EDISON

The future of equity research

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Frost Consulting

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Foreword

“The society welcomes the current review of the research business model as an opportunity to consider if the system is works in clients’ best interests and to consider what improvements are needed.”

CFA Society of the UK

“Clearer identification of the value of research and improved disclosure about the cost of research to clients are attractive outcomes, but we also need to take care to identify all the impacts of any change.”

Will Goodhart, Chief Executive CFA Society of the UK

About the authors

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Neil Scarth has held a wide range of roles in asset management and investment banking in Europe and North America over the last 25 years, ranging from running equity businesses at global banks to launching and managing various asset management products. Neil has comprehensive knowledge of the strategic and competitive framework that governs the inter-relationships between plan sponsors, asset managers and investment banks. His portfolio management experience has emphasised financial services in equity long/short (Deephaven Capital International, London, Symmetry Management, New York) and pension/mutual fund advisory (Trilogy Global Advisors, New York). Investment banking experience includes running integrated institutional equity business units for ABN-AMRO and Merrill Lynch. Prior positions included posts in equities management, equity research and private banking. He is a member of the UK Investment Management Association's Research Review Advisory Panel. Neil holds an MA from the University of Southern California and a BA from Carleton University.

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Executive summary

The Financial Conduct Authority (FCA) *Conflicts of Interest* document issued in November 2012 and follow-up consultation paper *CP13/17 Consultation on the use of dealing commission rules,* issued in November 2013, have the potential to be the most significant catalysts for change the equity research ecosystem has seen over the last century.

The FCA's eventual position on how asset managers use dealing commission to pay for goods and services from the providers of research is likely to be a key component in the upcoming MIFID II negotiations, which is expected to become European law by late 2016.

With the asset management industry continuing to consolidate and operate on a global basis (the top 120 asset managers now look after 53% of global AUM), these changes are likely to resonate on a global scale as asset managers are likely to adopt common systems globally to reduce complexity for their businesses, as we saw with the evolution of CSA/CCA payments.

This paper looks to add to the debate around the FCA's proposals. It finds that regulatory change has had a significant impact in the shaping of the equity research ecosystem. If the FCA's proposals remain intact, we see short-term and long-term impacts on the equity research industry.

In the short term we see six key developments:

1. **A continuation of the trend of a separation of revenues** generated from the trading of securities and the payments for research services.
2. **An opening of the content universe available to asset managers.** Historically the bundled payment for execution and research services restricted the universe of suppliers available to asset managers for research inputs to those produced by the investment banks. With the links being broken between

commissions and research spend, the competitive research landscape opens up significantly.

3. **Research produced from investment banks moving from an unpriced to a priced environment.** A recent CFA survey found that 58.7% of those surveyed felt the sell side should move to a priced environment for the provision of research.
4. **Continued shrinkage of the overall payments made for research services to investment banks.** 59.9% of respondents in the CFA society survey expected commission spend to go down if sell-side houses priced research.
5. **A reallocation of spend among research providers**. Price discovery tends to be a very good thing for high-quality producers of research, but is extremely commoditising for the average producers of research. 59.8% of those surveyed by the CFA felt the current research model does not best serve the investors, while 70.1% of those surveyed by the CFA felt that independent research would gain market share.
6. **A continued consolidation on both the buy side and sell side** as the buy side moves to produce more of its research inputs in house in response to pressures to move research spend from off balance sheet to on balance sheet, effectively paying out of their own P&L rather than through client commissions. 73.2% of those surveyed by the CFA felt that sell-side analyst numbers will fall in the next few years.

These changes are likely to force the equity research industry to change. After decades of failing to innovate, we believe there are six potential longer-term changes the industry may see as a result of the regulatory changes being proposed:

1. **Asset managers will start to access a network of new research inputs.** 'Differentiated alpha' is more likely to spring from research sources that are not used by virtually all of an asset manager's competitors.

Asset managers that have made the effort to identify and procure alpha-generating content from the unbundled universe will frequently guard the identity of those sources in an attempt to sustain this competitive advantage.

Over time we expect that an asset manager's approach to the wider content universe will become an intrinsic part of their investment strategy, from both an operational and client marketing perspective.

2. **Innovation in the delivery of research content in searchable format.** Research organisations are recognising that before they can become contenders for payment for research, they have to make it easier for asset managers to access the information they want.

   In a world where the default mechanism of finding information is Google, the onus on the research providers will be to create searchable XML documents and sites, moving away from pdfs.

3. **Changing research content at investment banks.** As asset managers start to price and value research inputs, the profit-maximising firm would look to optimise value to cost.

   Managers of cash equities businesses understand the value a good analyst can bring. They create value for their institutional clients through deep industry insight. They attract IPOs (with appropriate chaperoning) and allow banks to provide liquidity to their clients, for example, allowing a bank to price block trades more effectively. And ultimately they probably provide the best corporate access.

