Proposed text as basis for response to Jane Fuller's article, 'Clean Slate for Tinted Analysts', 'Opinion' column, FTfm, 5th May, '03.

by Jamie Stewart – on Independent Research etc.

(Suggested title options:

Slate the Tainted, Promote the Independents and Champion the Investors.

Of Mythology and Markets.

Gadarene Swine, Augean Stables and Research.

Augean Stables; Gadarene Stablemates.

Decontamination: the Final Solution.

Of Holes in Walls.

Chinese Burns, Whispers and Walls.

The Day the Walls Came Down.

All Could Be Well That Could End Well.

The Search for Research.)

FTfm's 'Opinion' gave rich food for thought last week: in Jane Fuller's call for a 'clean slate for tainted research', her opening reference to 'snouts-in-the-trough' culture triggered visions of the Gadarene swine (no such luck), passing rapidly on to the cleansing of the Augean stables – but in this instance well after the incumbents had bolted across the very threshold on which they had evacuated their copious bowels.

In moments of turbulence such as this, the safety rules - as well as an instinctive and orderly search for a solution – demand a start by analysing the analysis and the analysts. What went wrong – and why, and when? In the US and the UK it was the respective moves to 2-tier banking systems, aka integration, which heralded a theatrical segregation of activities marked by the hurried construction of some Chinese walls.

If you need frontiers, you need frontier guards to guard them, and overseers to guard *them*.....so regulators, bureaucrats, legislators and politicians magically appeared - Mandarins and Moguls, Mikados and Mongols, traipsing up and down every section of the wall from Gansu to Lioning. The results were inevitable: first, the nightmare of municipal do-gooders and partisan ideologists mingling awkwardly with market practitioners; second, the imperceptible but irresistible challenge to minor marketeer mentalities to explore, test and perforate every bit of friable pointing in those walls.

The result has been increasing leakage: at the risk of mixing the nationalist metaphors, the Dutch lad with all ten fingers plugging the breaches, but all in vain. Further geo-confusion: it hasn't necessarily been restricted to the US. The Spitzer settlement triggered an identifiable core of urgently whispered questions, amongst which the hoarsest was, "Will the same thing happen here?". The answer, almost certainly, is that it already has – but the different cultures may yet save the day. The US tendency to point fingers, blow whistles and sue it if it moves (preferably via class action) equates to a more reticent and circumspect approach here: we don't rock boats, we don't frighten the horses and we don't say that in front of visitors.....and the ability to get technology to turn a few files and e-mails in to *desaparecidos* is comparable both sides of the Atlantic. We'll see...

Meanwhile, far be it from any of us to reach for the 'c'-words: contamination, corruption, conflict, complicity, connivance and collusion. People, the press, investors and *agents provocateurs* tell us that analysts are all corrupt. Far from it: it is actually the integrated structure that makes them appear corrupt. They are, at heart, upstanding, honest citizens; at worst, and like the antihero of our prayers, some are hopelessly led in to temptation. The majority are earnest and conscientious – wasn't it as *teenage scribblers* that Nigel Lawson once described them ? – who, fresh as double cream from Wharton, Durham and Trinity (- any of 3), lack experience, length in the tooth and the ability to recognise when they see one a market cycle or a downturn.

They have been overpaid for reasons beyond their control; they have been duplicating each others' functions; they rarely differ from the moving average line (-or the in-house line) and too many are too inexpert. Reinforce this alarming picture with the impact of austere hierarchies, senior *dramatis personae* able to make lots of money, sometimes by proxy and remote control, irresistible inducements, vested interests, pressures, and expectations expertly managed – and the result is a crumbling of the sternest moral fibre comparable only with the rate of crumbling of the dodgy pointing in that wall.

This is designed neither to champion nor undermine the cause of the analyst. It is the structure and the rationale underlying it which count. Compare for a moment the reality of the integrated banking group with its loyal but feckless *alter ego*, the supermarket. It's all very well building supermarkets and inviting people to shop there, but would their buyers ever procure better goods with lesser margin prospects ? Would their till operators tell you that it is cheaper to buy 3 packs on the discount-deal than 2 full price ? Would the deli assistant tell you that the salami at Bettafare round the corner was better fare by far, and would the customer service manager admit that the vitamin supplements due in next Tuesday will be more expensive by 10% and packaged in smaller sachets in to the bargain ?

Come down to earth again from the gallery around the supermarket atrium. It's not just a matter of the unfortunate lot of the analysts in the unfortunate structures of the system. To find the solution to all ills, it is vital to look additional vagaries of market practice in the eye....and at the very eye of the storm is the additional quaint and quirky fact that all the miscreants fingered by Spitzer typified a self-propagating system whereby the natural, self-contained relationships between right and wrong, risk and reward, rights and duties and then remuneration and retribution have been broken up in such a way that no single component relates in a traditional way to any other.

