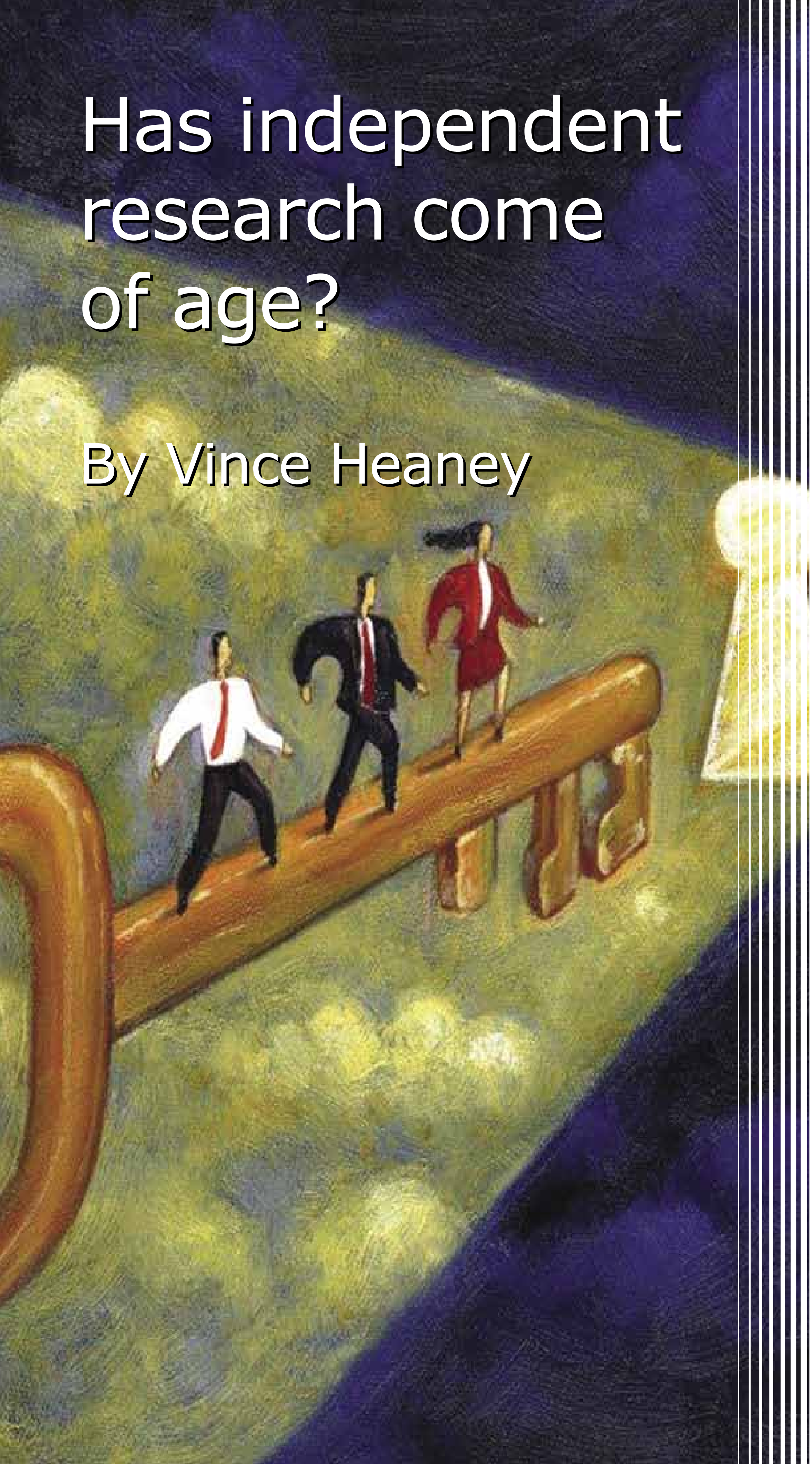
Has independent research come of age?

By Vince Heaney



Euro IRP

CSFI

Centre for the Study of Financial Innovation

The Centre for the Study of Financial Innovation is a non-profit think-tank, established in 1993 to look at future developments in the international financial field – particularly from the point of view of practitioners. Its goals include identifying new areas of business, flagging areas of danger and provoking a debate about key financial issues. The Centre has no ideological brief, beyond a belief in open markets.

CSFI publications can be purchased through our website www.csfi.org or by calling the Centre on +44 (0) 207 493 0173

Published by
Centre for the Study of Financial Innovation (CSFI)

Email: info@csfi.org
Web: www.csfi.org

ISBN: 978-0-9563888-7-2

Printed in the United Kingdom by Heron, Dawson & Sawyer

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NUMBER ONE HUNDRED AND ONE JUNE 2011

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Foreword

It has been the experience of many members of EuroIRP – the European Association of Independent Research Providers*– that the financial crisis served to differentiate more clearly independent research from the sell-side competition. Since then, it has played an increasingly critical and value-added role in the world of investment. Many of our clients also testify to the advantages that independence offers analysts – particularly the freedom to express unconflicted and controversial ideas and recommendations.

So it seemed appropriate to commission from the CSFI – an independent body adhering to the high standards represented by our membership – an independent report into this increasingly important industry.

The findings, while in part encouraging, highlight that the independent sector must still contend with an uneven playing field against the sell-side. EuroIRP remains committed to improving the position of our membership – and very much appreciates the substantial efforts the institutional fund management community has made to support and assist the independent sector.

Above all, we want to encourage and ensure the success of firms that work hard to provide the very best unconflicted research for investors.

Peter Allen
Co-chair EuroIRP
Managing Director Lombard Street Research

Elaine Mulcahy
Co-chair EuroIRP
Managing Director dealReporter

**EuroIRP was set up in 2005 to represent the interests of the independent investment research industry in Europe. With some fifty member firms, its goals are:*

- *to enhance the awareness and reputation of independent research;*
- *to change the perception that research is free;*
- *to work with regulators and investors to promote the awareness and acceptance of payment structures; and*
- *to improve the regulatory and fiscal environment in which independent research firms operate.*

Preface

As a journalistic witness to the "tainted research" scandal exposed by the dotcom crash, I was there at the birth of independent research as a sector – rather than just a few brave firms. Following its progress has chimed with the CSFI's interest in emerging trends in capital markets, including anything that enhances competition.

This is not to say that independent research is bound to be better than that offered by the sell-side – I have valued contacts with clever people on both sides – just that incumbents should be challenged. And where conflicts of interest persist, these are more likely to be dealt with if there is an independent alternative.

The sector is now entering its second decade, if the reforms triggered by Eliot Spitzer are used as the starting point. Whatever the "would be nice" reasons for having independents around, they have to stand on their own feet financially. The business model has often been questioned because it is up against sell-side research that is perceived as free. So an assessment of its viability and of ways that might improve revenues in future is well worth undertaking.

Vince Heaney, a former deputy head of the *Financial Times*'s Lex column and now an independent financial journalist, has dealt with analysts of all hues during his career. For this report, he interviewed 25 people both in the sector and outside it, and drew on a survey of EuroIRP members.

EuroIRP commissioned this report, and the question posed in the title obviously places the focus on the independent sector. The conclusions of the report, which looks at what will constrain or encourage the sector's growth, are provocative. We at the CSFI do not take an institutional position on the issues, and we accept that sell-side providers of information may disagree with the report's conclusions. That is as it should be: what the CSFI wants to achieve is a healthy debate on an issue of genuine importance to investors.