   However, such analysts are few in number and the economics of their business do not sustain in-depth research of a large tail of stocks. As investment banks prioritise profitable or potentially sustainable segments of their business, research patterns are likely to follow. This may encourage banks to specialise in areas of relative strength, where highly rated sector analyst teams are profitable and generate the greatest opportunities.

4. **Long-tail strategies to come into play with research aggregators potentially becoming some of the largest**

beneficiaries. There are changes (both regulatory and technological) taking place in the research market place that suggest to us Chris Anderson's theory of the long tail has many analogues to what we are seeing in the research environment.

Anderson explains "the theory of the Long Tail can be boiled down to this: Our culture and economy are increasingly shifting away from a focus on a relatively small number of hits (mainstream products and markets) at the head of the demand curve, and moving toward a huge number of niches in the tail."

Firms such as Gerson Lehrman Group, which filled the research gap by providing timely and proprietary insights from a long tail of expertise that broking firms have struggled to provide, is one such example.

As the research content universe expands and becomes more searchable, asset managers are likely to pick and choose niche services as they require them. The biggest winners in this space are likely to be those aggregators that can marry up supply and demand in the same way Amazon, iTunes and Netflix have in books, music and films.

5. **Stock exchanges facilitating the provision of research.** With the larger banks recognising that providing detailed research on a large tail of securities is no longer commercially viable, and with more and more sell-side houses exiting the cash equities business, stock exchanges around the world have started to recognise that this paucity of coverage on stocks listed on their exchanges is not in their best interest.

   Stock exchanges recognise that volume is generated not just by the institutional investment community, but also by both the private wealth and retail community who lack access to reliable data and high-quality research. We are seeing increasingly larger budgets by exchanges being allocated to providing research as they compete with each other to be an attractive listing venue.

6. **Growth in issuer-sponsored coverage.** As sell-side coverage diminishes, there has been a growth in the number of firms or

issuers commissioning a research provider to produce equity research.

We cannot help draw a parallel from the bond market, where there are three dominant information providers on bond ratings: S&P, Moody's and Fitch. Their information, paid for by issuers, is relied on as a base case by investment banks and asset managers. These market participants are free to take a different view from the ratings agencies (and profit from it if they are right). However, a lot of the ground work in providing that information has already been done by the ratings agencies.

As the cash equities business becomes increasingly commoditised, and asset managers remain reluctant to take on the cost of research onto their own P&Ls, there is a possible market solution in providing information from a number of issuer-sponsored houses. Instead of regulators facilitating this push, increasingly it seems the world's stock exchanges are providing the impetus for this.

As with the bond world, these houses will sit alongside the inputs from the teams at global investment banks and from niche research providers (the long tail). If the industry has the appetite for change, far from losing research inputs, the asset manager faces a world with a greater degree of choice, which is provided at a more transparent and lower cost. Better for the asset manager, better for the consumer. The alternative, of course, is that we do nothing and nothing changes.

The (changing) role of equity research

An industry born out of regulation

Before debating the future shape of the equity research industry it is worth dwelling for a moment on why the industry exists. To understand the scale of the challenge facing all participants in the equity research ecosystem, it is necessary to consider the historic regulatory and economic forces that have shaped the current environment. In understanding this, it will serve to elevate the importance and potential impact of current regulatory changes that are being proposed.

Paying from your client's pocket or your own?

For the traditional sell-side equity researcher, the principal customer is the asset management community. Three pieces of legislation have created an economic incentive for the asset management community to seek inputs from the sell-side rather than source these inputs internally:

- The Securities and Exchange Act, 1934, US
- Investment Advisor Act, 1940, US
- Investment Companies Act, 1940, US

The Securities and Exchange Act set the central architecture for secondary equity trading and issuance regulation including the formation the key US regulator, the Securities and Exchange Commission (SEC). A key section from a research perspective was 28(e) "Safe Harbor". This established that asset managers would *not* be in breach of their fiduciary obligation to their clients if they used equity commissions to purchase both brokerage services (execution) and research.

Key impact

The provision to allow asset managers to use equity commissions to purchase research established a practice that has defined the economic relationship between research producers and asset managers ever since.

Products/services that assist the asset manager in making investment decisions can be paid for via commission.

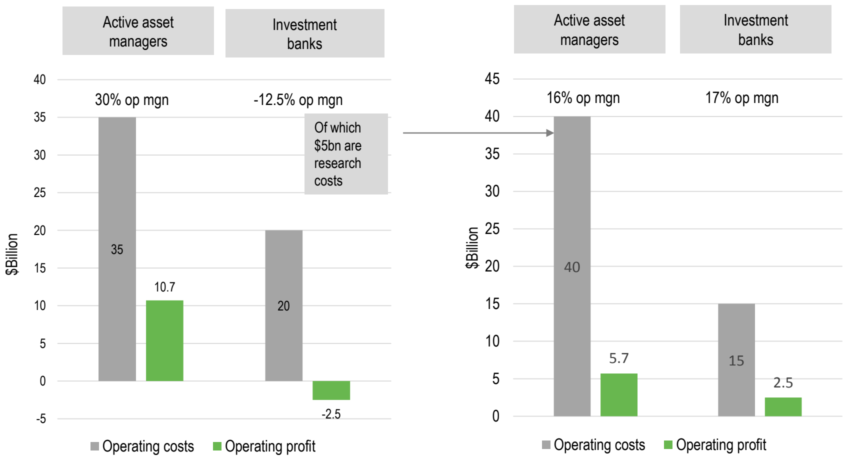
In the case of grey areas, asset managers must divide costs between research and non-research functionality. Together with other pieces of legislation, notably the Investment Advisors Act of 1940 and the Investment Companies Act of 1940, the principle has evolved that while asset managers can use commissions to purchase research, they cannot use commissions to subsidise any of their ongoing business expenses, including rent, salaries, travel, marketing, etc.

