors where you find good small or mid cap coverage, is the good research produced (A) by the integrated houses, (B) by the smaller houses or (C) is it difficult to generalise?"*

Integrated Houses	Smaller Houses	Difficult To Generalise	Other
0 0%	16 52%	11 35%	4 13%

Those respondents who answered that it was 'difficult to generalise' mostly put it down to the individual: *"it really depends on the analyst and how dedicated they are."* One investor also attributed it to a given firm's culture: *"It depends more on individual performance rather than the house per se. However, good research is normally produced by houses that: 1. Promote a culture of in-depth research rather than 'maintenance'/'journalism'; 2. Limit the number of stocks covered by each analyst."*

The survey was much less help on defining mid and small cap stocks – question 15. There was a varied range of answers, proving that there is no standard definition. Some felt small cap was below one billion euro market cap and mid cap was up to a few billion market cap but others looked at the sector as those stocks outside their own main benchmark.

7.4 How Can SME Research Be Made Economically Viable?

Annex 5 of the Forum Group Report suggested one option might be to make the issuer responsible for the provision of research as a listing requirement. Effectively this means the issuer must pay for coverage. While this is clearly a practical solution the issuer is not likely to be happy to see the broker producing a sell note, paid for out of the company's pocket.

Once an issuer has resolved to pay for coverage, currently there are two options:

- Arrange this via a corporate brokership - the issues resulting from this are covered in the Chapter on "Conflict".
- Sign a *research-for-hire* contract.

The latter is not uncommon in the US. Research-for-hire arrangements were discussed in an article in the Chicago Tribune in June 2003: *" When K2 Inc. bought Rawlings Sporting Goods Co. in March, along with the famous line of baseball equipment came something that K2 would rather not talk about: a company-paid analyst to write about Rawlings' stock. Despite an internationally known brand name and 116 years in business, Rawlings had become what some call a Wall Street orphan, ignored by analysts at the big securities firms. So last year it signed a one-year, $25,000 contract with private research firm J.M. Dutton & Associates, whose analyst initiated coverage in November with a "buy" rating."*

As we mentioned earlier, the idea of issuers paying for research is not a bad idea per se. The question is whether this can be organised in such a way as to ensure the research is independent. The company covered must not be the direct paymaster if objectivity is to be protected.

In this context it may be interesting to look at an idea floated by the SEC in November 2002. Roel Campos, SEC Commissioner, made a public statement entitled: "Let Issuers Pay for Analysts' Research."

"…. who, ultimately, will pay for the independent research; and who will select the research providers? One answer would be to require all listed equity securities to be rated by an independent analyst. The meaning of "independent" would be defined by SEC rules and enforced by the stock exchanges. Under this scheme, independent research would be funded by the exchanges, which would pass on those costs to the issuers as part of their listing fees. Since issuers are benefiting from access to capital markets it is appropriate that they should carry the costs. Over time, however, those costs might be shared by the investment banks through lower underwriting and banking fees in exchange for the issuers' business."

The global research settlement requires the brokers to offer an independent research note alongside its own research work. **This still leaves a gap in coverage on companies too small to merit big broker coverage.** We believe a case could be made for Europe to kill two birds with one stone by ensuring that schemes intended to stimulate independent research also promote coverage of the SME sector.

Appendix 1: The Committee Members

George Möller was appointed CEO of Robeco Groep N.V. in July 2004. From September 2001 to March 2004, George Möller was a member of the Executive Board and COO of Euronext N.V., with responsibility for its cash and clearing business unit. In 2003 he sat on the Tabaksblat committee, which produced recommendations for best practices as regards corporate governance. George Möller studied economics at the University of Groningen. He began his career with AMRO Bank, where he held various positions in the credit, syndicated loan and treasury departments. He then became corporate treasurer at Deli Company and afterwards moved to London in various positions for Pierson, Heldring & Pierson including as General Manager of MeesPierson, London.

