GLOBAL BROKERS SURVEY

Ref. – Eden: See p. 38

Rethinking the research model

With the UK's FSA seemingly ready to accept increased transparency rather than an end to bundling, asset managers have spent the last six months trying to decide how to split out their costs. Although this is by no means the debacle that the FSA's original plans threatened, it is no reprieve. The questions that banks and asset managers will have to confront may trigger root and branch reform of the investment banking model, but independent houses will have to fight hard to be among the gainers. Our survey gives some insight into those banks whose research is valued enough to warrant maintaining it as a viable offering. The rest may want to consider more radical solutions. By **Claire Milhench**.

IF BROKERS thought they could break out the champagne when the FSA indicated it was open to the idea of disclosure, they must have reappraised that notion once the full consequences became apparent. Whilst no definitive ruling has yet been made, softing seems likely to stay in the UK for research services, but this will be more narrowly defined, and splitting out payments for research and execution will have a far-reaching impact on investment banking models.

The increasing economic pressures on broker reasearch has already claimed its first scalp – in August Nordea outsourced its fundamental research to Standard & Poor's, paving the way for similar deals amongst the regionals and second-tier players. But it seems unlikely to trouble the bulge bracket firms, which will now be able to consolidate their dominant position. Although some of the Wall Street banks have scaled back their research as a result of the global settlement with New York attorney-general Eliot Spitzer, the blood-letting has not been as great as expected..

As well as requiring banks to provide independent research alongside their own, the settlement demanded a separation between research and corporate finance, putting the economics of the traditional banking model under pressure. The screw will be tightened further if disclosure encourages a split in commission payments for research and execution, especially if asset managers decide the banks' research isn't worth paying for.

"What is disclosed should lead to an interesting debate because some full service firms will want to disclose high research costs and others high execution costs," says John Meserve, president of BNY Research, Commission and Payment Services. "In the UK, the definition of execution is much broader than it is in the US. People are adding in a lot of research-type elements to bulk up the execution cost. But in the US it's the other way round, because full service firms are focusing on rolling out cheap execution with DMA products. It's cheaper for them to provide and the market is asking for it. You have to wonder if the day is drawing to a close for the traditional full-service broker, especially as alternative trading systems like ECNs are gaining traction, which basically disintermediate the full service model."

Meserve believes investment banks have a "dead business model walking" because it is becoming increasingly difficult to support the research department: "The math doesn't work!" he insists. Frans Lindelöw, head of equities at Nordea, agrees: "Fund managers are questioning the price of execution, and we're seeing more direct

MOST INDEPENDENT RESEARCH – GLOBAL

RANKING 1

04 Bank	Score	%
1. Deutsche Bank	60	14.96
2. UBS	53	13.22
3. Morgan Stanley	42	10.47
4. Citigroup	40	9.98
5. CSFB	39	9.73
6. Sanford Bernstein	33	8.23
7. ABN Amro	22	5.49
8. Merrill Lynch	21	5.24
9=. Goldman Sachs	19	4.74
9=. Lehman	19	4.74

RANKING 2

04 Bank	Score	%
1. Sanford Bernstein	300.00	8.18
2=. Kepler	266.67	7.27
2=. Ned Davis	266.67	7.27
4. Deutsche Bank	240.00	6.54
5=. Goldman Sachs	237.50	6.48
5=. Lehman	237.50	6.48
7. JPMorgan	225.00	6.14
8. Morgan Stanley	221.05	6.03
9. UBS	220.83	6.02
10=. ABN Amro	200.00	5.45
10=. Cazenove	200.00	5.45

MOST USEFUL RESEARCH - GLOBAL

RANKING 1

04 Bank	Score	%
1. Morgan Stanley	50	17.61
2. Deutsche Bank	45	15.85
3. UBS	41	14.44
4. CSFB	27	9.51
5. Merrill Lynch	24	8.45
6. Citigroup	22	7.75
7. Lehman Brothers	22	7.75
8. Goldman Sachs	18	6.34
9. ABN Amro	12	4.23
10. JPMorgan	9	3.17

RANKING 2

04 Bank	Score	%
1. Dresdner	266.67	10.61
2. UBS	227.78	9.06
3. Morgan Stanley	227.27	9.04
4=. Deutsche Bank	225.00	8.95
4=. JPMorgan	225.00	8.95
6. Lehman Brothers	220.00	8.76
7. CSFB	207.69	8.27
8=. ABN Amro	200.00	7.96
8=. Merrill Lynch	200.00	7.96
10. Citigroup	183.33	7.30

MOST IMPROVED FOR INDEPENDENCE – GLOBAL

RANKING 1

04 Bank	Score	%
1. Citigroup	31	24.80
2. Morgan Stanley	23	18.40
3. Merrill Lynch	15	12.00
4. Deutsche Bank	14	11.20
5. CSFB	12	9.60
6. Goldman Sachs	11	8.80
7. UBS	10	8.00
8. ABN Amro	9	7.20

RANKING 2

04 Bank	Score	%
1. Citigroup	258.33	15.23
2. Morgan Stanley	230.00	13.56
3. ABN Amro	225.00	13.27
4. Goldman Sachs	220.00	12.97
5=. CSFB	200.00	11.79
5=. UBS	200.00	11.79
7. Merrill Lynch	187.50	11.06
8. Deutsche Bank	175.00	10.32