Picture a corporate adviser or deal originator paying an initially nameless analyst from the secondary trading services downstairs to write on an unknown tame or candidate company. The object is to tempt institutions and individual investors – also all too often unknown – to subscribe share issues about which little or nothing else is known. The rewards promised to the analyst says more about the deal size, pricing and profile than the quality of expertise and accuracy of the recommendation. Insulated by the implied protection and preferral forthcoming from the powers that be on the top floor, the chain of causation is all far too disjoint and disfigured: the relationship whereby accountability and responsibility are linked in to the mix has been withered by default if not intent.

It is all dead convenient, yes; and it is excused - if not promoted – after the event by cries of 'cross-fertilisation'; 'integration'; 'outstanding teamsmanship' and 'superb house effort' (all aka lying through teeth). In a transparent and reliable professional arrangement, however complex, there need to be immediate, identifiable and effective links between cause and effect, risk and reward, responsibility and recompense. Once those links are loosened, draped across walls, under footings and through breaches, all hell breaks loose – and it has.

Of course, the Devil's advocate should have his turn at speaking up for the head of investment banking, who is, after all, paid to promote the interests of his department and his corporate clients. If there are analysts around downstairs, then why not get them to lend a hand(– paid, of course)? It is comforting to reach up to the highlands of Scotland for the adage, 'He who pays the piper calls the tune', and excuse the fiduciary farrago like that.......BUT, as every self-respecting piper knows, there is more proverbial responsibility to that adage than the curtailed wording reveals. His patron also has to take responsibilities: if the drone is out of tune, the piper catches 'flu, the listeners hate the skirl or thunder-clouds and rain appear, the patron is responsible for his commission, his largesse, the context - and is held answerable for what happens next. Out of a piobaireachds can be born laments and dirges.

Fuller's quest for the clean slates addresses the next in line of the 'Who? – Why? – What?' group of questions. Assuming the demand is there – and demand for the right research product certainly exists – she muses as to who is best equipped to provide it, how it is best protected against bias, and who pays.

Many of the best and most mature (not ageism, this: it concerns familiarity with market cycles when they stare you in the face; it is to do with the practiced pen-strokes of the 40-something analyst as opposed to the scribbles of Lawson's teenager) analysts work in independent research entities which obey the best commercial laws of the jungle and market-place: they survive and flourish if they are very good, their pricing structures reflect demand and supply, their product qualities and packaging are guided by appetite and take-up. They are paid on the basis of analytic excellence and clarity of vision – on getting it mostly right most of the time, unlike the analyst beholden to the integrated house who is paid – illogically and in lumpy fashion – by chips off the revenue block, regardless of whether he or she (can't be doing with the amorphous 'they') is good, right or telling the truth and therefore as often as not in sums singularly lacking in a proper sense of proportion or value....travesty if ever there was one.

The independent analyst constantly adjusts and develops style, approach and methodology; there is no stifling obligation to toe the line, follow house style, observe artificial consistency, avoid offending spurious loyalties or follow the homogenizing inclinations of the head of research, of the editor or, indeed, of the head of investment banking.

And what about bias? No independent analyst worth the salt would want, need nor yet risk the whiplash of bias. His revenues are normally geared to arm's-length, market rates; he would not expect to be paid erratically from a bulging pot of deal takings, and his market positioning, his very survival depends on his ability to call correctly. If it ever appeared that he had capitulated to pressure or had compromised independence and objectivity, he and his outfit would be sunk on the spot. It is the equivalent of a self-fulfilling prophecy.

Pay: vital, and it has 2 faces. First, negotiated rates reflecting market forces must – and will - govern pricing of independent research: far from scoops out of those overfull pots which defy common sense and moderation as well as triggering the greed and bribability which lead to tears. Second, the delicate question as to who pays for it. Here are, typically, 3 eligible p(-l-)ayers: the issuing corporate, the investment bank and the investor. By process of elimination, the investor should no pay: he is buying a precisely priced share in a company, not a package deal centred on an equity and a research text – and, in any case, who knows whether he ever read the latter? The capital goes to the issuer, and that issuer pays the price of the funding. Research facilitates the sourcing of those funds, and needs to be paid for. Whether the issuer does so as a cost in addition to the fees or negotiates a fee which reflects this as related expenditure, it comes to much the same thing. Current practice already has the newly enriched corporate paying a fee which covers the traditional in-house research, so it's hard to see why that shouldn't remain the case. The independent research entity ensures the lack of bias, precluding silly pricing on that score; market forces shape the production cost, reining in excess on that front…….and, most important of all, the investor, the capital provider, is protected throughout. The only residual risk is the unlikely outcome of faulty analysis or an incorrect call: again, market forces and trial and error guard against that, as does the independent analyst's fearful awareness of the adage that you're only ever as good as your last call.