Dorothee van Vredenburch is the Managing Director of Citigate First Financial. She founded First Financial Communications, now Citigate First Financial, in 1993. In addition to advising various clients regarding their financial and strategic communications, Dorothee has also been involved in more than 10 IPOs and many more mergers and acquisitions. Up to 1993, Dorothee had worked for six years in the City as an investment analyst at AMRO International Securities and Swiss Bank Corporation. In her last position as Executive Director of the brokerage house Carnegie International, she was responsible for the so-called "Deutschemark Bloc".

Count Arnoud de Pret Roose de Calesberg graduated as a commercial engineer from the University of Leuven. From 1972 until 1978 Mr. de Pret served as Corporate Account Manager at Morgan Guaranty Trust Company of New York, and from 1978 until 1981 he was Treasurer at the Cockerill-Sambre steel company. Between 1981 and 1990 he held various finance positions with UCB, first as Treasurer and then as Chief Financial Manager and Member of the Executive Committee. In 1990, Mr. de Pret joined Société Générale de Belgique as the Corporate Finance Officer. From 1991 to 2000 he was a member of the Executive Committee of Union Minière (the company is now known as Umicore), as well as Corporate Vice-President Finance, and in 1992 he became Chief Financial Officer. Today, Mr. de Pret holds several Board and committees mandates: Delhaize Group, Inbev, Umicore, Sibelco, L'Integrale, Euronext (Orientation Council) and Sebastien Holding.

Stewart Colley is the Investment Manager of the British Steel Pension Fund and the Corus Pension Scheme. With early spells in areas as diverse as semiconductor research and encyclopaedia sales, Stewart read mathematics at Trinity College, Oxford followed by operational research at Cranfield. After periods in consulting with Booz Allen & Hamilton and systems development with Colgate Palmolive, he joined British Steel's Head Office Operational Research Unit soon after the creation of the British Steel Corporation. He moved from there to finance, in Corporate Treasury, and qualified as a Certified Accountant. In 1982 he joined the Pension Fund as Finance Manager and progressively became more involved in the investment side. He was appointed Investment Manager in 1992.

Tjalling Tiemstra is the CFO of Hagemeyer NV. He was appointed a member of the Board of Management in 2003 in the position of Chief Financial Officer. Previously Mr Tiemstra held the position of CFO at Hollandsche Beton Groep and various senior financial and general management positions with Unilever.

Jan van den Belt is the CFO of Océ. He was employed by Unilever from 1970 in the Netherlands and UK. He worked at Shell between 1977 and 2000. In the period up to 1997 he held several management posts with Shell in the field of treasury and controlling and as CFO in various countries in Latin America, the United Kingdom and the Netherlands. From 1997 until 2000 he was CFO of Shell in Brazil. He joined Océ in 2000.

Peter Moon is the Chief Investment Officer of USS Ltd. Peter Moon entered the city in 1972, working for the Central Board of Finance of the Church of England, after graduating from University College London with an economics degree. He has held a number of positions since and has been Chief Investment Officer at the Universities Superannuation Scheme since November 1992. He was a member of the NAPF Investment Committee from 1990 to 1995 and Chairman of the NAPF Stock Exchange Sub-Committee from 1991 to 1995. He is investment advisor to Middlesborough Council, the London Pension Funds Authority and MBNA Europe.

Dr Daniel Summerfield is Adviser, Responsible Investment, at the Universities Superannuation Scheme. He is responsible for co-ordinating USS's work to improve corporate governance performance of investee companies through the development and implementation of its engagement policy in the UK and overseas. He has been involved in setting up a number of initiatives including the International Forum for Active Shareowners (IFAS) which aims to facilitate better international co-ordination and communication between pension funds on governance issues. Previously, he was the head of corporate governance at the Institute of Directors where he was responsible for the IoD's work in corporate governance and corporate social responsibility. He was also project director of the Independent Director initiative which aims to support and promote the role and contribution of non-executive directors.