REGIONAL BREAKDOWNS

MOST INDEPENDENT RESEARCH – EUROPE

RANKING 1

04	03	Bank	Score	%
1.	(5)	Morgan Stanley	24	14.55
2.	(2)	Sanford Bernstein	21	12.73
3=.	(9)	CSFB	20	12.12
3=.	(3)	Deutsche Bank	20	12.12
5.	(1)	UBS	19	11.52
6.	(7)	Citigroup	15	9.09
7=.	(-)	Goldman Sachs	11	6.67
7=.	(-)	Lehman Brothers	11	6.67
9.	(-)	ABN Amro	9	5.45
10.	(4)	Merrill Lynch	5	3.03

RANKING 2

04	03	Bank	Score	%
1.	(-)	Sanford Bernstein	300.00	11.00
2.	(10)	UBS	244.44	8.96
3=.	(-)	Goldman Sachs	240.00	8.80
3=.	(-)	Lehman Brothers	240.00	8.80
5.	(7)	Morgan Stanley	233.33	8.56
6.	(-)	Deutsche Bank	230.00	8.43
7=.	(-)	ABN Amro	200.00	7.33
7=.	(4)	Cazenove	200.00	7.33
7=.	(-)	CSFB	200.00	7.33
7=.	(-)	Merrill Lynch	200.00	7.33

MOST USEFUL RESEARCH – EUROPE

RANKING 1

04	03	Bank	Score	%
1.	(4)	Morgan Stanley	23	25.56
2.	(1)	UBS	14	15.56
3.	(3)	CSFB	12	13.33
4.	(2)	Deutsche Bank	10	11.11
5=	(7)	ABN Amro	7	7.78
5=	(-)	Goldman Sachs	7	7.78
5=	(8)	Lehman Brothers	7	7.78
8=	(5)	Citigroup	5	5.56
8=	(6)	Merrill Lynch	5	5.56

RANKING 2

04	03	Bank	Score	%
1=	(8)	Deutsche Bank	250.00	12.83
1=	(5)	Merrill Lynch	250.00	12.83
3.	(3)	CSFB	240.00	12.31
4=	(-)	ABN Amro	233.33	11.97
4=	(2)	Lehman Brothers	233.33	11.97
4=	(1)	UBS	233.33	11.97
7.	(9)	Morgan Stanley	209.09	10.73
8.	(10)	Goldman Sachs	175.00	8.98
9.	(4)	Citigroup	125.00	6.41

MOST IMPROVED - EUROPE

RANKING 1

04 Bank	Score	%
1. Citigroup	17	28.33
2. Merrill Lynch	10	16.67
3= Deutsche Bank	9	15.00
3= Morgan Stanley	9	15.00
5. ABN Amro	7	11.67

RANKING 2

Bank	Score	%
1. Morgan Stanley	300.00	20.60
2. Citigroup	242.86	16.68
3. ABN Amro	233.33	16.02
4= Merrill Lynch	200.00	13.73
4= CSFB	200.00	13.73

market access – that means brokerage is no longer the high margin business it was. One of the reasons we outsourced our company research to S&P was because we wanted to find a model which would make sense for Nordea. By reallocating our resources we can have a bigger impact."

Sandy Bragg, an executive director of Standard & Poor's in the US, believes that the trend towards transparency will level the playing field between the sell-side and the independents, because "asset managers will start to ask themselves if they're getting the best research for their money". As a result, some investment banks will decide not to bother distributing their research to the buy-side and focus solely on investment banking instead, because, "that's where the margins are".

This is the dream of the independents – that banks other than Nordea will accept that their models are unsustainable, and that asset managers will naturally gravitate towards independent providers. Unfortunately, it's not that simple, and not just because of the difficulties of actually paying an independent house if you don't want to write a cheque. (And no-one does.) Whilst managers say they value independence, the reality is that they continue to vote for the breadth and depth of coverage, company access, and discounted trading that the bulge-bracket firms can offer. This is amply illustrated by this year's survey, where the Wall Street firms dominate the rankings, much to the disappointment of those smaller brokerage outfits who lack a corporate finance arm.

Daniela Meyers, Instinet.

The mid-tier dilemma

Exane is typical of the regional brokers that have had to think hard about their market position in the last two years. Whilst Exane always prided itself on the independence of its research and the fact that it was 80% owned by its staff, it has too often been pigeon-holed as a French equity specialist, and seen the greater spoils go to the bulge-bracket firms. "Asset managers say they value independence, but in practice this is just one criterion amongst many," says Alain Kayayan, CEO of Exane. "Independence is not enough – size matters, that was why we decided to go for a merger." Exane accordingly absorbed BNP Paribas's troubled brokerage arm at the start of the year, after the bank bought up 50% of the business. This is intended to help Exane leverage its position in the French market to build a pan-European franchise.

"We had to respond to the fact that asset managers have steadily reduced their broker relationships from 40 or 50 brokers to around 20 or so," says Kayayan. "That has led to a situation where the biggest brokers have the largest slice of the commission cake." The merger with BNP Equities should strengthen Exane's hand in the secondary market, and help it to broaden its European coverage. The broker now has 35 analysts in London and 65 in Paris, up from 60 overall pre-merger.

Instinet has also responded to the industry shift, launching an Independent Research Consultancy at the start of this year to fit research firms to its asset manager clients. This currently has between 30 and 40 researchers on board, although the number is fluctuating all the time as new providers come to IRC's attention. "We don't provide research of our own, neither do we have any proprietary trading or market-making – execution is what we do best," explains Daniela Meyers, head of independent research at Instinet Europe.