Jane Fuller
Co-director, CSFI

Executive summary

The market environment

Market is worth about £250m

- Five years after the introduction of the FSA's new regime on unbundling, the independent research sector is growing, both in number of firms and in the demand for their services by buy-side fund managers.

- Regulatory change in the UK has been an important element underpinning that expansion.

- Hard data on the size of the European independent research sector are not readily available. Recent estimates suggest the market is currently worth about £250m.

- The market remains highly competitive. After a reduction in headcount in 2008-09, the sell-side is investing in research again, while buy-side commission budgets remain under pressure.

- The independent sector must still contend with an uneven playing field. The sell-side model is increasingly a combination of execution, research that at times is commoditised and corporate access based on leveraging client banking relationships.

- Corporate access does not fall within a definition of research, which requires it to contain 'original content' and is, therefore, not a legitimate use of dealing commissions.

Recommendations

The regulatory arena

- Pursuing the introduction of a mandated market share for IRPs, or subsidising the production of independent research, is not the best course of action. It risks compromising the quality of research, which is the sector's point of differentiation.

- EuroIRP should push for a stricter implementation of the UK unbundling regime, specifically the exclusion of corporate access payments. It should also lobby for the introduction of similar market mechanisms in European countries currently without such schemes.

Pursuit of corporate access agenda

- The FSA admits that corporate access might not be a legitimate use of dealing commissions, depending on how it is structured. The regulator points to the new Financial Conduct Authority as the conduit to pursue the corporate access agenda, given its expected focus on wholesale conduct.

- Establishing a single clearing house for CSA payments would be difficult to accomplish and in practical terms would be little different from the functions already provided by independent brokers.

- CSA payment mechanisms are not perfect but are moving in the right direction. The best practice agenda drawn up by EuroIRP in 2007 should be pursued alongside the corporate access agenda.

- Euro IRP should also: 1) Analyse the feasibility of developing research value metrics as a positive step towards more widely establishing independent research as a value-added product rather than a cost. 2) Develop its public relations strategy to counter the perception of independent research as being no different from expert networks.

Market structure

- Independent research in Europe will continue to grow from the current low base. But it is a niche rather than mass-market product,valued partly for its exclusivity, and is likely to remain a relatively small proportion of the market.

- Anecdotal evidence points to the benefits of scale when dealing with buy-side clients and the cost of regulatory compliance appears set to increase, placing a greater relative burden on smaller firms.

Potential umbrella organisation

- To consolidate and build on progress to date, the scale of the operators within the sector needs to increase through partial consolidation.

- A potential future model is one in which providers of unique services group together under a co-branded umbrella organisation to market their services more effectively, to help meet the cost of regulatory compliance and to offer execution services to capture more of the value chain. This organisation could be created from the universe of existing IRPs and independent brokers.

- This model has the potential to capture a greater proportion of the value chain as well as dealing with the VAT problem. It need not compromise either the quality of the research product or a realistic definition of independence that includes execution-only broking but excludes proprietary trading, asset management and investment banking services.

Introduction

A decade after Eliot Spitzer uncovered sensational evidence of tainted research by analysts working at investment banks, the relationship between the sell-side and its clients is headline news once again. The insider dealing trial of Raj Rajaratnam, founder of the Galleon Group, turned on whether the hedge fund's trading was based on a "mosaic" of research and publicly available information, or inside information provided by investment banks and corporate insiders.

Need for unbiased investment research

Spitzer's earlier investigation in the wake of the tech bubble focused attention on the need for unbiased investment research and led to the "global settlement", which provided funds to support independent research. Little of these funds made it across to Europe, and the UK instead followed a more market-driven approach, by 'unbundling' dealing commissions into research and execution components following the recommendations of the Myners Report on the responsibilities of institutional investors.

Regulatory change helped spur the development of the independent research sector but, entering a second decade, have independent firms proved their worth and found a sustainable business model? The development of electronic delivery channels has facilitated a continuing proliferation of investment bank research, and independents must compete with this output, which is still perceived by many to be 'free'. Banks, meanwhile, continue to use their relationships with corporate clients as leverage with buy-side fund managers. As the insider dealing trials show, alleged abuses still exist, but overall is the playing field now level?

This report, commissioned by the European Association of Independent Research Providers and published by the CSFI, describes the sector and analyses what has made at least parts of it viable and assesses whether, and how, it can continue to grow. The conclusions are my own and are not necessarily endorsed by the CSFI.

The business model

The independent research sector is a very varied market, with providers offering fundamental and technical analysis across a range of asset classes as well as macroeconomic research. While not providing an exhaustive picture of the sector, a combination of questionnaire responses and interviews with EuroIRP member firms has created the following picture from a significant proportion of the association's membership:

Model of subscriptions plus CSAs

- The dominant model is a combination of hard cash subscriptions with Commission Sharing Arrangements. CSAs are designed to allow fund managers to choose a broker for execution and direct the research portion of the commission to another research provider [See flowchart on Page 7].

- In the credit markets, for example, CSAs are not well established with the emphasis remaining on the subscription model. In the equity markets, CSAs are more widely used.

- Where CSAs exist, the trend is for the proportion of revenues received through these mechanisms to increase. Some IRPs also report that the frequency of payment from CSAs is increasing – from annual to quarterly.

- Additional revenue streams are provided by agency broking services and consultancy fees.

Definitions of what constitutes independence also vary. Some IRPs view the offering of execution-only broking services as a conflict of interest with independence. The consensus view, however, is that pure agency broking, as a payment mechanism rather than as the primary focus of the business, is acceptable. Proprietary trading, investment banking services and asset management are generally considered inconsistent with independence.

Most issuer-pays arrangements are also deemed incompatible with independence, particularly examples where a company, perhaps not covered by the large sell-side institutions, pays for research into its own business. Broader macroeconomic research commissioned by clients, however, was deemed acceptable by some IRPs. For example, a client might commission a report into a particular economy with exclusive rights to the analysis for a specified period.

Introductions do not meet independence criteria

In the US, the independent research sector, also known as the alternative research sector, includes a considerable number of expert network companies, which provide access to industry experts for fund managers seeking corporate information.
The use of expert networks is less widespread in Europe and companies offering introductions – 'dating agencies' – rather than research with original content do not meet the criteria for independence according to EuroIRP's member firms.

Size of the market

A growing number in top 250

Hard data on the size of the independent research sector is not readily available. Thomson Reuters Extel conducts an annual survey, which ranks research providers from both the sell-side and the independent sector, based on the share of fund managers' votes. The 2010 survey shows that the independent sector is growing, both with regard to the number of firms in the top 250 and as a share of the overall vote.

In 2010, Redburn Partners, a pan-European equity broking and research house, became the first independent provider to enter the top 20 of the Extel survey in terms of votes won. In absolute terms, however, the independent sector's share of the vote remains very small.

EXTEL - INDEPENDENT RESEARCH PROVIDERS		
EXTEL PAN-EUROPE 2008 - 2010		
Year	**Number of Firms in top 250**	**% of weighted Extel vote**
2008	27	2
2009	31	2
2010	37	3

EXTEL 2010 - TOP 20 INDEPENDENT RESEARCH PROVIDERS RANKING		
Rank	**Research Provider**	**Weighted Points**
1st	Redburn Partners	22364
2nd	Autonomous Research	4846
3rd	Absolute Strategy Research	4110
4th	Helvea	3294
5th	Arete Research	3080
6th	New Street Research	2231
7th	BCA Research	2044
8th	Capital Economics Limited	753
9th	Auerbach Grayson	444
10th	DRUGANALYST equity research	421
11th	Lombard Street Research	385
12th	Coleman Research Group	250
13th	Empirical Research Partners	245
14th	Smithers & Co.	227

Continued on next page

15th	Longview Economics	219
16th	Aviate Global	186
17th	PH Partners	153
18th	Independent Strategy	132
19th	Vigeo	120
20th	Consumer Equity Research	97

Integrity Research Associates, an information provider specialising in the investment research industry, suggests that the share of the fund manager vote may not be a good proxy for spending on research. Its estimates (shown below), drawn from a variety of sources, give the independent sector a far larger share of the market than the Extel vote. Integrity combines 'top-down' estimates of commissions as well as 'bottom up' calculations aggregating the revenues for individual research providers. The estimates for alternative research include hard dollar/cash payments as well as commissions.