Martyn King is a Director of RCM in London (part of Allianz Dresdner Asset Management) and leads the European Financial Sector research team (based in London and Frankfurt) as well as jointly leading the Global Sector Team. Prior to taking up his research role he worked as a portfolio manager for European equities, at RCM (then known as Kleinwort Benson Investment Managers) and before that with Lloyds investment Managers and MGM Assurance. His early career was spent with Boustead Commodities Limited where he was engaged in a range of activities spanning the financial futures and commodities markets. Martyn graduated with a BA (Hons) in economics in 1983 from Pembroke College, Cambridge.

Appendix 2: The Investor Survey

Section A: Participant Details

1.	Would your company be best described as: (A) pension fund (B) insurance company (C) asset management company (D) hedge fund (E) wealth management company (F) private client adviser; (G) other (please specify)
2.	What are your total assets under management (AUM) to the nearest billion?
3.	What are your European equity AUM to the nearest billion? (This includes the UK, of course)

Section B: Is There A Need For Independent Research?

4.	Integrated investment banks now disclose banking relationships in their research. As a result an investor reading the research is aware of the potential conflicts of interest. In your view, is the current level of disclosure adequate to enable you (as an investor) to adjust for any potential bias: (A) Disclosure is adequate (B) It varies (if so, please comment below) (C) Disclosure is not adequate (If so, how could this be improved?)
5.	Integrated investment banks now disclose that the bank may or may not have a proprietary trading position in the researched share. In your view, is the current level of disclosure adequate to enable you (as an investor) to adjust for any potential bias: (A) Disclosure is adequate (B) It varies (if so, please comment below) (C) Disclosure is not adequate (If so, how could this be improved?)
6.	What role, if any, can or should independent research reports play at the time of an IPO or issue? Please comment in a few sentences.
7.	In an IPO which is of more use (A) the opinion of the syndicate analyst (B) the opinion of the independent analyst (C) neither

Section C: How Is Research Paid For?

8. At present, how do you pay for broker research?
   - (A) Traditional broking commissions
   - (B) Cash fees paid from our own P&L
   - (C) All our brokers are paid by commissions but we have introduced a system whereby a few large brokers get all the flow. These large brokers then pay fees to the smaller brokers (commission sharing).
   - (D) A mixture of the above (please specify)

9. With more and more focus on transaction cost analysis, is an increasing part of your firm's European equity business going through electronic crossing systems or direct market access terminals?
   - (A) No
   - (B) While only a small part of our flow goes via these systems at present, we see the % rising
   - (C) These systems already handle a meaningful part of our order flow

10. Is your firm in favour of 'unbundling' of research?
    - (A) Yes, we are in support of unbundling
    - (B) We are neutral
    - (C) We are opposed, and if so, please specify why
    - (D) This topic has not been discussed

11. Would you expect the broker's behaviour to change if remunerated by fees as opposed to commissions on turnover? If so, please explain?

Section C: How Is Research Paid For (continued)

12. Is the number of brokers you deal with expanding or contracting?
    - (A) Expanding – if so, are small brokers being added?
    - (B) Stable
    - (C) Contracting – if so, are small brokers being cut off?

13. Is there a difference between the brokers that the fund managers want to reward and the brokers that the dealing teams feel provide best execution?
    - (A) Not an issue
    - (B) A source of occasional conflict
    - (C) A source of regular conflict (if possible, explain)

14. Do you currently allocate a portion of the research budget (commission or fees) to independent research and if so, on average how much?
    - (A) No
    - (B) Less than 3% of total commissions/fees
    - (C) More than 3% but less than 10% of total commissions/fees
    - (D) 10-20% of total commissions/fees
    - (E) Over 20%.
    - (F) I have no idea

Section 4: Research On Small And Mid Cap Stocks

15. How do you or your firm define mid and small cap stocks?

16. Are you satisfied with the amount and quality of research on small and mid cap stocks?
    - (A) Fairly satisfied
    - (B) In some markets it is good but in some markets it is inadequate
    - (C) This is a real problem.