"We set up the consultancy to choose the appropriate research providers for individual clients and encourage them to trade with us more. The whole problem with bundling is that the end investor is paying for something that isn't necessarily adding value. With our model we charge x number of basis points for execution and the asset manager only pays for research when they think it has added value." This payment goes directly to the research house, which receives a statement every month to see what trades their research has generated.

The mid-tier brokers and independent

research houses are hoping their position will improve if the FSA approves a new "comparative disclosure" regime currently being developed by the UK's Investment Management Association (IMA). John Tiner, CEO of the FSA, threw down the gauntlet in March when he challenged the industry to develop a trial solution before the end of the year. If the industry fails to deliver a high quality and workable solution, the FSA will reconsider the need for stronger regulatory intervention, which might include the dreaded rebating proposal as set out in CP176.

"CP176 doesn't get rid of the conflicts of interest, it just moves them around," says Gordon Midgley, director of research at the IMA. "For example, asset managers normally block trade across several clients' portfolios. But if one client won't pay for research and the others will, then one is benefiting at the cost of the others. It's no good to say the asset manager should separate that portfolio out and treat it differently, because how can the manager forget all they have learned from the research used in running the other portfolios? It's impractical and the costs go up. Rather than try to eliminate the conflicts of interest, we should leave them in a place where we can recognise, monitor and manage them. We shouldn't move them to a place where they're less visible."

Methodology

235 asset management firms responded to a questionnaire, which asked them how important they considered independence in research, and which banks supplied the best research. A total of 100 responses were received from the GI 100 companies (the world's largest asset managers).

Respondents were asked a range of questions covering commissions, the importance of independent research, in-house analysts and third party research. For all these areas the results are shown as either a summary or an average of all responses received. Respondents were also asked which global brokers were the best at providing independent and useful research and which local specialists were the best in individual markets. For the questions relating to third party research, the party that ranked first scored three points, the party that came second scored two points and so on. The final scores are all the points added together and represented as a percentage of the total points. These tables make up Ranking 1.

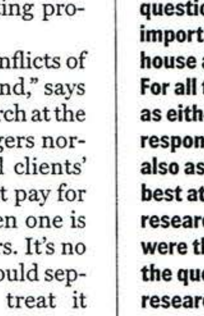
Responses were also examined from a qualitative perspective. To qualify for this section a research house needed to receive a minimum of three responses. Out of the total number of their responses, we looked at what percentage placed them first, second and third, then these percentages were multiplied by three, two or one point respectively. The final score is a percentage representation of each house's total score. These tables make up Ranking 2.

REGIONAL BREAKDOWN OF RESPONSES

	Percentage
Europe ex UK	58.97
UK	30.77
US	7.69
Other	2.56

Disclosure code

The IMA's solution is founded on its existing disclosure code. This was developed post-Myners to allow pension funds to see trading costs attaching to their accounts, and make the process of softing more transparent. It sets out a template, covering areas like volume of trading, commission paid, and level of softing by individual counterparty. The first reports were passed to clients in spring 2003 (following a year's collection of data) and at the end of 2003 the IMA surveyed its members and found 94% complying with the code. However, a much smaller percentage of trustees were actually reading them.



Frans Lindelöw, Nordea.

The IMA is now looking to tighten up definitions and get more detail into areas like dealing venues and methods, broker selection and transaction volume allocation, dealing efficiency monitoring, and conflicts of interest to ensure a more consistent application. The FSA wants firms to split out the commission paid for execution and that paid for research, but the aim of the IMA's table is to invite questions from the pension trustees, so they can see where the volumes are directed and whether they are being treated differently from other clients. It is questionable as to how informed trustees are about this issue, however.

The IMA is also having to respond to the fact that the FSA wants UK firms to include all their clients, regardless of where they are based. Currently, only UK clients are covered by the code of practice. "That's a big change and it would really impact smaller managers because of the systems changes necessary," says Midgley. "We will need to get buy-in on the industry solution from the members by December but it is yet to be proved how much client interest there actually is."

Continental European regulators are said to be waiting to see how the UK's proposals pan-out before they act. "The major interest is in the US. The SEC has a working group that is due to report in the autumn, and we understand that they are talking to the FSA, so maybe we'll see some convergence on this issue," says Midgley. "But the SEC has looked at the question of bundled research before and has always baulked at it and put it in the 'too difficult' box."

The US industry is said to favour a solution similar to comparative disclosure, but there are fears this may not go far enough. SEC Chairman William Donaldson is known to be in favour of disclosure and transparency, and wants to narrow the scope of the research definition to exclude screen-based news services and so on. However this is the tip of the iceberg in terms of softing in the US, and the usage of commission to buy shelf-space for funds was banned in August.

The decline of softing

Unsurprisingly, research by Greenwich Associates issued in May revealed that there had been a general decline in US soft dollar volumes of 18% last year to US$1.24 billion, or 11% of overall equity commissions. Greenwich said this reflected the expectation that soft dollars were unlikely to escape regulatory action, and it anticipated deeper cuts in the coming months. Ted Aronson, chair of the CFA Institute, and principal of quant specialists Aronson, Johnson + Ortiz, says that last year's scandals were to blame. "That's one of the silver linings to the mutual fund scandal - it got clients hopping mad." At present the declines are hitting the major wire houses and the banks but Aronson expects the indies to get hit in the next phase.