2010	Commissions	Sell-side Research	Independent/Alternative Research
	$bn	$bn	$bn
North America	11.0	5.5	1.8
Europe	5.1	2.9	0.6
Asia	4.7	2.4	0.2
Total	20.8	10.7	2.6

Integrity's universe of providers, however, includes 'primary research' providers such as expert networks and other industry consulting firms and survey/market research providers. For these latter providers, Integrity estimates their financial services revenues excluding the amounts received from companies. It therefore probably overestimates the size of the market for independent research. Globally, fundamental firms represent 30% of Integrity's universe by number.

Start-ups appear in the market

Instinet, the independent broker, has also estimated the size of the UK and continental European independent research market based on a variety of sources, including figures from Integrity Research. Instinet's figure, which it warns is an estimate rather than a precise value, is that the UK/European market for IRPs is currently worth €286m.

While hard estimates of the market's size are thin on the ground, anecdotal evidence strongly suggests the independent research sector is growing. EuroIRP's membership, for example, has increased rapidly over the last two years, and both research providers as well as buy-side and sell-side firms refer to the number of start-ups appearing in the market.

Sector growth is a function of both supply and demand factors as well as regulatory change.

Supply push: Nobody ever says, "I wish there was more research"

On the supply side, the financial crisis prompted a cut in sell-side research headcount during 2008-09. Perhaps unsurprisingly, the reduction in sell-side capacity was particularly marked in the credit markets. In 2010, however, the headcount shrinkage stopped and has started to reverse. "I met the global head of research at Citi recently," says one IRP. "He told me they were hiring again and he was far more upbeat than the last time I had seen him shortly after the financial crisis broke."

Sell-side shrinkage starts to reverse

With pressure to reduce costs, the profile of investment bank research teams has also changed. In many instances younger, cheaper, lower-level associates have replaced managing directors in their mid-30s as senior analysts. "It's a bit like Logan's Run out there," says one IRP. "The investment banks are a young man's domain." A proportion of analysts facing these circumstances will set up as independents.

The frustrations of working on the sell-side contribute to the flow of senior analysts striking out on their own. One with a successful track record described how the focus on measuring performance in mechanistic ways had shifted the emphasis away from the quality of the research. The requirement to service a long tail of clients meant the only way to cover them all was deliberately to call outside normal working hours. As long as the call to the client's office was electronically captured and lasted 15 seconds it counted towards the required quota. Similarly, performance was judged on the number of morning meetings at which the analysts spoke, not whether they had anything new to say. Such practices raise questions about the quality of the research at some firms.

Setting up as an independent is, however, only likely to appeal to a certain type of individual. Analysts lacking an entrepreneurial streak, or those dependent on a large bank franchise for their relative success, are unlikely to start their own firm. The senior analyst referred to above, for example, was made redundant during the post-crisis period not because of his performance but the bank had cut coverage of his sector. With a well-documented record of calling the market correctly, he would seem the ideal candidate to become an independent, but is concerned about the viability of the business model.

Brand value is both a critical success factor and a potential barrier to entry, limiting expansion of supply. Independent start-ups without an established following for their analysis are likely to find it tough to gain traction in a market crowded with sell-side research, which clients still perceive to be free at the point of consumption.

Brand value critical to success

As one IRP describes the situation, "the first hurdle is to get out of the junk mail folder, as nobody ever says 'I wish there was more research'." One fairly recent start-up described its efforts to convey its seriousness of intent to clients by ensuring, on day one, that it had a full team in place offering complete sector coverage with branded products. Only a relatively small number of research teams will possess the required market credibility as well as the inclination to set up as independents.

Banks have increased salaries substantially

Some IRPs also cite difficulties in being able to compete with sell-side remuneration levels to attract senior analysts. With pressure on bonus pools post-credit crunch, many investment banks have altered their remuneration mix to increase substantially the salary component. This can deter some from leaving the sell-side as well as affecting the ability of IRPs to lure them away.

The growing number of IRPs is, therefore, unlikely to become a flood, although the sector looks set to continue to expand, particularly when the demand side of the equation is considered.

Demand pull: Being independent is good, being right is better, being both is ideal

Interviews with large fund managers back up the results of the Extel survey – independent research is a growing percentage of buy-side research budgets. Part of the reason is dissatisfaction with the sell-side offering. Of course, referring to "sell-side research" is a massive generalisation and the quality of output from the investment banks varies significantly. One interviewee on the sell-side disagreed strongly with the idea that the quality of published research had been devalued. He highlighted the fact that the numbers attending the bank's pure research seminars (with no corporate access) were running at record levels.

One large buy-side manager noted that alongside the sell-side's renewed investment in their research operations in 2010, an effort had been made to move away from low-grade research to higher quality output: "They are becoming more like-minded with the independent providers and taking a more strategic view." Also, since the ranks of the independent sector are filled with people who gained their experience as sell-side analysts, it would be unrealistic to suggest that there are no insightful analysts at investment banks.

Conflicts of interest exposed

While impossible to quantify, there is anecdotal support for the idea that the reputation of sell-side research suffered as a result of the credit crunch, both because it exposed conflicts of interest and because the banks got the market so wrong. This view is by no means universal, however, with one buy-side firm correctly highlighting that many investors were just as wrong about the market. But the crisis has affected the demand for research by marking the end of the credit-fuelled bull market. As one IRP puts it, "the appetite for independent research existed pre-crisis, but until 2007, with a bull market in a number of asset classes, you didn't need to read research, you just needed to be invested."

Sell-side research: conflicted and commoditised?

The shortcomings of sell-side research pre-date the financial crisis. Bulge bracket banks' corporate finance and trading relationships with their corporate clients have long resulted in scepticism about the independence of their views. In compiling this report few believed there was a far greater degree of objectivity in the post-Spitzer and post-Myners world. In the US the proportion of sell recommendations on equities has increased to some extent. But in Europe, several interviewees highlighted the practice of analysts never putting a sell recommendation on a company for which their firm is house broker.

As one large fund manager puts it: "We don't care that much what rating the bulge bracket put on a stock. We look at the information and the analysis and ignore the conflicted recommendations." For some, this merely reflects the reality that the banks can earn far more from corporate finance fees from clients than from commissions from investors.

Trend to promote short-term trading

Alongside potential conflicts of interest, the trend for banks' published output to promote short-term trading ideas is commonly cited as one of its significant drawbacks. "These days there is more trade-linked material, not even pretending to be research," says one IRP. "There are three-bulletpoint 'research' notes with seven pages of disclaimers." Electronic delivery, across a growing number of platforms both office bound and mobile, has fuelled a massive proliferation in the quantity of research that clients are bombarded with. There is a measure of agreement from both the sell-side and the buy-side that this has been to the detriment of quality.