17. If you answered (C) to question 16, could you explain where the greatest gaps are? For instance, is coverage more limited on stocks with a capitalisation under €500m?

18. In markets or sectors where you find good small or mid cap coverage, is the good research produced
    - (A) by the integrated houses,
    - (B) by the smaller houses or
    - (C) is it difficult to generalise?

Appendix 3: The Recent Evolution Of EU Equity Research

Don't brood on what's past, but never forget it either" Thomas H. Raddall

Introduction

Since the early 60's the UK has had a strong equity culture[31] and, following the removal of exchange controls in 1979, these funds started to shift assets into Continental European equity markets, resulting in a boom in those markets.

The local or national brokers in each country played a very important role. Sometimes it was the big banks – such as ABN and Amro in the Netherlands, Dresdner in Germany, Creditanstalt in Austria and Santander in Spain. Sometimes it was smaller banks or brokers such as Schroeder Muenchmeyer Hengst in Germany, Pierson Heldring Pierson in the Netherlands and Carnegie in Scandinavia. In France broking was in the hands of the agents de change and the big names were the likes of Bacot Allain and Cholet Dupont.

The UK market was also a single capacity system with business done by the broking partnerships. Big names included James Capel, Rowe & Pitman, Philips & Drew, de Zoete & Bevan, Cazenove and Grieveson Grant. Some of these UK firms also built up serious "European" desks (this meant excluding the UK) to handle the business - Savory Milln was one such name. The Americans were simply not a factor on the brokerage side although they were already becoming a real force as investors in European equities, both through London offices and the US offices – Fidelity is a classic example.

Regulatory Changes In the Late '80's Transform the Landscape

In the late 1980's Big Bang blew the old UK broking world apart, and we talk about this in some detail below. On the other hand, this was not just a British phenomenon. France had its own "Petit Bang." Since Napoleon's time the agents de change had enjoyed a monopoly on share trading. Mr Edouard Balladur, then finance minister, brought in reforms whereby initially French and foreign banks and other institutions could buy up to 30% of the capital of the agents de change. This would then move to 49% and finally 100% by 1990. By 1992 the monopoly was to be eliminated and anybody could start a brokerage in Paris.

As one analyst put it: "*In the 1980s, European capital markets changed radically. Traditional intermediaries such as the agents de change in France and banks in Germany saw their roles significantly reduced by the introduction of automation on the floor of the exchanges.*[32]"

---

[31] This was led by pioneers like George Ross Goobey at the Imperial Pension fund

[32] "Changes in the structure and dynamics of European securities markets" by Alexandros Benos and Michel Crouhy in the Financial Analysts Journal, Association for Investment and Research May/June 1996

However 'Big Bang' was the biggest single change, because of the instantaneous change in ownership. With a single exception – Cazenove - the main UK stockbroking partnerships decided that it made sense to sell out to the better capitalised investment or universal banks. The US investment banks arrived with a vengeance on the London scene, partly through acquisition and partly on a DIY basis.

The stated goal of 'Big Bang' was to make dealing in shares more competitive and efficient. The key changes were: (1) that all stock exchange members could now operate in "dual capacity" both executing clients orders and trading for their own account; (2) that the minimum commission scale was abolished; (3) that best execution – i.e. matching the best price - became a requirement; (4) that "corporate membership" by banks and financial institutions was allowed, and (5) a computerised dealing system (SEAQ) was established. This impact of the resulting revolution is summarised by the Forum Group Report as follows:

> *"Over the last two decades, the growth of financial conglomerates and integrated firms (principally universal banks and investment banks) has been a particularly important factor in the investment industry. For example, in the United Kingdom, as a consequence of 'Big Bang' reforms in 1986, ownership of London Stock Exchange member firms by non-member financial institutions was permitted for the first time. These "integrated" firms were able to act in a dual capacity as both a broker and a dealer.*
>
> *The expanding range of activities undertaken by many such integrated firms has increased the potential for conflicts of interests between different constituencies of clients, on the one hand, and between the client and the firm, on the other hand. In integrated firms, corporate finance and other activities often provide a funding contribution that finances a portion of the research budget."*[33]