Although the average commission is still four cents, a lot of business is now being done at one cent a share because of the rise of ECNs and alternative trading systems. "Commissions are coming down and if clients keep pushing, within the next five years it's not inconceivable that soft dollars will disappear and directed commissions will be zero. Instead asset managers will

GLOBAL BROKERS SURVEY

MOST INDEPENDENT RESEARCH – US
RANKING 1

04	03	Bank	Score	%
1=	(-)	ABN Amro	4	19.05
1=	(8)	Deutsche Bank	4	19.05
1=	(6)	UBS	4	19.05
4=	(10)	Bear Stearns	3	14.29
4=	(-)	Goldman Sachs	3	14.29
6.	(7)	Citigroup	1	4.76
7.	(-)	Lehman Bros	1	4.76
8.	(3)	Merrill Lynch	1	4.76

MOST USEFUL RESEARCH – US
RANKING 1

04	03	Bank	Score	%
1.	(2)	UBS	7	28
2=	(4)	Deutsche Bank	6	24
2=	(8)	Goldman Sachs	6	24
3.	(3)	Morgan Stanley	3	12
4.	(5)	Lehman Brothers	2	8
5.	(1)	Merrill Lynch	1	4

MOST USEFUL LOCAL MARKET BROKERS

US
1. Sanford Bernstein
2=. AG Edwards
2=. Cantor Fitzgerald

JAPAN
1. Nomura
2. Calyon

UK
1. ABN Amro
2=. Calyon (Chevreux & Calyon)
3=. Dresdner

FRANCE
1=. Calyon (Chevreux & Calyon
1=. CDC Ixis
3. Exane

GERMANY
1=.Calyon (Chevreux & Calyon)
1=. Deutsche Bank
1=. HVB

SWITZERLAND
1. UBS
2=. Calyon
2=. Citigroup

NETHERLANDS
1. ABN Amro
2=. Kepler
2=. Heileser

NORDIC
1=. Carnegie
1=. Ensklida
2. Danske Bank

have to pay for trading out of their own budgets." He outlines a similar future for research, arguing that asset managers should be prepared to pay for research if they think it is valuable.

However, 50% of US institutions interviewed by Greenwich said that they were opposed to, or strongly opposed to, paying hard dollars for access to research and research services. Aronson dismisses this: "We've come a long way baby! You *can* get paid with a cheque. The independent research houses will have to move to hard dollars. Some people might lose revenue or go out of business as a result, but if they can't make that move then maybe they shouldn't be in business." He believes the same is true for the investment banks: "The standard investment banking model when it comes to research is dead."

Unfortunately, developments in the US have already shown that it is the providers of third party research who would be most affected by a revision of soft dollar rules. Last December the indies were put under pressure by an ill-judged statement issued by the Investment Company Institute, recommending the elimination of soft dollars for third party research and the banning of directed brokerage. This prompted some big asset managers to announce that they would only pay for independent research using cash. In practice this meant that they would use no independent research, relying instead on their in-house analysts and the research provided by the big Wall Street firms. It was the first clear indication that the big boys were closing ranks, and were willing to sacrifice the little players to preserve the status quo. In the US, third party research is particularly linked to the smaller brokerage houses and some of the big players clearly had little hesitation in cutting that adrift.

Barry Marshall, Gartmore.

But, as the Alliance in Support of Independent Research made clear in its letter to Donaldson in response to the ICI statement, ending third party soft dollar arrangementswould have impaired the ability of small asset managers to compete with their larger peers, and limited the ability of medium and small sized broker-dealers to compete with the Wall Street firms. The ICI's proposal was a solution for the big firms at the expense of the small, as it granted a significant competitive advantage to research produced in-house by Wall Street firms.

"The ICI statement was somewhat odd," reflects S&P's Sandy Bragg. "Why single out the independent providers and not address the sell-side? It raised eyebrows." He argues that whatever is introduced for the independents should also be applied to the sell-side; this is vital because the indies are already fighting an uphill battle. "It is extremely difficult for a small independent research provider with a limited budget to market itself directly to a large number of asset managers," said the Alliance. Likewise, many smaller broker-dealers lack the resources to employ internal research staff. The only way these firms can compete with their larger peers for institutional order flow is to purchase the research of independent providers. The ICI's proposal would have handed an economic advantage to broker-dealers with proprietary research departments by allowing them a payment mechanism not available to firms offering independent research. "Under such a scenario, few independent research firms would survive and even fewer would be created, denying investors an important source of fresh and unbiased information," said the Alliance.

The ICI statement unleashed a storm of controversy as some ICI members went on record to say that this wasn't their view. "It was seen as something of a bombshell, and not representative of the industry," says Gareth Jones, managing director, BNY in London. As a result, the ICI backtracked, and despite the rush by some companies to endorse it at the time, none has consciously adopted the proposal since.

Payment mechanisms

But the indies still fear that if regulators allow no mechanisms for payment other than hard dollars, they are likely to get squeezed out. Rusty Ashman, secretary of the Association of Independent Research Providers, which was set up as a direct response to CP176, says that selling research can be a long process. "You have to charge a small amount to start with and then you have to convince managers that your advice is of value. That means building up a reputation, and you're only as good as your last call." Ashman's own group, Stockcube, will give asset managers free access to its website for three months, then draw users' attention to when Stockcube gets it right. Hopefully this will prompt a subscription.