In defence of the sell-side, a bank's research must now try to meet the needs of clients with very different market outlooks and time horizons. The growth of the hedge fund industry has underpinned the greater focus on shorter-term trade-linked material, which will not necessarily meet the requirements of a traditional long-only fund manager. In the years preceding the financial crisis, the growing hedge fund industry provided an increasingly significant proportion of dealing commissions, so investment bank research catered more to its needs.

According to one sell-side equity analyst, "the internet has eroded the content of research. There is a lot of repetition of facts and less reliance on the interpretative power of the analyst." In an environment where more can amount to less, buy-side clients say that IRPs often provide better research than the sell-side. "The brokers provide a certain level of commoditised research," says one fund manager. "To find value we have to go elsewhere and IRPs provide value at the top end." One large fund manager, however, did question the pace of innovation in new product: "It's been a long time since I saw any new or really exciting products from the independent sector, which might be because it's a tough environment to be investing in growth and innovation."

Some fund managers state that if an idea makes their funds money it is not important whether the provider is an independent research house or a large investment bank. But, in addition to the question of quality, electronic delivery has fuelled rapid dissemination of information, both authorised and unauthorised. "In 2009, I wrote a piece of research that went against the prevailing consensus, calling the bottom of the market in my sector," says one sell-side equity analyst. "Within half an hour of publication, I received a call from an investor, who was not on the distribution list, but had been forwarded the research by a third party and wanted to discuss it. In his email trail were literally hundreds of recipients – from other banks, to news services and investor relations people – none of whom were on the distribution list."

Clients value exclusivity

With research that is perceived as free, few apparently feel obligated to respect non-proliferation clauses, even when to do so would be to their advantage. Proliferation is obviously a risk for independents too, but the fact that clients value the product partly for its exclusivity helps counteract the problem.

"We need to understand what's implied in the market price in a stock, sector or particular geography, and the bulge bracket firms are useful in gauging that," says one fund manager. "But we are looking for value-added insights that are not in the market. Bulge bracket research is more likely to be in the market and, therefore, in the price. Information is becoming commoditised, but insights that are not widely available are valuable."

Independent research fills a growing demand both for high quality analysis untainted by corporate bias and for research that is not widely disseminated, thereby providing the buyer with a market edge. For an IRP, however, exclusivity is a dual-edged sword. "If an independent research provider becomes mainstream, then the economic advantages to that IRP increase, but for the buyer, the value of that information drops. The more independent research remains a niche, the more benefit it is to me," says one fund manager.

'You can't sell poor quality research'

This exclusivity issue creates a constraint on the potential growth of an independent provider. Some IRPs, for example, explicitly address this question by placing a limit on the number of clients who receive their service. Expansion must, therefore, take place by product diversification by area of expertise, sector or geography. This is not without its problems, since a business model based on the insights and 'brand value' of experienced analysts cannot be stretched too thinly without the risk of adversely affecting quality. "Our client base likes that we are independent, but if our ideas were wrong they wouldn't take our research," says one IRP. "You can't sell poor quality research."

Regulatory change: in pursuit of a level playing field

The third factor influencing the development of the independent research sector is the regulatory environment, specifically the regime governing soft commissions and bundled brokerage arrangements. In Europe, the UK has moved the furthest towards a regulatory requirement for unbundling with the changes introduced in the wake of the Myners report.

Appointed by the Chancellor of the Exchequer to carry out a review of institutional investment in the UK, Paul (now Lord) Myners published his eponymous report in March 2001. One of the report's findings was 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".

Purchasing decisions not entirely separated

In response, four years later, the Financial Services Authority published new rules that limited investment managers' use of dealing commissions to the purchase of "execution" and "research" services. It required investment managers to disclose to their customers details of how those commission payments had been spent. The new rules came into effect at the start of 2006 and were intended, in the FSA's words, to "promote a more level playing field in the production of research, whether within investment banks or by third parties".

The pros and cons of CSAs

In practical terms, the mechanism adopted by the industry to implement the new rules has been CSAs, which are designed to allow fund managers to choose a broker for execution and direct the research portion of the commission to another broker or independent research provider.

While allowing the separation of commissions into different payment streams, the purchasing decisions between execution and research have not been entirely separated. Anecdotal evidence suggests that fund managers remain influenced in their allocations by the desire to retain access to other aspects of investment banking relationships, such as access to IPOs and company management. Under a truly unbundled system the payment of one counterparty for execution services and another for research should not affect the business relationships between the parties. But as one fund manager says, "our trading desk may execute with one firm to access liquidity while stopping trading with another firm whose research we value. In an ideal world that shouldn't matter, but it can adversely affect the relationship with that research provider."

The system also falls short of the vision of full unbundling envisaged in the initial FSA proposals in the wake of the Myners report (FSA CP 176, April 2003), under which fund managers would have been required to pay for research out of their own fees, rather than from clients' commissions. Instead, the final rules required only that fund managers provide adequate disclosure of these costs to their clients under industry-led guidelines developed by the Investment Management Association and the National Association of Pension Funds.

Adoption of similar arrangements in continental Europe has been slow and patchy. France was the second European country to unbundle brokerage commissions, introducing a CSA structure at the start of 2008. Denmark, Germany and Finland also have commission sharing arrangements, but Spain, Italy, Sweden, Norway and Switzerland do not.

CSAs are viewed as a positive force

CSAs, *in principle*, are viewed as a positive force by the vast majority of market participants surveyed. While not representing full unbundling, CSAs have created a payment mechanism that has facilitated the increased consumption of independent research by fund managers. "We were one of the first to move to the CSA system, about four years ago," says one large portfolio manager. "Prior to that point 70 per cent of our business by execution and research taken was with our top 10 brokerage counterparties. Now, 80 per cent of our execution is with the top 10, but they only provide 60 per cent of our research. CSAs provided the scope for us to take research from other sources and we have done so."

Also, the fact that fund managers are allocating commissions to pay for research, rather than spending their own management fees, is an advantage in markets where research is considered a pure cost rather than a source of added value. This point is illustrated by the lack of traction the independent research sector has achieved in countries without CSA payment mechanisms. "A lot of continental European fund managers view research as something that the banks provide for free and there is no hard cash available in their budgets to purchase it," says one IRP. "Without CSAs it is difficult to make much headway."

While agreeing with the positive aspects of CSAs in principle, the terms and implementation of these payment mechanisms still attract widespread criticism from IRPs. Many of those surveyed for this report echoed the findings of a EuroIRP/Investorside report published in May 2007[1], which said:

- CSA administration is causing cashflow and accounting issues for independent research firms.
- Contractual terms and pricing…disadvantage independent research firms.
- There is a need for wider CSAs to increase competition on the execution component.
- The practice of pre-funding of "proprietary" (internal investment bank) research is inconsistent with the principles of unbundling and commission sharing.
- CSA/CCA executing brokers enjoy asymmetric pricing knowledge on research.

1. www.euroirp.com/cms/documents/CSA_CCA_Final.pdf

Some are better at paying than others

Current experience among the IRPs surveyed varies widely. For some, recent quarterly payments were not received for more than 100 days, despite repeated email and telephone chasing. Meanwhile, at the other end of the spectrum are those who state: "I don't know what the bleating over payment is all about, I hope this report isn't going to be a litany of the usual whinging."

Clearly, some sell-side institutions are better than others at making payments.

But, while problems still exist, the direction of travel, at least with regard to slow payment, appears to be in the right direction. "Four years ago, it was hard to get the mainstream brokers to give you a share of the commission pot. For example, you couldn't get a penny out of Merrill Lynch," says one IRP. "But now they have put teams in place to manage commissions and often there will be virtually no difference between an independent CSA management programme such as Instinet's and, say, Deutsche Bank."