We describe below five key factors behind the change in competitive landscape:

(A) The Importance Of Execution

The first factor in the increasing importance of these big banks was capital and appetite for risk, as typified by the US banks. Since the late 1980's US houses, in particular, have made a successful assault on the European Securities markets, both primary and secondary. One reason has been their ability (capital) and willingness (culture) to take principal positions in a period when major institutions have increasingly demanded that their brokers provide liquidity and speed of execution, for instance with the emergence of large scale program trading. In many years the trading book was a big money-maker too.

More recently new technologies have started to have a very major impact on trading patterns too – we describe this in Section 4.2, 'The Changing Face Of Execution.'

[33] The Forum Group Report, section 5.1, page 24.

(B) The Boom In New Issues Justified Paying Top Dollar For Star Analysts

Secondly, as mentioned before, the ability to cross-subsidise research made them an unmatchable bidder in the race for the top analysts as discussed previously in this report.

It is hard to overstate how much this additional source of funding influenced the price which analysts could command. What investors paid in commissions sometimes seemed almost an irrelevance. Put bluntly "no IPO flow = no star analyst". Why would the investment banking division be happy to subsidise the agency research department – the answer is that the analyst was an integral part of the marketing pitch for new issues business (and also for winning M&A work). So the reverse was also often the case: "no star analyst = no IPO deal." The late 1980's and early 1990's saw a booming IPO market so this source of revenue was extremely important.

The hiring of a top analyst team could instantly move a bank into pole position in the rankings in a country or sector. One of the biggest breakthroughs for the US investment banks in the period post big bang was the recruitment by Goldman Sachs of the Warburg German team in 1993, the year before the Deutsche Telekom mandate was awarded. This was still a period where the US banks were nowhere in the rankings. This is well-illustrated by a quote, in translation, from the Frankfurter *Allgemeine Zeitung* of 23rd February, 1994:

> *" The Institutional Investors have chosen S.G. Warburg as the bank with the best research. For the last 3 years Warburg has published the best sector research and country analysis. Also for macro economic research and UK sector research Warburg is among the top. Second on the list is James Capel, then Barclays de Zoete Wedd, Smith New Court, NatWest Securities, Kleinwort Benson Securities, UBS and Goldman Sachs.*
>
> *Despite the aggressive expansion of the research – among others the whole Germany equity research team from Warburg under Timothy Plaut went to Goldman Sachs – the investment bank was in 8th place*
>
> *…….. The best analysts for German equities were Timothy Plaut, Nicholas Jones and Stefan Sanne from Goldman Sachs. When that team still worked for Warburg, the British bank was voted the best in German equities."*

(C) The Rising Importance Of Sector Coverage Over Country Coverage

The old breakdown of research coverage in Europe by country – the Austrian team, the German team – gave way to sector coverage – European Chemicals. The later introduction of the Euro made this even more logical – Euro Zone fund managers have changed equity asset allocation away from the high domestic percentages of the past, thus reorganising their fund management approach along industry lines.

This sectoral trend was embraced and led by the integrated investment banks, several of which already had strong US based sector teams whose expertise could be leveraged.

The corporates also found this more logical – the IR department of Unilever was probably more interested in the comparison with Nestle than with Royal Dutch. Sector teams were absolutely crucial in winning big IPO mandates. For example the tech and telecom teams ballooned up during the IPO booms and contracted as this business disappeared. **In a sector-dominated environment smaller (especially domestic) securities players struggled to maintain share.**

(D) The Growth Of Buy-Side Research And Its Impact On Broker Servicing

This sector development has been paralleled by the larger fund managers creating or expanding their own in-house research capability. In the late 1980's the fund management analyst was usually a graduate trainee who spent a couple of years following a sector before being given the real prize of a fund to run.