On the brokerage side, Jamie Stewart, head of institutional marketing and research at the Eden Group, is not convinced that even with disclosure, it will be possible to eliminate retrocessions. However, he does believe transparency will prompt an increase in the use of independent research and brokerage, because it will become more apparent who is good at what: "The problem is that no asset manager wants to make hard dollar payments because margins are under pressure so there is less cash sloshing around." Exane has also wrestled with the problem of pricing research, but as Kayayan points out, the question is whether the market will accept it. "Asset managers are often reluctant to pay directly for research. A business model that relies on asset man-

GENERAL INFORMATION
TOTAL ANNUAL COMMISSION PAYMENTS TO EQUITY BROKERS

	Percentage
Less than US$1 million	36.36
$1-5 million	18.18
$5-20 million	36.36
More than $20 million	9.09

Average
Proportion of commission payments for execution only: 38.07

INTENTION TO DISCLOSE SEPARATELY TO INVESTORS THE COMMISSIONS PAID FOR EXECUTION ONLY AND THE COMMISSIONS PAID FOR BUNDLED SERVICES

	%
Yes	19.56
No	80.43

DO YOU USE SOFT DOLLARS/SOFTING?

	%
Yes	31.37
No	68.63

If yes,

Average proportion of total commissions accounted for by soft dollars?	40%

If yes,

Do you anticipate a reduction in the proportion of commissions accounted for by soft dollars?

	%
Yes	37.5
No	62.5

Factors determining which brokers receive commission, providing best execution is met. (1 = most important)

	Average
Quality execution	2.80
Fund manager to analyst (broker) contact and quality of research	2.95
Analyst (fund manager) to analyst (broker) contact and quality of research	3.16
Salesman to fund manager contact and quality of research	4.11
Overall relationship with broker	4.20
Programme trading ability	6.06
Access to new issues and deal flow	6.11
Willingness to commit capital	6.88

ON A SCALE OF 0 TO 5 (0 BEING IRRELEVANT, 5 BEING FUNDAMENTALLY IMPORTANT):

	Average
How important is the independence of broker research?	3.75
How independent, do you feel, is the broker research that you take?	2.7

IF YOU CONSIDERED BROKER RESEARCH TO BE MORE INDEPENDENT, WOULD YOU GIVE IT GREATER WEIGHTING IN YOUR INVESTMENT DECISION-MAKING?

	%
Yes	55.88
No	22.05
Maybe	22.05

DO YOU USE THIRD PARTY RESEARCH?

	%
Yes	75.69
No	24.3

DO YOU EXPECT YOUR USE OF THIRD PARTY RESEARCH TO INCREASE, DECREASE OR STAY THE SAME IN THE NEXT 12 MONTHS?

	%
Increase	25.29
Decrease	14.94
Stay the same	59.77

DO YOU PAY TO RECEIVE THIRD PARTY RESEARCH?

	%
Yes	57.94
No	42.05

HOW DO YOU PAY FOR THIRD PARTY RESEARCH?

	%
Soft Dollars	46.43
Direct Cash Payment	39.28
Step Out	14.28

IF YOU USE THIRD-PARTY RESEARCH, WHAT PROPORTION OF THAT THIRD-PARTY RESEARCH IS PRODUCED BY:

	Average
Specialist vendors/non-brokers	62.93
Independent broker boutiques	37.07

DO YOU INTEND TO SEPARATELY DISCLOSE COMMISSION PAYMENTS FOR THIRD PARTY RESEARCH?

	%
Yes	11.76
No	88.24

agers writing a cheque cannot currently be sustained on a large scale."

This suggests there will still be a need for innovative payment mechanisms such as those developed by Gartmore and Fidelity. Fidelity has been running its answer to the bundling conflicts of interest problem since 1999; it started in the US, and then in 2001 it was adapted by its sister company Fidelity International for the UK. About 90% of Fidelity International's segregated assets are now within this system, which separates the decision-making on research by the portfolio managers from the decision-making done on the trading desk about where to go for execution. This gets rid of the conflict about having to pay off research with trading volumes.

Fidelity describes the system as its broker segmentation programme, because it puts brokers in different categories and each year agrees levels of fees and commissions with them according to the type of trade. After a certain volume threshold is reached, some of the commission is paid out to other houses for research, and above an even higher threshold, Fidelity operates a commission recapture programme, where commissions are rebated back to the client.

For the researchers, Fidelity's portfolio managers and analysts have a budget of votes or points which they use to rate each individual piece of research that they receive. The votes are totted up for each research house and Fidelity gives the providers a quarterly statement with manager comments. The votes are then translated into a monetary value and the research providers are paid accordingly. The traders therefore have no knowledge of, or reference to, the research used when they come to execute orders. And the portfolio managers are free to commission the research they need, regardless of whether Fidelity trades with that house or not. Similarly, Fidelity can reward independent research houses that have no execution desks.

Fidelity believes that it is unlikely to have to modify this arrangement to fit the FSA's demands as it has already taken out softing for market-data services, and the division between research and execution removes many of the main conflicts of interest. Fidelity's system has also been extensively explained to clients, and most have assented to its use, even those who dislike softing. "Our process applies a discipline to putting a value on research," says a spokesman. "At present we lack a market value, which is why there is so much confusion. But it's a subjective process – two managers can have two entirely different views on how useful a piece of research is, and even the sell-side can't value some of the things they provide."