Remaining problems with the management of CSAs are also partly the result of variations in the efficiency with which fund managers administer the allocation of commission pots. "As a large organisation, for us the cost of doing business through CSAs is not excessively high, but it is time intensive," says one large portfolio manager. "A lot of other asset managers don't have as formalised a process as us for assessing the monetary value of the services they receive. We have a committee that meets regularly and we assign a value to every analyst phone call, email or meeting that we have. It's not easily automated and takes a huge amount of time, which for a smaller fund manager would be very onerous."

From votes to dollars

Payments to research providers under CSAs are further complicated by large fund management groups' use of a voting system to allocate research commissions. The individual fund managers are given a number of votes, each worth a designated dollar amount, to allocate to the research providers whose services they value. While in broad terms IRPs report a link between receiving a greater share of the fund managers' votes and getting paid more, the process is far from transparent.

Not all managers are diligent about voting

Some asset management groups will only pay for research from their top 50 providers, thus excluding niche operators who may add considerable value but are not rated by enough managers to get paid. Voting is carried out retrospectively, at best at quarterly intervals but often less frequently, further weakening the link between payment and services provided. Others highlight that not all managers are diligent about voting, or overlook the smaller providers when allocating their votes.

The need for scale as a means of getting on the manager's radar is also perceived as an issue for IRPs. "If you had a collection of really good independents in different sectors selling into the same fund management account under the same name, you would get paid more than if each independent sold separately," says one IRP.

Voting as a means of allocating payment is a subjective approach, which recognises the difficulties fund managers face in measuring the value added by research. "How much is one good idea from a US stock analyst worth, compared with regular contact with a macroeconomic analyst or commodities specialist?" says one fund manager.

Others, however, take a different view. "Originally, prior to unbundling, the banks lobbied the regulator saying that disaggregation was too difficult to achieve, which was clearly proved wrong," says one broker. "Similarly, for organisations that carry out thousands of transactions every day to argue that they cannot figure out how to pay for research is nonsense. The buy-side will not be overly rigorous in pressing for change because the vote is a means of deciding how to spend their clients' money, not their own."

'Squeeze on payments to IRPs'

The use of commissions to pay for research involves the purchase of a service that has relatively fixed production costs (the analyst's time and effort) with a variable stream of income. Since the financial crisis, which has put assets under management under pressure, the size of commission budgets has decreased. "With the reduction in commission dollars, there is a squeeze on payment to IRPs," says one fund manager. "The ability to try new providers has also reduced."

One buy-side interviewee described how IRPs may become "prematurely exultant" when they become part of the fund manager vote, only to realise later that actual payments may be small and take a long time to arrive. Some IRPs with strong franchises have had the confidence to try to move to a contracted model, with a minimum payment. This strategy relies on finding a sponsor within a fund management firm who is prepared to allocate research budget to the product.

Corporate access: bundling in disguise?

Several IRPs are more concerned about the contractual terms of CSAs than the delays and vagaries of payment. The vast majority of CSAs are "pooled" rather than "individual" or "directed commission" agreements. The structure of these arrangements creates an asymmetry of information, which favours the broker administering the CSA.

In a pooled CSA, while the provision of research is subject to arrangements between the money manager and research provider, the commission split for execution and research is negotiated between the money manager and the executing broker. Only a "participation letter" exists between executing broker and research providers, which governs the payments to the outside vendor from the client pot.[2]

Individual CSAs have both an agreement between an executing broker and research provider and an agreement between a money manager and a research provider. The

2. www.euroirp.com/cms/documents/CSA_CCA_Final.pdf

money manager will direct certain deals to the executing broker, signalling they are for the account of the specific research provider. The executing broker will retain the execution element of gross commission and then pay out a pre-agreed "research element" to the research provider.

Ability to prioritise banks' claims on payments

While individual CSAs can offer more contractual protection for the IRP, the pooled version, without directed trades, allows for a greater separation between trade and execution, as envisaged in the unbundling regulation. Pragmatically, having a smaller number of CSA agreements is also less of an administrative burden for the fund manager, who wields the power in contract negotiation with small independents.

The executing broker retains control over the gross commission pot until instructed to pay by the money manager. Control of the pot, however, also provides brokers with asymmetric pricing knowledge on research as well as increasing their ability to prioritise the bank's own claims on commissions – the practice of pre-funding the bank's own research before paying out.

With commission pots under pressure, the investment banks are pushing for a larger share of them. Most significantly, they are using the advantage they enjoy from the structure of CSAs to use dealing commission to receive payment for the "corporate access" services they provide. According to many IRPs, corporate access is, in essence, a travel agency and introduction service that the banks provide off the back of their banking and broking relationships. Typically the bank/broker will arrange a roadshow giving fund managers access to senior management from a corporate client.

This access is highly valued by fund managers. "Corporate access is incredibly important," says one large fund manager. "In 2010 our London investment teams held more than 5,000 meeting with companies, half at our offices and half off-site." In a world of increasingly commoditised and rapidly disseminated information, fund managers view corporate access as another means to find a market edge. "At its core, corporate access is an important and legitimate activity," says another fund manager. "In surveys that look at what fund managers consider to be of most value, corporate access is seen as more important than written research and access to analysts."

'Corporate access is incredibly important'

Other than arranging the meetings, the banks and brokers involved do not generally contribute other services. "Given our size we don't need brokers to gain access, but often the brokers will organise a roadshow," says one large fund manager. "The brokers don't participate, they have to sit outside the meeting and we don't tell them what questions we have asked the corporate client."

But for smaller companies or businesses in niche markets, even large fund managers need the broker's relationships to facilitate access. "In these circumstances the broker is adding value," says one. "It's no different to using an expert network. You hear far more complaints about using commission payments for access through brokers than you do about expert networks."

Some fund managers do not allocate dealing commissions to pay for corporate access, and some distinguish between access where the broker has added value and where it has not. A growing proportion of commission income, however, is being allocated to corporate access. While not collecting precise figures on money spent, Extel monitors the proportion of commission the buy-side says it is spending on corporate access. It estimates that corporate access now accounts for about 25 per cent of commission dollars paid for research and advisory services, and that this has increased from 15-18 per cent over the last three to four years.

Without the same corporate finance and banking relationships as the bulge bracket firms, IRPs cannot compete in providing corporate access. (Investment banks also have the ability to determine which investors gain access to the most sought after IPOs, which clearly has an influence on their trading relationships with the buy-side.) The use of dealing commissions to pay for corporate access reintroduces a market distortion of the very type that the FSA rules sought to eradicate by only permitting dealing commissions to be spent on research and execution.

Prospects for further regulatory change: Has the FSA declared victory and moved on?

Research must contain 'original content'

The FSA's last public statement on unbundling was in April 2009, accompanying the publication of a post implementation review of the new 'use of dealing commission' regime, which the regulator commissioned from Oxera, an economic consultancy. The FSA concluded that:

> "In particular, the report found that the new regime has clearly delivered benefits to the market. Commission rates have fallen and the new regime has limited the use of dealing commission to the purchase of 'execution and research', encouraged greater separation in the purchase of execution and research and improved the provision of information."

The consensus among those surveyed was that the prospects for further action by the regulator were not high. Having commissioned the Myners report, acted on its findings and declared itself satisfied with the implementation of the resulting rules, many felt that the FSA's focus would lie elsewhere. In the wake of the crisis, the regulator would instead be more concerned with issues of financial stability.