Key impact

This provides an economic incentive for asset managers to purchase external research – it can be funded by their client's commissions while research generated by their internal staff cannot.

Exhibit 1 illustrates the impact if the c US$5bn a year spent by investment banks to deliver research were to be absorbed by the P&L of the asset managers, namely their margins could be cut by 50%.

Exhibit 1: Asset managers' margins would halve if they absorbed the cost of investment bank research



Source: Frost Consulting estimates

Advent of the waterfront coverage model

The creation of integrated investment banks through the 1986 Big Bang in the UK and the 1999 Gramm-Leach-Bliley Act in the US led to the adoption of investment banking cross-subsidising research. The ultimate impact of this was the creation of the waterfront coverage model and the production of research far beyond that which an institutional investor commission pool could support on a standalone basis.

The Gramm-Leach-Bliley Act of 1999 (repeal of Glass-Steagall) repealed the provisions of the Banking Act of 1933 that mandated the separation of retail and investment banks. In reality, regulatory decisions had already watered down the provision. Travellers Group acquired investment bank Salomon Brothers in 1998. Travellers' subsequent merger with Citibank effectively created the first US integrated investment bank. Others soon followed.

Key impact

The creation of the integrated investment banking model had important implications for the production of equity research at investment banks. These banks offered a range of services, and research could support these products beyond its traditional role of providing investment recommendations to asset managers. Research was often critical in securing high-margin investment banking mandates for IPOs or M&A.

Integrated investment banks had the ability to cross-subsidise products. Since research was being used for more than security recommendations to asset managers, the research 'revenue' could extend beyond research commissions generated by institutional investors. Investment banking and other internal departments could contribute to the cost of research production as it served their wider objectives.

Consequently, at least some research production was not related to end asset manager demand. This evolved into the 'waterfront research coverage' model, in which most large banks would attempt to cover as wide a range of stocks and sectors as possible to try to capture corporate finance business. The result was an 'over-supply' of research relative to actual end demand, with large, liquid stocks often covered by more than 100 sell-side analysts.

These key pieces of legislation largely determined the organisation and economics of research distribution until the first decade of this century. Since 2000, a new set of regulations has come into force that has put into reverse the drivers that led to the growth of the equity research industry, and have led to the current ongoing restructuring of the industry.

Separation of corporate finance and research

In 2001 New York Attorney-General (NYAG) Eliot Spitzer began an investigation of potential conflicts of interest at Merrill Lynch regarding equity research recommendations being influenced by investment banking client considerations. The investigation expanded rapidly and in 2002 the NYAG filed a suit against several integrated investment banks alleging various aspects of this conflict of interest. The banks settled for US$1.4bn later that year and agreed to a number of measures to separate investment banking from the research function. In addition they agreed (for a limited period) to fund independent research recommendations that they would also make available to their retail clients. As a part of the settlement the firms paid US$460m to fund independent research for a five-year period ending in 2009.

Key impact

Theoretically this settlement ended the cross-subsidisation of research by investment banking, forcing research departments to realign their cost base and product offering to the primary source of revenues: commissions from institutional investors.

Best execution: Opening up competition

In 2001 the UK Treasury appointed Paul Myners, former Gartmore chair, to review the institutional investment landscape. The result, the Myners Review of Institutional Investment of 2001, initiated changes that are still reverberating throughout the industry. Among other things, the author argued that asset managers should change the way they treat client commissions for the purchase of research and execution services. This opened the debate on use of commission.

The compromise solution was the FSA's CP-176 in 2003. This allowed UK asset managers to continue to use commissions to purchase both execution and research services, but mandated that research and execution commissions must be split. While not specifically mandating commission unbundling, it was identified as a potential solution to the previously opaque bundling of commissions. In an unbundled trade, the execution fee would remain with the executing broker, while the non-execution fee could be placed in a Commission Sharing Agreement

(CSA) – an account from which the asset manager could pay any type of research producer, not just brokers.

This differed significantly from the US ‘soft-dollar’ arrangement. Rather than paying specific pre-agreed bills, the CSA structure allowed the asset manager to retroactively distribute CSA commissions to a wide variety of service providers. Current market practice is that asset managers normally instruct investment banks holding their CSA balances to pay third-party research providers every quarter.