Is all this really a *new* solution ? As is so often the answer, yes and no. Certain integrated houses have seen the writing on the wall and begun to pre-empt its effects. The Spitzer affair unmasked some nice, cosy arrangements whereby the primary people paid lip service to ensuring 'independent' research by means of the derisory gesture of asking their neighbours further along Wall Street to write some external research on the forthcoming deal.....and guess who was allocated a bigger share of the underwriting as a result, alongside payment of a US$250k cheque, to emphasise the length of the arm which held it out ? Sandy Weill at Citi heeded the prophets of doom months back, removed his analysts to another building and (100% Citi-owned) company, switched brass plates and business cards and told the world that Ms Krawchek would shortly be moving from Sanford Bernstein to head up a new, independent research company that, coincidentally, used to generate Citi's research offering. Institutions could find a sleeve long enough to accommodate their sniggers: a veritable *trompe l'oeil.* But Gartmore has acted nimbly on the buy-side to set up well-flagged formulae with Goldmans and Merrills whereby they secure best execution, cut out the brokers' unwanted by-product without paying for it and still manage to arrange for funding of their preferred independent research products in to the minimaliste bargain.

And what about the 'no' part of the answer? Spare a comparative thought for the precedent all around us, albeit in other sectors. Law and medicine, for example: practitioners recognized the needs for transparent and ethical conduct long ago, although coming far from the austere days of no advertising nor promotion and single-tier practice. The results are excellent standards of supervisory control, expectations – and delivery – of consistently high quality and of unbiased service where the Law Society, the FPC and the BMA, for example, represent experience, discipline and control meted out by weathered practitioners (- interesting to note that their headaches arise only when the bureaucrats and politicians begin to meddle: look at the recent modifications of the legal sentencing provisions, and the gloriously confused limelight bathing the third largest employing entity in the world after the Chinese and the Russian armies: the NHS.....is there a lesson to teach and to learn in the financial market-place??) Those professionals refer, outsource and exchange information as a matter of course, and tend to rely on 3rd party assessment and publication of their services for promotion and expansion. They are required to be objective and factual in provision of information and publicity. Even the ASA is preaching the whiter-than-white word, and manufacturers and their advertising gurus responsible for misleading the consumer get short shrift.

It is, of course, interesting to observe the FSA's current intentions to tighten the rules and the system in the wake of all that has happened. A cynic would say that *it is too little, too late; that it is a matter of slamming the stable (Augean, of course) door after the horse has bolted; that chipping away at an intractable and problematic block is never going to cure its ills: that a new broom is needed. The gestures of forcing disclosure of analysts' track records, banning them from holding shares in the companies they cover, tightening the rules on their co-pitching to corporate clients with investment bankers......it is all sticking-plaster and soothing words where scalpels and grafts are what is called for. (N.B.: This is Stop Press stuff: there is a piece in today's (12th May) Times Business Section on these outline plans, shortly due to be announced.)*

If the measure of best practice were adopted in the financial market-place whereby primary issues were supported by independent research and not by internally generated product, all possible objectives would be achieved. Some of the best brains in the business would be offered a harness to link them back opportunistically from independent pastures new to their erstwhile stables. Institutional investors would continue to balance their in-house analysis teams with selected secondary brokers' research and Independent Research as they saw fit, and retail investors would benefit indirectly by that buy-side blend as well getting to know the independents and drilling down as deep as they need in their pay-per-view websites. Both would sleep more easily in the knowledge that they could subscribe new issues with relative confidence. Corporate advisory and origination departments could run as many departmental analysts as they want and can afford to support their cause internally yet without promoting their issues externally. The analysts working for secondary trading departments and their clients could continue to work without the distractions, confused loyalties and fickleness of the primary activities aforethought. Reasonable salary and bonus scales would be re-established. The regulators would give a sigh of relief – perhaps even a smile.

The government might just stop interfering. But most important of all, the investor would come out safe and sound. Even the mythologists would be happy: those Augean stables would look squeaky-clean once more, and the Gadarene swine could get their snouts out of the trough which Jane Fuller envisaged without their going on to leap off Beachy Head in short order.

But.....will it all happen ?

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A. J. S. – Eden Group.