Corporate access, however, was not addressed by the post-implementation review, neither was it specified in the list of services that could not be paid for out of commissions under the new regime. Clearly, a bank or broker arranging for fund managers to meet its corporate clients does not fall within a definition of research, which requires it to contain 'original content'. But as is often the case with regulations, the banks will push the boundaries and seek out the grey areas until they

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are required to alter their behaviour by further regulatory change. Fund managers, as discussed above, also consider some forms of corporate access to contain value-added broker services.

Greater scrutiny of wholesale conduct

The FSA was prepared to comment on the issue for this report. The regulator's current position is that corporate access may not be a legitimate use of dealing commissions because, depending on how the service is structured, it might not be genuine research. On the question of whether the issue warranted further regulatory attention, the FSA drew attention to a speech in March 2011 by Hector Sants, FSA chief executive, to a British Bankers Association conference.

The government intends to establish the Financial Conduct Authority to supervise consumer protection and markets, including an increased focus on wholesale conduct. Mr Sants said: "The FCA must be prepared to intervene early to deal with emerging wholesale conduct issues, particularly where these have a link to retail markets and consumers. If necessary, the FCA should also be prepared to develop additional regulatory requirements for wholesale market participants where market discipline alone is not delivering appropriate standards."

Greater scrutiny of wholesale conduct could be interpreted to include looking again at how fund managers spend clients' money on services provided by investment banks and brokers.

VAT treatment favours the sell-side

A further source of inequality between independent research providers and sell-side investment banks and brokers regards the treatment of VAT. Logically, given the goal of creating a level playing field, when unbundling was introduced the FSA should have consulted with HMRC and arrived at a common treatment for VAT on research services, irrespective of payment mechanism. Instead, the issue remains a grey area. The basic position is that the provision of research services is subject to VAT, while services that facilitate or arrange trading activity are exempt. In practice, however, the situation is not as straightforward. As EuroIRP explains:

> "There is a generally accepted financial markets view that commission paid out under a CSA structure is VAT-exempt as it is classified as an ancillary transaction within a financial transaction, and financial transactions are VAT exempt. However, the view of some VAT experts is that unless the transaction can be shown to have resulted from the advice being paid for, it does not count as such.

'VAT issue represents a distinct risk'

> "The VAT issue represents a distinct risk under CSA type arrangements, as the sums of money can be substantial, and the conclusions drawn by the financial services industry appear to conflict with the advice provided by certain specialist VAT advisers."[3]

3. www.euroirp.com/cms/documents/CSA_CCA_Final.pdf

For IRPs producing equity research the link between the advice given and resulting trades is easier to establish than for firms offering macroeconomic research. The picture that emerges from the research providers interviewed for this report is that IRPs generally charge VAT, while the investment banks do not. The participation letters that govern payments to IRPs under investment bank CSAs also usually explicitly state that any payments made are inclusive of VAT, requiring the IRPs to absorb the tax on their share of the commission pot.

There is scope to lobby HMRC

Under European Union law, tax exemptions should not be interpreted in a way that works to the detriment of outsourced services. Gaining clarification from HMRC, however, would be time-consuming and costly. As one IRP puts it, "we went a long way down the road of seeking clarity from HMRC, but it would have cost a great deal of money to pursue the issue. People won't want to pursue it."

EuroIRP recommends that firms take advice from VAT specialists when structuring their terms of business and some IRPs have obtained opinions stating that their services are exempt. There is also scope for the trade association to lobby HMRC on the independent research sector's behalf rather than have individual firms seek a number of opinions.

Looking ahead: What needs to be done to level the playing field?

In the US, the global settlement negotiated by Eliot Spitzer included provisions to subsidise the development of independent research for a limited period. The UK, with Europe slowly following, has given more emphasis to seeking a market solution.

Still competing against a subsidised product

Five years after the introduction of the FSA's new regime, the independent research sector is definitely growing and regulatory change has underpinned that expansion. Many IRPs, however, believe that the playing field remains far from level. Certainly there is anecdotal evidence from both research providers and buy-side clients that the sell-side model is increasingly a combination of execution, research that at times is commoditised and corporate access based on leveraging client banking relationships.

IRPs continue to compete against a cross-subsidised investment banking research product – the true production cost of which is opaque – in an environment where an increasing proportion of dealing commissions is allocated to services outside the spirit of the unbundling regulations.

Is there a need for further regulatory change?

Quotas

Some IRPs, looking to the larger share of the research market captured by independents in the US than in Europe, would like to see some form of subsidy or mandate to help the sector increase in size. As one puts it, "if policymakers want to reduce the systemic reliance of asset managers on the incumbent investment banks, they need to provide active incentives or require that a certain quota of research budgets is spent on independent research."

Adverse effect on quality

The problem with such a solution, however, is that it could have an adverse effect on the quality of research, which is one of the critical points of differentiation for the independent sector. Buy-side clients clearly state that they value the market insights that independent research provides. If the current supply of high quality research were insufficient to meet a mandated market share, there is no guarantee that subsidising new production would ensure the gap was filled with material of a similar standard. As one IRP puts it, rather more colloquially, “you risk ending up with a lot of idiots spouting rubbish that will tarnish the whole industry. If you genuinely aspire to be best in class, there are clients who are prepared to pay well and pay efficiently.”

‘A lot of idiots spouting rubbish’

The conclusion of this report is that pursuing the introduction of a mandated market share or subsidising the production of independent research is not the best course of action.

Direct comparisons with the US market are also difficult because of the larger role played by expert networks compared with the European market. Global settlement did help kick-start the independent research market, but it was the introduction of Regulation Fair Disclosure (Reg FD) in August 2000, which requires all publicly traded companies to disclose material information to all investors at the same time, that paved the way for the development of expert networks.

Arguing the case for quotas and/or subsidies in Europe based on a US comparison would also probably prove difficult in light of recent high-profile investigations and charges of insider trading brought by the Securities and Exchange Commission against US hedge fund managers and employees of expert networks. Any regulatory change is likely to focus on tighter control of existing expert networks rather than providing incentives that in the US greatly increased their number.

Press coverage of the SEC actions in influential newspapers, such as the *Financial Times*, has lumped independent research in with unregulated networking services. EuroIRP submitted a complaint to the FT, which said:

> “EuroIRP takes exception to the outrageous assertion in the article ‘Brought to Court’ that ‘concern about professional insider trading has developed alongside the exponential growth of both independent research firms and hedge funds and other rapid-fire traders’. ...To imply that legitimate independent research – i.e. that free from conflicts of interest that investment banks routinely wave aside – is a source of growth of professional insider trading is irresponsible and does a disservice to investors seeking honest views on the market.”

The FT, however, defended its position on the grounds that several sources had provided the opinion voiced in its article.

IRPs should consider a proactive PR strategy

The FT’s coverage raises the wider question of how the independent research sector is perceived both within the financial services sector and by the wider public. Independent research providers, through the vehicle of EuroIRP, should consider a more proactive public relations strategy. Given that tighter regulation of expert networks and their use is probable in future, EuroIRP should contribute publicly to the debate as a means of strengthening the sector’s reputation for independence and integrity.

Revisiting the unbundling regime

A potentially more productive approach than pursuing a market share quota would be to push for stricter implementation of the UK unbundling regime and for the introduction of similar market mechanisms in European countries that lack them. While the UK regime falls short of full unbundling as envisaged by the Myners Report, the creation of an "itemised bill", separating research and execution, and the development of the CSA payment mechanism has underpinned the growth of independent research. The adoption of similar mechanisms across continental Europe could provide a catalyst for further sector growth.

