Establishing transparency in analysts' company notes

It is the structure of an integrated bank – not its employees – that is behind the corruption controversy in research, writes **Jamie Stewart**

FT fm 19v03

TALKING HEAD

Many commentators and investors would have us believe that all analysts are corrupt – especially since the series of Wall Street scandals that sparked the intervention of Eliot Spitzer, the New York attorney-general.

But, of course, the majority are earnest and conscientious. If anything, they are too young to recognise a market cycle when they see one, and they are overpaid for reasons beyond their control.

The real problem is the structure of the integrated investment bank: it makes analysts appear corrupt.

When a corporate adviser or deal originator pays an initially nameless analyst from secondary trading downstairs to write about an unknown company, the object is to tempt retail, pension fund and other institutional investors to buy new shares about which little is known.

The rewards promised to the analyst say more about the deal size and profile than the accuracy of the recommendation. There is little responsibility or accountability in the relationship.

Many of the best and most mature analysts work in independent research houses which obey the best laws of the marketplace: they flourish if they are very good, their pricing structures reflect demand and supply, their product qualities are guided by take-up.

Moreover, they are paid on their analytic excellence and their ability to get it mostly right most of the time. This is in stark contrast to the analyst beholden to the integrated house – who is paid with chips off the revenue block, regardless of whether he or she is good or right.

The independent analyst constantly adjusts style, approach and methodology: there is no stifling obligation to follow house style or avoid offending spurious loyalties to the head of research or the head of investment banking.

Of course, there is the thorny issue of who should pay for research: issuing corporate, investment bank or investor? By elimination, not the investor: he is buying a precisely priced share in a company – not a package deal comprising an equity and a research note he may have never read.

Current practice has newly enriched corporates paying a fee to the banks which covers traditional research – so it is hard to see why that shouldn't remain the case when the research is provided by an independent rather than an integrated house.

Is all this really a new solution ? Yes and no. Certain integrated houses have already seen the writing on the wall. Months back, Sandy Weill, chairman of Citigroup, removed his analysts to another building and announced that Sally Krawchek would shortly move from Sanford Bernstein to head up a new, independent research company that, coincidentally, used to generate Citigroup's research.

Gartmore, the US-owned but UK-based fund manager, has been nimble on the buy-side to set up well-flagged formulae with Goldman Sachs and Merrill Lynch whereby they secure best execution, cut out brokers' unwanted by-product without paying for it and still manage to arrange funding for their preferred independent research.

If the measure of best practice were adopted in the financial marketplace so that primary share issues were supported by independent research rather than by internally generated product, everyone could be happy.

Fund managers would – as they saw fit – continue to balance their own in-house analysis with selected secondary brokers' research and independent research. Retail investors would benefit indirectly by that buy-side blend – and some may get to know the independent research houses that run pay-per-view websites.

The analysts working for secondary trading departments and their clients could continue to work without the distractions and confused loyalties that go with the primary activities of their employers.

Reasonable salaries would be re-established. Regulators would give a sigh of relief. The government might just stop interfering. But most important of all, the investor would come out safe and sound.

Sandy Weill of Citigroup has seen the writing on the wall Reuters

Jamie Stewart is head of institutional investment at Eden Group, a UK financial services group.