Gartmore has been operating its new system for just over a year and now has seven brokers on board. As well as the original pair – Goldman Sachs and Merrill Lynch – ABN Amro, Citigroup, CSFB, UBS and Deutsche have signed up. Three other major firms are said to be close to joining, but Barry Marshall, chief operating officer, says that beyond that there would be marginal value in signing more.

The system works as follows: Gartmore has set a commission rate with the brokers on particular equities. Out of this, a portion is paid for execution and the rest goes into a research pot. At the end of the month, based on an assessment of the value that each research house has given, Gartmore directs the brokers to pay the appropriate sum. "We call this introductory brokerage, but the FSA calls it commission sharing," Marshall explains. "A lot of people said it was too difficult to make it work but I think our success is evidenced by how many banks have signed up. We have made payments to 40 different research houses so far but we now need to discuss with the execution houses what is the proper price for execution, and what methodology we should use to decide that. We also need to look at the value of the research."

He says that Gartmore makes it clear that any broker providing research in the system only gets the execution as well if its execution is any good. "CP154 puts the onus on asset managers to adopt best execution. In

Take your partners by the hand

July 27 heralded the start of the global settlement, whereby the 10 Wall Street firms who settled with Spitzer over allegations they had made biased stock recommendations during the dotcom bubble had to start distributing independent research alongside their own. Claire Milhench reports.

FOR THE LAST 12 months research houses have been competing keenly to be selected by the independent research consultants responsible for pairing off the settlement banks, and some clear winners have emerged from the unseemly scrum. BNY Jaywalk, Standard & Poor's, Renaissance and Morningstar all scooped five franchises apiece (see table).

This concentration was not hard to predict – because there was no overall co-ordinator of the process, it was always a possibility that a few well-known players would carry off all the prizes. S&P and Morningstar were widely tipped to succeed because they were already working closely with many of the banks. BNY Jaywalk's victory is more interesting, but equally understandable, given the choice it offers – there are some 150 research houses on the platform - and whilst the banks only ever access between 20 to 50 of these, the competition to be selected as the 'best in show' ensures investors are getting a good deal. "Those firms compete day to day for part of the settlement money," explains John Meserve, president of BNY Research, Commission and Payment Services.

MONITORING

To prevent the banks from choosing to distribute the independent research that most agrees with their own line, the independent consultants will monitor the settlement over the next five years, whilst some banks are using a performance measurement test to determine who gets picked. The application of the settlement varies quite considerably from bank to bank. In some cases, the consultants have ruled that if a research provider covers that stock, it will get shown, but in others, only one independent will get shown. In some instances this is an economic issue – some banks were directed to set aside more money for independent research than others – but each consultant also has its own views about what is most useful to investors.

"We have established that we can surpass the fundamental coverage provided by the sell-side."
SANDY BRAGG, STANDARD & POOR'S.

It is important to remember that the global settlement is targeted at helping retail investors make up their minds about a particular stock – this is fundamental, not technical research. This may account for the triumph of S&P and Morningstar, which are able to offer buy/sell/hold recommendations across thousands of stocks. John Piecuch, communications manager at Standard & Poor's in New York, says that in the last 18 months the house has increased its US stock coverage from 1,200 to 1,500. He believes S&P has done well from the settlement because it offers a consistent methodology across such a broad universe. "We also have a good track record in the performance of our recommendations."

Sandy Bragg, an executive director of S&P, adds that the S&P offering is very comparable to what the sell-side is offering, so it is a good second opinion against which to measure the investment bank's recommendation. Now he is looking to leverage the expansion begun by the settlement to grow S&P overseas. "The settlement has led us to significantly increase our analytic coverage and that has global implications," he says. "We have increased the numbers of staff in Europe and Asia to cover non-US stocks and we will be adding even more this year. We have established that we can surpass the fundamental coverage provided by the sell-side in the US, but we would like to be an independent that can be meaningfully compared to the sell-side globally."

the past I'm sure there were instances where brokers got the execution to reward them for the research, but to do both well requires two totally different skill-sets. Why should a good research idea come from the same place as good execution?"

He believes that investment banks must now be thinking about their business models very carefully, and sees a future with 10 big execution houses and 1,000 small research firms as a better solution. "We prefer to take our raw data and research from different places than everyone else. If you're looking to get an edge it doesn't make sense to go to the same place. In the same way, if you don't do your own analysis you're just being spoon-fed by an investment bank and you're not offering anything different to your clients."

Marshall argues that the Gartmore model has the benefit of telling providers exactly how much their research is valued. "Until now the buy-side hasn't known what it is paying for and the sell-side hasn't known what parts of the business are most valued. The theory of this arrangement is that one investment bank's research pot could pay out to another bank that's better than them, but the bulk of the recipients are independent research houses or small brokers with specialist research." Because of this, Gartmore isn't putting all of its business via the arrangement just yet, but Marshall says this is the aim for the future. "However, we need to sort out the pricing for that. We're having discussions with the banks at the moment – some are happy to move to that model and some are less keen, but that just means I can create some competition between them."

Buy-side inertia

Marshall is an evangelist for opening up the market to greater scrutiny and exploring new payment systems, saying: "There is nothing unique about our industry – it should still be about negotiating prices for our services. But there seems to be some inertia from the buy-side to address these issues, even though CP176 asks for sensible purchasing policies to be adopted. I would really like to see movement from some other asset managers on this because it's no good if only Gartmore is doing it."