Through the original CP-176 edict and subsequent interpretations and refinements, eligible services in the UK include research, execution and certain types of market data, so long as the raw data has been manipulated to add analytical value. In the UK it is the asset manager’s responsibility to determine ‘eligible services’ based on their understanding of the spirit of the UK regulation. Consequently, many managers divide market data components to determine their eligibility for CSA payment.

What happens in one market often follows in others. The separation of execution and research payments was reinforced in the US through NMS 2005 (Regulation National Market System). The most salient measure of this regulation was the establishment of the concept of ‘best execution’. This made it incumbent on both brokers and asset managers to achieve best execution for their clients.

This was followed by Commission Guidance Regarding Client Commission Practices 2006 in the US, updating the guidance on 28(e) and allowed the creation of the Client Commission Arrangement (CCA), the US equivalent of the UK CSA.

The EU enshrined the concept of best execution as part of MIFID 2007.

Key impacts

This set of regulations had six impacts on the equity research industry:

1. **It enshrined the principle of best execution and the concept of paying for execution and research services separately.**
2. **By separating the payment mechanisms, it effectively ended an investment banking oligopoly over asset manager research spend.**
3. **It created a two-tier system among investment banks; those that offered a CSA execution product gained market share, others lost share and commission income.**
4. **It rationalised asset managers' execution counterparty lists.**
5. **It opened up competition for asset manager research spend to a much wider group of industry participants. This has significantly expanded the potential content universe for the asset manager, although most are yet to capitalise on this change.**
6. **With assets being increasingly managed on a global basis, best execution was an interesting case study of how regulation eventually moves to other markets.**

Global adoption of the CSA/CCA regime

The term unbundling refers to the separation of the execution and non-execution components of the equity commission. This theoretically allows asset managers to choose the best provider of each service. Some valuable research providers may be sub-optimal in terms of equity execution, while other banks excelled at execution but produced less compelling research.

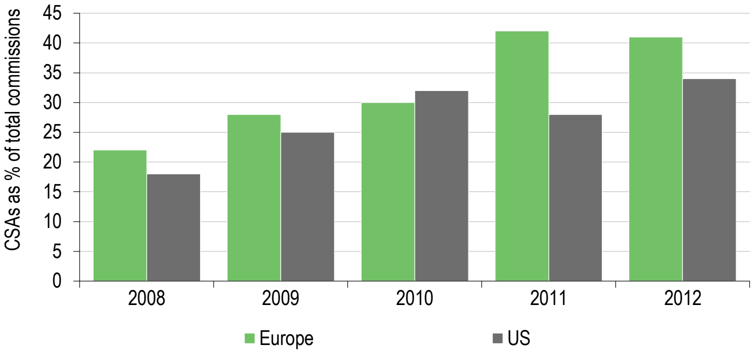
In the CSA transaction the execution commission would be retained by the investment bank handling the trade, while the (larger) non-execution component would be kept in an account at the bank on the asset manager's behalf. As CSA trades accumulated, the balance in the account would rise. Periodically the asset manager would instruct the bank to pay research producers directly from the accumulated funds in the CSA account.

Although commission unbundling was originally a UK regulatory initiative, its spread has been accelerating both in terms of its market share in the total commission market and geographically for three key reasons:

1. It is indirectly supported by ‘best execution’ regulations.
2. Once asset managers become accustomed to CSAs they appreciate the flexibility in commission allocation that these structures deliver. As the UK subsidiaries of global asset managers used the structure, CSAs were frequently rolled out globally because most asset managers prefer not to run multiple operational systems in different regions.
3. Asset managers in geographies in which unbundling is difficult (usually because of unintended tax considerations) find themselves at a competitive disadvantage in an increasingly global asset management market. These managers frequently lobby the local regulator to allow CSAs to enhance their competitiveness. The most recent example was the approval of CSAs by the Swedish FSA in October 2012.

Consequently, CSAs are rapidly becoming the dominant commission category globally.

Exhibit 2: CSAs growing as a percentage of total commissions



Source: Greenwich Associates

Two-tier banking system: A UK case study

The profound changes engendered by the transition to the unbundled commission environment are best illustrated by the experience in the UK, where global unbundling started and where CSA penetration is highest. Currently, CSAs represent around 70% of total commissions in the UK market.

This has had a major impact on the economics of investment banks with knock-on effects for investment bank research production.

The end of the one-to-one relationship between research and execution quickly created a two-tier system among investment banks. Large banks that offered a CSA execution product (the ability to allow asset managers to direct research payments to third parties including bank and non-bank research producers) gained execution market share.

