

Reform of analysis aimed at regaining investor trust

By David Wells

The 10 investment banks involved in the final settlement have been making changes in the way they conduct research since investigations into conflicts of interest in Wall Street began. Now they hope to complete the revamp and regain investor trust.

The key step consists of separating research staff from investment bankers. This involves physically separating the employees and having different reporting lines, legal and compliance staffs, and budgeting.

The agreement also affects pay, a thorny issue for researchers. A lucky few once made more than \$10m a year and many made more than \$1m. Given the settlement and the three-year-plus bear market in US stocks, they face the prospect of harder work, stricter rules and less money.

According to the Securities and Exchange Commission, compensation rules now state that an analyst will be judged largely on the quality and accuracy of his or her research. Decisions concerning pay will be documented to ensure analysts are not remunerated for contributions to investment banking work and investment bankers are not evaluating their performance.

These rules are designed to give analysts more freedom in choosing what stocks they cover and how that coverage is cast. Investment bankers are to have no role in determining what stocks are followed and are prohibited from using analysts to solicit business.

Many of the banks plan to adopt the rules worldwide, not just in the US. Jamie Stewart, head of institutional investment at UK-based independent brokers Eden Group, said it was a necessary step. "UK investors have been every bit as badly injured as US investors. Investors must be certain that this history will not repeat itself."

The banks will have to create systems to ensure personnel do not seek to

influence the contents of research reports for purposes of obtaining or retaining clients for investment banking, including creating and enforcing firewalls between researchers and investment bankers.

This includes retaining an independent monitor who will assure that a bank has complied with the reforms through a written report to regulators.

Disclosure will also be beefed up. The first page of research reports will include a statement that the analyst's employer "does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report."

When a researcher terminates coverage of a stock, he or she will issue a final report discussing why that decision was made. And each quarter, charts - including analysts' names, performance, ratings, price targets, and earnings per share forecasts - will be published on the web sites of investment banks alongside an explanation of its rating system.

Investors will also be given alternate opinions and a shot at learning how to make more informed decisions.

For five years the banks involved are required to pair with no fewer than three research firms that have no investment banking ties. Payments for this service will total \$432.5m. The banks will make reports from their partners available to customers, notifying them through customer account statements, on the first page of research reports, and on the firm's web site.

An independent consultant for each bank will have final say in the choice of partners and will provide an annual report to regulators about the research.

Seven groups will pay a total of \$80m for investor education, with \$52.5m being used for a fund approved by the SEC, NYSE and NASD.