At least one asset manager is picking up the baton - BNP Paribas Asset Management, headquartered in Paris, is attempting to introduce a French fiscal-friendly version of Gartmore's model. The manager currently uses a combination of its own in-house analysts, investment bank research and independent houses, who are paid hard dollars. It asks its portfolio managers and in-house analysts to select between five and 10 counterparties that they think are useful, and an effort is made to concentrate 80% of the business with the top eight relationships. "These are our strategic counterparties and we ask a lot of these people so we try to match our commission spend and trading volumes with the service they provide," says Philippe Lespinard, chief investment officer of BNP Paribas Asset Management. "It takes a whole year to match the budget so it doesn't have to be a constraint on best execution."

Half of these counterparties are European, with one French bank, and the other half are US-based. The other 20% of the business goes to specialist players, who may offer a particular research product. "So there's an incentive for those brokers in the mid-tier to become a strategic counterparty." Lespinard says BNP Paribas is now working towards the goal of putting together a budget for execution and a research-only budget, accepting that they may not match. "We have to ready the counterparties to absorb some of the research trades and we have made some progress towards this. We are looking at the legalities of the agreements right now." Lespinard recognises that this will create some new challenges, as the strategic counterparties who are executing will have to direct commission back to those in the specialist camp for research services.

"The 20% tend to be very good at research in the area that they have chosen to specialise in. That doesn't necessarily mean they are bad at execution but as they are smaller houses they may have liquidity constraints, or we may use up all our annual commission budget with them in a couple of block trades. So it's not worthwhile for us to maintain all those dealing relationships, because there are connectivity costs associated with that. We think it's preferable to strike an agreement with them and reward them for their research."

Lespinard stresses that this development is in its early stages and the eventual arrangement is likely to look a little different to the Gartmore model as it will have to be compliant with French law. "Also, the smaller specialist houses have to be willing to be paid in this way. But it will deliver savings on high volume execution for BNP Paribas and give the trading desk more flexibility in choosing the best-placed counterparties to provide the liqudity we need. And it will satisfy the regulatory pressure to pay for execution and research separately, and be transparent."

Lespinard says the French regulator hasn't moved as fast as the FSA on this issue, but BNP Paribas wants to be ahead of the pack, and adopt best practice. "We can see the trend and there is no reason why we can't start moving in that direction ourselves. The investment banks will get the same money as before but the nature of the relationship will change from a trading to a service relationship."

GUIDE TO THE GLOBAL SETTLEMENT PARTNERSHIPS

Company	Settlement	Independent total (US$m)	IRP research ($m)*
BEAR STEARNS	80	25	BNY JAYWALK
CITIGROUP	400	75	S&P, ARGUS, MORNINGSTAR, RENAISSANCE CAPITAL, THOMSON FINANCIAL
CSFB	200	50	BNY JAYWALK, S&P, RENAISSANCE CAPITAL
GOLDMAN SACHS	110	50	MORNINGSTAR, S&P, RENAISSANCE CAPITAL
JPMORGAN CHASE	80	25	MORNINGSTAR, RENAISSANCE, BOE SECURITIES
LEHMAN BROS	80	25	BNY JAYWALK
MERRILL LYNCH	200	75	BNY JAYWALK, MORNINGSTAR
MORGAN STANLEY	125	75	ALPHA EQUITY RESEARCH, ARGUS, BUCKINGHAM RESEARCH, FULCRUM, IPOFINANCIAL.COM, SOLEIL SECURITIES, S&P, ZACKS
PIPER JAFFRAY	32.5	7.5	BUCKINGHAM. MORNINGSTAR, RENAISSANCE, S&P, ZACKS
UBS	80	25	BNY JAYWALK
TOTAL	1,387.5	432.5	

*PART OF SETTLEMENT TOTAL, TO BE SPENT OVER 5 YEARS.
SOURCE: GI SOURCES

Wafer-thin margins

If such models become the norm, many investment banks will have to revise their current approach to research provision. Splitting execution and research payments will horribly expose those who are not adding value and with margins in execution trending to wafer-thin, it won't be possible for everyone to continue to indulge themselves with the production of maintenance research.

"The banks have already started to cut costs because they know they will soon have to account for it," says BNY's Meserve. "Coverage has fallen off on a lot of small and mid-cap firms. The problem for the investment banks is that research is a cost centre, not a business, although it's in the process of becoming a business. It can no longer be used to support IPOs, so I expect to see more moves to outsource this function to independent providers."

The first of these deals occurred in the summer, when Nordea outsourced its research capability to Standard & Poor's. S&P already had an agreement with the bank to provide research coverage for all non-Scandinavian equities, but under a new five year deal, Nordea has closed its Nordic research department, which employed 30 people, and established a new integrated research unit, the Alpha Research Team. This is staffed with in-house sector specialists, quantitative analysts and strategists, who advise clients on trading strategies and timing.

For its part, S&P has set up a 20-strong equity research team in Stockholm, to provide research and recommendations on 200 Nordic stocks. It gets a fixed fee for its services plus a performance fee related to a benchmark.

"Nordea is interested in our ability to provide fundamental research and analysis, such as a 12-month view on a stock," says Julien Hardwick, European head of equity operations at S&P. "The Alpha team will then interpret that information for their clients. Basically Nordea wants to focus its resources where it can add value. They decided there was no value in continuing to compete at the basic level, only at the more intellectual level."