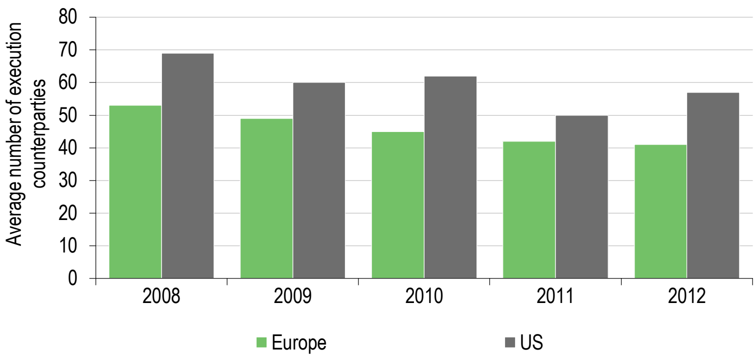
Most asset manager trading desks had long wanted to rationalise extended inefficient execution counterparty lists, whose ranks had been swollen by the one-to-one research/execution relationship of the 40-year-old bundled commission system. They now had the ability to pay a virtually unlimited number of research providers through a limited number of CSA execution providers.

Many mid-sized and smaller brokers that did not offer a CSA execution product were increasingly compensated for their research via CSA payments from other banks, rather than through equity execution.

This had three important impacts:

1. It meant that, as their order flow declined, these dealers quickly developed expensive excess capacity in their trading operations.
2. The CSA payments from other banks were almost always at lower absolute amounts than the previous execution relationship, placing pressure on the economics of the firms as a whole.
3. As CSAs represented c 70% of total UK commissions, banks that did not offer a CSA execution product were left competing for the remaining 30%.

Exhibit 3: Decline in the number of execution counterparties for asset managers



Source: Greenwich Associates

Regulatory change and a cyclical downturn

The perfect storm

The far-reaching regulatory changes we have described came at a time (and partially as a result) of the worst bear market for equities since the 1930s. This meant a significant decline in available commissions for the cash equities business. The effect is particularly severe outside North America where commissions are calculated as a percentage of the value of the share price.

Since the onset of the global financial crisis in late 2007, the equity businesses of the global investment banks have been under economic pressure. Investment bank ROEs, which frequently exceeded 25% through 2007, have retreated to low-single digits – positive for some and negative for others.

Meanwhile, the investment banks' weighted average cost of capital, which hovered at mid-single digits for most of 2001-07, has doubled in many cases. This reversal in spreads has caused even the most historically profitable banks to re-assess their business models.

Some of this is cyclical: cash equities, M&A and IPOs have been in a bear market as the successive sub-prime debt and sovereign wealth crises have elevated macro risk and reduced investor and corporate confidence.

However, some of this is structural and permanent. From a balance sheet perspective, higher regulatory capital requirements, more expensive capital and the forced reduction in activities including proprietary trading will substantially reduce earnings leverage. From a product perspective, the rise of equity derivatives, private equity and ETFs have provided substantial competition to traditional actively managed cash equities.

Quantifying the impact: C 50% fewer analysts

Between a savage bear market in equities (in an *ad valorem* market) and commission unbundling, Frost estimates that the available secondary commission to the sub-set of UK small and midcap brokers not offering a CSA execution product fell by c 80% between 2007 and 2012. This combination of factors had inescapable implications for their research budgets. A substantial wave of consolidation and exits from the cash equities business has led to a meaningful reduction in brokerage/research capacity in this sector.

While it is difficult to quantify the impact due to the unpriced nature of research from investment banks, there is a general acknowledgement that the industry has seen a significant reduction in both revenues received by and budgets allocated to investment banks producing equity research:

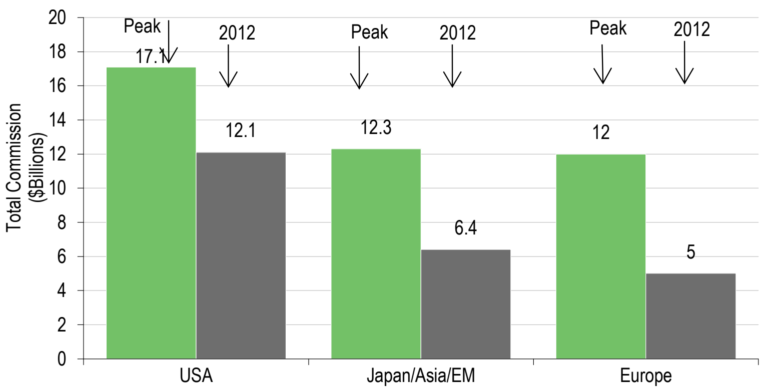
- On the revenue side, Frost estimates that there has been a 43% reduction in global commissions for equity research as shown in Exhibit 4.
- On the cost side, Frost estimates that we have seen a 40% reduction in budgets allocated by the c 600 firms producing equity research from US$8.2bn at the peak to US$4.8bn in 2013 (see Exhibit 5). Note that these costs only represent direct analyst costs. The additional expenses of an integrated cash equity business would include trading, sales management, IT and infrastructure, etc. The research costs depicted likely represent c 25% of total cash equity costs for large investment banks.
- Anecdotal evidence from multiple research aggregators indicates that the average number of analysts following all global equities (including those with no coverage) may have fallen by c 50% between 2007 and 2012, from roughly four analysts per stock to about two.
- The World Federation of Exchanges estimates that 35-40% of all publically traded equities have *no* research coverage. This is a

reflection that there still is a significant concentration of analyst coverage toward the more liquid securities.