The FSA was careful to avoid giving a definitive answer on the eligibility of paying for corporate access under the current rules. But the regulator's response holds out the prospect that such services could be deemed an ineligible use of dealing commissions and that there will be a conduit for re-examining the practice with the creation of the FCA. It is also probable that the issue of corporate access will be examined if there is increased regulatory scrutiny of expert networks in the wake of the US insider trading scandals.

Exclusion of access would not require new regime

With a five-year delay between the publication of the Myners report and the introduction of the new rules on the use of dealing commissions, it is clear that achieving regulatory change can be a drawn-out process. The advantage of pushing for the exclusion of corporate access, however, is that it would not require the introduction of a new regime for allocating dealing commissions, but merely add to the list of excluded services. Much would depend on the definition of corporate access, and the banking sector can be relied upon to lobby in favour of the status quo. To counter this, EuroIRP should press the FSA to re-open the debate through the FCA.

If corporate access were no longer bundled in with sell-side research, a sharper distinction would be possible between commoditised and value-added research. One fund management house interviewed for this report has already changed its model to reflect this distinction. Three years ago, the fund manager was using five or six brokers for research, but has reduced this number to one or two for the basic information required. It has instead increased consumption of independent research. Stripped of the add-on of corporate access, it seems reasonable to assume a drop in demand for some sell-side research. The impact on supply is more difficult to gauge, since sell-side research undoubtedly performs a marketing function for the banks and has a marginal cost of production of zero (the cost of sending an email).

The high value the buy-side attributes to corporate access suggests that the market for these services would continue to thrive, even if payment was no longer through commission. The buy-side would probably increase the proportion of this access arranged by itself, while demand might well increase for independent corporate access services. In March 2010, for example, Instinet launched Meet the Street, a corporate access product for the US market, which aims to match buy-side investors with corporate management teams through an internet-based service. Instinet's product is in competition with Liquidnet, which launched its InfraRed service in June 2009, and ConvergEx, which has offered its Management Access service since January 2010.

Refining the CSA mechanism

CSAs remain a sore point for some IRPs, but the conclusions of this report are:

Argument for improving the system

- CSAs, by providing a mechanism for fund managers to pay for research out of commissions, have contributed to the growth of the sector and have the potential to help establish the independent sector in continental Europe.

- The system is not perfect, but this is an argument for improving it, not starting again from scratch. Payment delays still occur, but as much from inefficiencies in buy-side administration as from the sell-side broker sitting on the commission pot. The operation of the system has improved and continues to move in the right direction.

- IRPs can be at a disadvantage in pooled CSAs where they have a participation letter rather than a contractual agreement. These contractual arrangements reflect the balance of negotiating power between large fund managers and sell-side institutions on the one hand and smaller independent research providers on the other.

While, pragmatically, a large organisation is likely to have the upper hand in dictating terms, the independent sector should promote best practice. The recommendation of this report is that EuroIRP strives to have its best-practice guidelines recognised by the FSA, and that this agenda is pursued alongside efforts to lobby the regulator for the exclusion of corporate access from CSA payments.

Guidelines for best practice set out by EuroIRP:

- Payment for research must be made “promptly”, as mandated by the SEC. Neither investment banks nor money managers should be able to sit on commission pots.

- Equal treatment of “proprietary” and third party research by the executing broker – no first take for its internal research.

- No deductions from the research component for execution.

- Transparency on agreements to avoid onerous terms, especially on pricing, being imposed on IRPs.

- Money managers work to reduce unnecessary payment delays due to their evaluation and reconciliation process, recognising the damage this causes independent research firms.

- Money managers maintain at least one CSA relationship with a pure execution provider, which serves as a check on global broker execution pricing.

- Money managers increase the diversity in their CSA lists, encouraging competition and ensuring they generate appropriate commissions across all the markets and sectors in which they need to buy research.

A clearing house for CSAs?

As well as helping promote competition in execution, independent brokers have developed the capability to offer commission management. Among the companies offering this service are ConvergEX, Financial Sockets (bought by State Street in 2008), IND-X and Instinet.

Independent brokers offering a commission management service have obvious advantages from an IRP's perspective compared with a sell-side broker looking to maximise its share of the commission pot. Some IRPs suggest that a further step is needed in the form of a clearing house arrangement for CSAs that would overcome the bias towards sell-side interests in bulge bracket CSA programmes (being able to see the whole commission pot and exert control over when it is disbursed). From the point of view of receiving payment there would, however, be little difference in practical terms between an independent broker's CSA programme and a clearing house fulfilling a similar function.

Establishing a single clearing house would be difficult. Although it adds to the administrative burden, fund managers prefer to have a range of CSA agreements, so that one broker cannot see the entirety of their market activity. Post financial-crisis concerns over the concentration of counterparty risk in one clearing house could also prove a stumbling block. Meanwhile, experience from the regulatory push for mandatory clearing of OTC derivatives suggests that a requirement to clear would be met by the development of a number of competing providers rather than one single entity.

Preferable to support independent brokers

Given that independent brokers running CSA programmes can meet the needs of IRPs, it appears preferable to support the growth of these providers, rather than push for the introduction of a further layer. Of course, the choice of CSA provider rests with the fund manager, so an IRP does not have the ability to direct business towards independent providers. However, it appears plausible to suggest that the existence of competition in execution and commission management may be a contributory factor in the improved efficiency of some sell-side CSA programmes.

A rigorous procurement process for research

Allocating a proportion of dealing commission to pay for research, rather than requiring fund managers to pay for it from their own fees, is not necessarily the best way to arrive at a value for research. It relies on the diligence of busy fund managers in assessing, after the event, a product they may have consumed several months previously. "Too many fund managers are paying lip service to the idea of unbundling, by simply deeming that the commission pot should be split 50/50 between research and commission," says one large fund manager.

It is, however, hard to place a precise figure on the value a fund manager derives from research. Many IRPs track the success of their recommendations, although this is easier for those providing advice related to specific securities than top-down analysis.

Some also run paper portfolios based on their recommendations, although such arrangements have the potential to compromise an IRP's independence. "Let's say I'm running an asset allocation model with an exposure to fixed income," says one IRP. "If I were to have a conversation with PIMCO, the world's largest bond investor, during which they tell me they are changing their view on the bond market, this might influence the decisions I take on my own portfolio. How much of the performance would be down to PIMCO and how much down to me?"

Some fund managers are more systematic and comprehensive in their assessment of the research they consume. But a formal approach, as discussed earlier, is time-consuming.

'Not having a measure of value-added is suicidal'

A lack of common metrics for assessing research is part of the problem. "For an independent whose sole product is its research, not having a standard measure to gauge its value added is simply suicidal," says one IRP. "Until we have something to measure the value-added aspect of our research then it will continue to be looked upon as a cost, suffering the same problems as those endured since the early 2000s." For this IRP, based in France, part of the reason for the failure of independent research to gain traction in the French market, while independent asset management has flourished, is the lack of a standard tool such as net asset value (NAV) to measure results.

Would it be possible to develop a standardised measure? A 2009 online article in "The Trade News"[4] argued that "some industry experts expect that one of the critical next steps to help institutional investors fully unbundle their execution and research decisions will be the development of a rigorous research procurement process, including specific research value metrics." The article quoted Richard Phillipson, Director of Institutional Consulting at Investit, an investment management consultancy: "We work with fund management organisations to see what value they believe they are getting for their IT spend and you can actually come up with a value-for-money score. It is not impossible to think of something similar for the research field."

Analysing the feasibility of developing research value metrics would be a positive step towards more widely establishing independent research as a value–added product rather than a cost.