The 'Capital International'[34] model was very different and much admired and copied. At Capital being an analyst was a *real* job and their very experienced teams of analysts often had better access to company top management than the sell side equivalents. As other fund managers copied this model it became more normal for specialist sectoral funds to be allocated to these analysts, accelerating the trend whereby money is managed on an industry basis. (The investment consultants have been supportive of these trends, seeing these in-house capabilities as a major part of asset management house's value-added).

As analysts and in-house dealers became more than assistants and gained more and more influence on where business was directed – previously just the choice of the fund manager – so servicing these funds became more challenging for a broker. **That is, the bulk of the commission allocation was directed to a handful of global houses who were able to manage the account as a whole, i.e. giving a service to the whole matrix of fund managers, dealers, analysts on a coordinated basis.** Here individual relationships are less important. This was also a blow for the smaller brokers, who relied on people contact.

It may be worth pointing out that the quality, aims and methodology of buy-side research still varies. The Forum Group Report indicates: "*Buy-side analysts often source research from sell-side analysts, and then use this information as a base for their own research*."[35] The range is quite massive from analysts with their own ideas, own models and many years experience to analysts who simply synthesize and summarise the views of the top three rated sell-side analysts. It would be interesting to see if unbundling would reduce the level of duplication in the latter.

[34] A major US asset management house.

[35] Forum Group Report, Section 4.2, Page 18

(E) The Rise And Rise Of The Hedge Funds

While the sophisticated matrix models at fund managers were popular with the investment consultants, who preferred process to individual fund manager's brilliance, a new problem emerged.

Some of the best and most creative individuals felt that working in these well oiled machines, particularly with collegiate decision making, takes some of the fun out of the job. The result was a massive growth in European equity hedge fund sector in the second half of the 90's. In these funds the star fund managers regained their autonomy and could make serious money too.

For the small brokers this had pros and cons. On the positive side the individual fund manager was again important, making it a 'people business' once more. Voting systems were less prevalent – if the fund manager liked the idea he/she dealt straight away – what those in the industry sometimes call 'feeding time at the zoo.'

However the hedge funds high turnover levels made transaction costs a real issue, and this trend favoured the big brokers. One side effect of the hedge fund boom has been a growing frustration amongst large pension funds who find themselves well down the large brokers' commission lists, given their low portfolio churn rates.

Appendix 4: SEC Fact Sheet on Global Research Settlements

US Structural Reforms [36]

- The firms will separate research and investment banking, including physical separation, completely separate reporting lines, separate legal and compliance staffs, and separate budgeting processes.
- Analysts' compensation cannot be based directly or indirectly upon investment banking revenues or input from investment banking personnel.
- Investment bankers cannot evaluate analysts.
- An analyst's compensation will be based in significant part on the quality and accuracy of the analyst's research.
- Decisions concerning compensation of analysts will be documented.
- Investment bankers will have no role in determining what companies are covered by the analysts.
- Research analysts will be prohibited from participating in efforts to solicit investment banking business, including pitches and roadshows.
- Firms will implement policies and procedures reasonably designed to assure that their personnel do not seek to influence the contents of research reports for purposes of obtaining or retaining investment banking business.
- Firms will create and enforce firewalls between research and investment banking reasonably designed to prohibit improper communications between the two. Communications should be limited to those enabling research analysts to fulfil a "gatekeeper" role.
- Each firm will retain, at its own expense, an Independent Monitor to conduct a review to provide reasonable assurance that the firm is complying with the structural reforms. This review will be conducted eighteen months after the date of the entry of the Final Judgment, and the Independent Monitor will submit a written report of his or her findings to the SEC, NASD, and NYSE within six months after the review begins.

US Enhanced Disclosures

- Each firm will include a disclosure on the first page of each research report stating that it "does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report."
- When a firm decides to terminate coverage of an issuer, it will issue a final research report discussing the reasons for the termination.
- Each quarter, each firm will publish on its website a chart showing its analysts' performance, including each analyst's name, ratings, price targets, and earnings per share forecasts for each covered company, as well as an explanation of the firm's rating system.

[36] Source SEC Website