These numbers seem to be broadly consistent with the experience of practitioners in the equity research field. The World Federation of Exchanges estimates there are c 45,000 listed securities excluding investment funds. On the basis of each analyst covering 10 stocks, this would suggest that analyst numbers had fallen from 18,000 at the 2007 peak to 9,000. It would also suggest that the cost of covering a stock is US$55k, similar to numbers quoted by ANALEC, which suggested the cost of covering a single stock can be as high as US$60k.

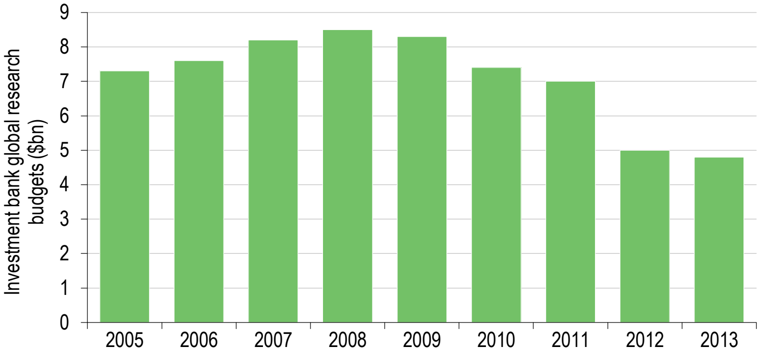
It is worth pointing out that the numbers alone do not capture the loss of expertise. At many investment banks a response to the decline in revenues has been to replace experienced but expensive senior analysts with junior and therefore cheaper analysts. The data does not capture the generational and experiential loss.

Exhibit 4: 43% decline from peak to 2012 in equity commission payments



Source: Frost Consulting

Exhibit 5: 40% decline from peak to 2012 in capital allocated to producing investment banking research



Source: Frost Consulting

In short we have seen a withdrawal of capacity from the sell side in response to declining revenues. To provide a more real illustration of the impact on any one market, we have listed below (this is by no means comprehensive) a number of names that have either exited the cash equities business in the UK, significantly scaled down their operations or merged with others (in theory reducing equity research capacity):

1. Altium – exited cash equities
2. Arbuthnot Securities – acquired by Hanson Westhouse
3. Astaire – exited the cash equities market
4. Brewin Dolphin – merged with Singers to create N+1 Singers
5. Collins Stewart Hawkpoint – acquired by Canaccord Financial Inc.
6. Dresdner Kleinwort – significant scaling down ahead of sale
7. Evolution Group – acquired by Investec
8. Execution Noble Group – acquired by Espirito Santo
9. Fairfax – went into administration
10. ICAP – exited full service cash equities
11. ING Bank – significantly scaled down equity research coverage to focus on core Benelux market

12. Jendens – went into administration
13. Lehman Brothers – probably the most famous casualty of the credit crunch
14. Lloyds Bank – exited a brief foray into the cash equities market
15. Matrix – closed down cash equities
16. MF Global – went into administration
17. Nomura – understood to have closed Nomura Code
18. Piper Jaffray – significantly scaled down its European cash equities team
19. RBS – exited cash equities business
20. Religare Capital Markets – exited from UK investment banking
21. Seymour Pierce – bought out of a pre-pack administration by Cantor Fitzgerald Europe
22. UniCredit – closed London cash equities operation

Changes ahead: All eyes on the UK

The debate as to how much of withdrawal of capacity is structural and how much is cyclical would probably be less in focus today were it not for a paper issued by the FSA in November 2012. Without this paper it may be entirely possible that the cyclical upturn in revenues of investment banking departments as the world's economies gradually recover would have created the very real possibility that nothing really changes.

While both asset managers and investment banks acknowledged that the old model was unsustainable, little progress had been made in developing a new one. Regulatory intervention may provide structure that market forces in themselves had not achieved. In the long evolution of regulation relating to research procurement, this FSA short *Conflicts of Interest* document issued in November 2012 may be the most significant catalyst for change in almost a century.

The FSA paper was issued as part of a thematic review of the UK asset management industry carried out between June 2011 and February 2012. While the majority of the press headlines were focused on banning the use of commissions to pay for corporate access, a closer read of the paper suggests there are much deeper implications.

Through a *Dear CEO* letter issued to 195 CEOs of UK asset management firms, the CEOs had to confirm by 28 February 2013 that they were compliant with the conflicts of interest regime set out by the FCA.

The paper reminded the CEOs of asset managers that:

- They act as agents for their customers.
- They should act in the interests of their customers and treat all customers fairly.
- They should have policies in place to deal with the conflicts of interests that are likely to arise as a result of acting as an agent for their customers, putting their customers' interests ahead of their own firms.

- They should spend client commissions on eligible services as set out by the UK COBS.