Nordea says the arrangement is a response to growing pressures in the equity research market, such as constrained margins, regulatory reforms and low credibility. "We wanted to position our business where we think the market is heading," says Frans Lindelöw, head of equities at Nordea. "We believe there's a disconnect between what clients want and what they are getting. There are over 650 analysts worldwide following Nordic stocks, all of them essentially producing the same sort of research and not all of them adding value for clients. Transferring the function to an independent provider improves the credibility of our company research, makes the economics of the research function more transparent, and enables us to focus on generating strong investment ideas for our clients."

He says the Alpha team won't have to produce particular kinds of research every quarter, but will develop new ideas and solutions. "The aim is free up analysts and help them to be more creative by allowing them to think beyond the calendar research. It's a better model for the same cost, and the great

Case study: Goldman Sachs

Goldman Sachs, which has previously failed to figure much in GI's survey, has entered the top 10 rankings this year. It has also been recognised as one of the most improved research houses for independence. Claire Milhench talks to Neil Crowder, co-head of pan-European research, about the bank's approach and how it differentiates itself from the other bulge bracket firms.

GOLDMAN SACHS is fairly unique in the City for having had the same heads of research for four years. Neil Crowder and Anthony Ling took up the reins in March 2000, and whilst the average tenure for research heads in London is about a year, they're still there. This relative longevity of service has enabled them to implement a consistent strategy that should make Goldman Sachs a much stronger research competitor under an unbundled or more transparent regime.

Crowder says that the bank has tried to differentiate its product and service by focusing on fewer clients, but treating them well. This has made for a more profitable, efficient business. "We have segmented the client base pretty thoroughly and introduced marketing analysts for our top clients," he says. "These analysts offer a specialised, high value-added service to our core accounts. About 80% of our revenue comes from 20% of our accounts." Goldman's own surveys have shown that improvements made to its research offering over the last four years have resulted in the bank going from an average ranking of eighth to fourth in ratings from its top clients. "We had a period where clients felt we had good execution and mediocre research, with many of the top clients not seeing us as that important, but that's changed in the last few years," he comments.

Crowder attributes this to a number of factors, not least the decision to make the product much less maintenance oriented. "We have encouraged our analysts to look for proprietary sources of information, to think creatively and be much more detective-like in finding information," he explains. Although the bank still does some maintenance research, this has been steadily falling over the last three years, and last year a rule was introduced banning written maintenance research. "For a bulge bracket firm that's pretty groundbreaking," says Crowder. "There's an expectation that you'll just provide it but we wanted to differentiate our product from that of our competitors. There's a lot of maintenance research out there and it doesn't add much value. We see more value in identifying the key drivers of price movements in a particular stock and trying to find out what is going on with those key drivers."

"There's a lot of maintenance research out there and it doesn't add much value."

NEIL CROWDER, CO-HEAD OF PAN-EUROPEAN RESEARCH, GOLDMAN SACHS.

This shift in focus should pay off in the medium term. The industry is about to undergo significant change and as Crowder points out, the winners will be those who can offer a differentiated product. "People aren't going to pay for a seventh maintenance report," he observes. As part of the drive to provide a better product to clients, Goldman Sachs has also encouraged its credit and equity analysts to work more closely together, "but only where it makes sense," says Crowder. "We want them to call on resources that they maybe didn't access before and be aware of what's going on outside their own market. That has led us to publish some joint research where we thought it would help clients."

The bank has also tried to differentiate itself in the way that it recruits and trains young analysts. "We started in 2000 hiring people straight out of university and we put them through intensive training, including the CFA," Crowder says. "We hired more each year, all through the downturn, and in recent years this approach has paid off. My challenge now is retention – a lot of our competitors reduced their junior headcount in the downturn and our people are in demand across the City."

Crowder believes that the structure of his research department will ensure that it is well-placed as the industry begins its shake-out. "Clients will look to hone down their relationships and we have positioned ourselves for that. There is still some excess capacity in the industry and a lot of people doing the same thing. I expect to see some consolidation, particularly amongst the second-tier houses, because there are a lot of players in the middle not adding value."

advantage for us is that we have secured one of the largest independent research providers on an exclusive basis in the Nordic region."

Hardwick believes that this deal could become the blueprint for the industry. "This is a bold move on Nordea's part. The market needed a significant player to come along and take this kind of decision. At other investment banks people are not at all clear about the strategy that they're going to pursue over the long-term, but the cost and regulatory pressures are increasing." He says that the next outsourcing arrangement need not necessarily be with a regional player. "We are talking to a whole range of players from the smallest local provider to the big global firms." However, it seems more reasonable to expect the regionals to crack first. Our survey results show a decline in regional fortunes, with a poor showing from the local players in Europe's ranking two, where they traditionally do well.

There is likely to be increasing polarisation in the market, with the big asset managers looking to the bulge-bracket brokers, who will focus on the large cap stocks. "There won't be any point in looking at anything below the FTSE 250, because the margins are too thin," argues AIRP's Ashman. However, as long as regulators support a disclosure solution rather than an end to bundling and softing, the big boys will continue to benefit. The only bright spot on the horizon for the small independents is the potential for innovative payment mechanisms under a more transparent regime. This will make it easier to measure who is really providing value, and whose research isn't worth the paper it is written on.