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4. www.thetradenews.com/csas-unbundling-or-unravelling

Extracting revenue from the value chain

No pressure to make managers spend fees on research

Reform in the wake of the Myners report backed away from requiring fund managers to spend their own cash to purchase research, although there are recent signs of greater scrutiny of how fund managers spend their clients' money. In April, *FTfm*, part of the *Financial Times*, reported the findings of an unpublished draft report, *Financial Markets 2020*, based on a survey of more than 2,600 industry participants and government officials in 84 countries by the IBM Institute for Business Value. According to the article, "the 'overpaid' fund management industry is destroying $1,300bn of value annually", of which "credit rating agencies, sell-side research and trading are seen as destroying... $459bn, largely due to the perceived inaccuracy of much of the analysis these sectors deliver."

There does not, however, appear to be any regulatory pressure to make managers spend their own fees on research, so the current system of using variable commission payments to pay for research will probably persist. Pressure on fund managers to justify their purchasing decisions will continue to be reflected in the highly competitive nature of the research market.

"We are in the middle of a shift in market tempo and positioning that has been unfolding since the sub-prime crisis, which will continue to have a profound impact on how assets are handled worldwide and how the fund management industry is run," says one IRP. "Amid ongoing global deleveraging, free cash for investment will become a scarcer resource and fund managers will have to fight harder to maintain and grow assets under management. In that environment there is pressure for fund managers to keep budgets under control and part of that process is keeping control of spending on independent research."

For revenue not earned through hard cash subscriptions, IRPs will remain vulnerable to downward pressure in markets where the size of commission budgets is falling or where there is competition for a larger share of the commission pot by rivals (the corporate access issue).

Agency broking

Increase share of revenue

One potential response is for IRPs to attempt to capture a larger share of the revenue stream by offering agency broking services themselves or in conjunction with third party independent brokers. Obviously, the ability to earn the entire gross commission rather than just the research portion significantly increases potential revenues. This is the model followed by Redburn Partners and, since the beginning of 2011, by Autonomous Research, which were respectively number one and two in Extel's 2010 ranking of IRPs.

Agency trading has other advantages in that it provides a clearer answer to the tricky question of VAT in the prevailing tax environment. Offering execution and research in the same manner as an investment bank does would help an IRP to structure its services as ones that facilitate financial transactions, and so are exempt from VAT.

Purist concern with offering trading

For the purist, offering agency trading represents a conflict of interest with the concept of a truly independent research provider. A definition of independence, however, that includes execution only broking but excludes proprietary trading, asset management and investment banking services, appears reasonable. This leaves the distinction between being an independent broker and an independent research provider.

Redburn, which declined to be interviewed for this report, is described by other IRPs as having a greater focus on secondary trading than research. Autonomous, which previously received the vast majority of its revenue through CSAs, views agency trading as a payment mechanism, not the focus of its business.

It may appear that a proposal that includes execution broking is suggesting a bundled response to the shortcomings of the unbundled regime. But this recommendation recognises that the UK regime, while stopping short of full unbundling, has established the principle of separate payment for research and execution. Under this proposal, IRPs would have the ability to capture more of the revenue stream, but execution would not be a requirement of every business relationship and IRPs would also continue to use other revenue sources such as subscriptions.

For some IRPs, the idea of providing anything other than research may appear too great a departure from their business model. Pressure to achieve scale, however, may make diversification into agency broking a logical step. There is support for the view that a number of niche providers, grouped under a single umbrella organisation, could achieve a higher profile and command a greater share of the fund manager vote and spend.

Cost pressures, too, are likely to increase. “I can foresee a world where there is a scale game in the independent research sector,” says one fund manager. “With a trend towards tighter regulation, the larger, more successful firms will be better able to meet rising compliance costs. Tougher regulation might lead to sector consolidation.”

Umbrella organisation

‘A scale game in independent sector’

One potential vision for IRPs that do not want to offer broking services in-house would be to group together with similar firms, retaining their distinct brand identities, but sharing the cost of an umbrella organisation that met the costs of regulatory compliance and offered execution broking services on behalf of the members. From the buy-side’s perspective, dealing with one larger agency broker would have the advantage of keeping down the number of counterparties and reducing the administrative burden.

Elements of this model are already in place. Instinet, for example, offers “Instinet Access” in the US market, which provides an outsourced sales and marketing service for seven IRPs on a revenue sharing basis. While Instinet obviously hopes to drive business through its broking and commission management platforms, this is not a requirement of the service it offers to IRPs. Bloomberg is also pushing into the independent research space through its “Tradebook” platform, which offers agency broking, algorithmic trading and access to dark pools as well as providing access to, and sales support for, IRPs. Bloomberg Tradebook also joined forces at the start of 2010 with Investorside, the US trade association for IRPs, in a global marketing initiative, organising events to introduce and showcase the work of IRPs.

“Bloomberg looks good as they are putting top-class analysts in front of clients, while the IRP benefits from Bloomberg’s brand recognition. The IRP can get fund managers paying for their research through an agency broker CSA and the broker can get the benefit of trading volume, although there is no requirement to use any one particular broker,” says one IRP. “There is potential for a win-win situation with mutual clients.”

In addition to the potential benefits provided by these agency broker relationships, an umbrella organisation would have the advantage of presenting the buy-side with an entity with critical mass and providing the potential for economies of scale in meeting compliance costs.

Conclusion

Has the independent research sector come of age over the last decade? In terms of becoming an established part of the research market that is highly valued by its buy-side customers, the answer is definitely yes. Market conditions are undoubtedly competitive. Commission budgets remain under pressure, the investment banks are investing in their research operations once again after a post-crisis retrenchment and the number of independents chasing a slice of the action is increasing. But, in a world overloaded with electronically delivered commoditised research, true insight that delivers a market edge is highly sought after and the independent sector is well placed to provide that added value.

The environment in which the independents supply their services is not yet a level playing field. Regulatory change, primarily in the UK, to unbundle dealing commissions into research and execution components has underpinned the development of the independent research sector. The CSA payment mechanisms, which facilitate this unbundling, are flawed and cumbersome, but their operation is improving. Use of dealing commissions to pay for corporate access services provided by investment banks is, however, evidence of continuing market distortions that legislation in the wake of the Myners report sought to eradicate. While there appears no case for affirmative action in favour of the independent sector through subsidies or quotas, there is a case for pressing the FSA to re-examine the unbundling debate when the FCA becomes operational.

Potential to capture more of the value chain

Where the sector has yet to come of age is in terms of its scale. Independent research is valued partly for its exclusivity and so, by definition, is a niche rather than mass-market product. It is doubtful, therefore, that the sector will ever be more than a relatively small proportion of the market, although in Europe it will continue to grow from the current low base. But to consolidate and build on progress to date, the scale of the operators within the sector needs to increase through partial consolidation. A potential model for the future is one in which providers of unique services are grouped together under a co-branded umbrella organisation to market themselves more effectively, to meet the cost of regulatory compliance and to offer execution services to have the potential to capture more of the value chain. This vision of the future need not compromise either the quality of the research product or a realistic definition of independence.

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Two further interviewees wished to remain anonymous: one is a hedge fund manager at a London-based firm and the other is a former senior equity analyst at an investment bank

Vince Heaney is a freelance financial writer, prior to which he was deputy editor of the Financial Times Lex column. Before becoming a journalist in 2000, Vince spent nine years as a proprietary trader in the banking and hedge fund industries and eight years as an agricultural commodities trader. He holds a degree in economics from Cambridge University.

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