The paper set out that as part of its thematic review the FSA found:

"We identified that many firms had failed to establish an adequate framework for identifying and managing conflicts of interests. We also identified breaches of our detailed rules governing the use of customers' commissions and the fair allocation of trades between customers. We concluded that most of the firms visited could not demonstrate that customers avoid inappropriate costs and have fair access to all suitable investment opportunities.

We found that the attitude towards customers established by senior management best explained why some firms managed conflicts well and others badly. A few boards had defined and embedded in their business a credible, long-term commitment to serve their customers' best interests and had established robust arrangements to identify and manage existing and new conflicts of interest. But in most cases senior management failed to show us they understood and communicated this sense of duty to customers or even that they had reviewed or updated their arrangements for conflicts management since 2007."

Best practice procurement of research

The FSA paper set out best practice and examples of poor practice when it came to allocating significant spend on procuring research services.

In terms of best practice it highlighted:

- One firm had carefully considered which services represented valuable inputs to its investment process and challenged brokers about why it should pay for other services.
- Another firm set a maximum spend on research services and, once these limits were reached, switched commission rates for the brokers concerned to execution-only rates for the remainder of the commission period.

In terms of weak practice it highlighted cases where:

- There was no centralised organisation of commission allocations.
- Few firms reviewed whether products and services met the evidential standards as set out by COBS 11.6.5E (as set out prior to proposals in CP13/17). In particular it highlighted the procurement on market data not meeting the criteria and how firms failed to demonstrate how paying for corporate access or privileged access to IPOs from client commissions met the standards for research or execution services.
- Firms failed to disclose to customers details of commission payments made.

COBS 11.6.5E

…an investment manager will have reasonable grounds to be satisfied that the requirements of the rule on use of dealing commission are met if the research:

a) **is capable of adding value to the investment or trading decisions by providing new insights that inform the investment manager when making such decisions about its customers' portfolios;**
b) **whatever form its output takes, represents original thought, in the critical and careful consideration and assessment of new and existing facts, and does not merely repeat or repackage what has been presented before;**
c) **has intellectual rigour and does not merely state what is commonplace or self-evident; and**
d) **involves analysis or manipulation of data to reach meaningful conclusions.**

Based on this guidance, and to demonstrate that they are in compliance with the regulatory guidance, we would expect to see UK asset managers:

1. Establish research budgets for each of their investment bank research providers. One example could be an asset manager agreeing to Tier 1 access to an investment bank's autos research for US$250k pa and Tier 2 access to the investment bank's pharma and tech research for US$100k pa.
2. Asset managers will have to devise a mechanism to determine what these absolute monetary research compensation levels should be, both on an aggregate and individual basis.
3. With finite research budgets, asset managers would have to be selective about what services and products they procure. This would be a marked departure from the current form of consuming investment bank research. Historically, large asset managers get virtually all research from all providers. This was based on the premise that once an equity execution dealing relationship was in place with an investment bank, it would make available all its research.

Eventually we believe this is likely to evolve into a situation where each asset manager determines implicit prices they are willing to pay based on the perceived quality of the analysts/research and levels of service provided.

November 2013: CP13/17

Once the potentially profound impact of the November 2012 *Conflicts of Interest* paper were digested by participants in the equity research ecosystem, almost all parties requested further clarification from the regulator. Participants were looking for clarification in terms of how serious the regulator was about following through with its thematic review and clarification of the language of some parts of the paper.

Martin Wheatley, chief executive of the FCA, left little doubt that this was an area the regulator was serious about following through on when he spoke at the FCA Asset Management Conference on 30 October 2013.

CP13/17 Consultation on the use of dealing commission rules was issued within a month of his speech by the FCA and reaffirmed and clarified many of the aspects raised in the original *Conflicts of Interest* paper of November 2012.

The latest paper adds corporate access and raw market data to the list of goods and services that cannot be paid for using dealing commissions.

It also looks to strengthen the language for what research services qualify for being paid for through dealing commissions, noting that the criteria is in COBS 11.6.5E is cumulative and changing the language such that if goods or services do not meet these cumulative tests and are charged to dealing commission, it would establish non-compliance of the rules.

Through the consultation period further clarification of the FCA's position is likely to be sought. The original thought requirement (COBS 11.6.5E) becoming part of a cumulative criteria test for instance is one many are seeking clarification on. Consider this example: a company makes a bid for another company. Within 24 hours an analyst comes out with a change in recommendation citing the bid is attractive and will create value for shareholders in the short and long run. Within 48 hours two further analysts issue 'me too' research affirming the same view. The question many are looking for clarification on is whether the second and third analysts' views actually meet the test of original thought.

Global impact: Why all eyes are on the UK

The asset management industry is global and continues to consolidate. A June 2013 study by Boston Consulting Group highlighted that 120 managers look after US$33tn of AUM, around 53% of the global total. The same study highlighted that in 2012, the top 10 US asset managers took 65% of all net asset inflows in the US, up from 54% the previous year, suggesting the big are just getting bigger.

The preference for asset managers is to reduce the complexity of their regulatory processes and dealing systems. The IMA's March 2013 communication to its members highlighted just how complex this could become by examining the implications for a US broker interacting with the UK asset manager. In the US, the SEC specifically allows for corporate access payments to be made through client commissions.

Thus a UK asset manager interacting with a US broker that had set up a roadshow would have to decide which rules apply, the FSA or SEC rules, when giving instruction to a US broker. If the UK rules apply, the US broker would not be able to aggregate the order with that of other clients if it generated research credits that were being applied to pay for corporate access as permitted by the SEC.

It is not in the scope of this paper to look at the impact on the UK as a competitive asset management destination. What we are aware of is that the UK is taking a lead on research commission spend and the UK asset management industry is a sizeable one; IMA members manage £4.5tn or around c 11-12% of total global AUM. As such many asset managers are focused on the changes taking place in the UK.

One can see how in a world where best execution was mandated in one market and not in another, similar issues would have been observed. As with best execution, there is potential for the changes in the UK to be eventually adopted globally.

We believe that while the initial regulatory impetus comes from the UK, ultimately, the effect is likely to be global. The UK regulator is one of Europe's significant voices. The basis of the changes proposed in CP13/17 is likely to be their position ahead of the MIFID II negotiations; MIFID II is expected to become European law by 2016.

As in the instance of CSAs, once the London subsidiaries of large global managers started to use the products, they wanted to deploy them globally to avoid running multiple commission allocation systems in different regions. The regulatory rationale in the case of fixed commission budgets is even stronger: it will be very difficult for asset managers to justify why in some regions the client's research spending is capped, while in other regions it is not.

What the FCA changes mean for research

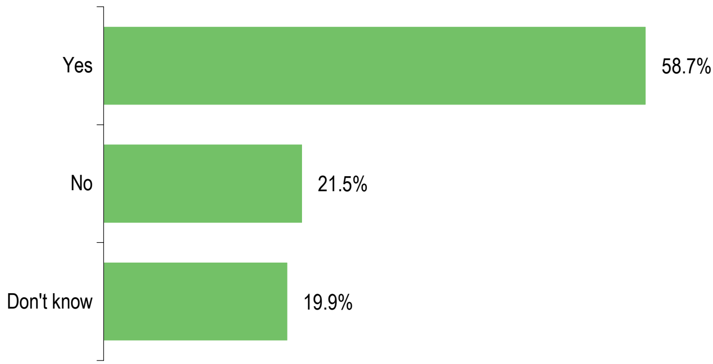
The *Conflicts of Interest* document suggested best practice was for asset managers to switch to execution-only commissions with investment banks once their specified research payment thresholds had been reached. If enforced, or if voluntarily embraced by asset managers whose CEOs have guaranteed the firm's compliance with FCA directives, this change has significant implications. Key developments we would expect to see include:

1. A continuation of the trend of a separation of revenues generated from the trading of securities and the payments for research services.
2. An opening of the content universe available to asset managers. Historically the bundled payment for execution and research services restricted the universe of suppliers available to asset managers for research inputs to those produced by the investment banks. With the links being broken between commissions and research spend, the competitive research landscape opens up significantly.
3. A move in research produced from investment banks from an unpriced to a priced environment. A recent CFA survey found that 58.7% of those surveyed felt that the sell-side should move to a priced environment for the provision of research (see Exhibit 6).
4. A continued shrinking of the overall payments made for research services to investment banks. 59.9% of respondents in the CFA society survey expected commission spend to go down if sell-side houses priced research (see Exhibit 7).
5. A reallocation of spend to research providers. Price discovery tends to be a very good thing for high-quality producers of research, but is

extremely commoditising for the average producers of research. 59.8% of those surveyed by the CFA felt that the current research model does not best serve the investors, while 70.1% of those surveyed by the CFA felt that independent research would gain market share (see Exhibit 8 and Exhibit 9).

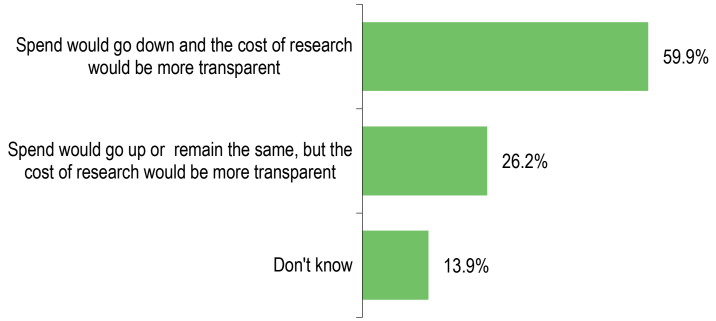
6. A continued consolidation on both the buy-side and sell-side as the buy-side moves to produce more of its research inputs in-house in response to pressures to move research spend from off balance sheet to on balance sheet, effectively paying out of their own P&Ls rather than through client commissions. 73.2% of those surveyed by the CFA felt that sell-side analyst numbers would fall in the next few years.

Exhibit 6: CFA survey 2013: Should sell-side firms operate a schedule of prices for different elements or levels of research provision?



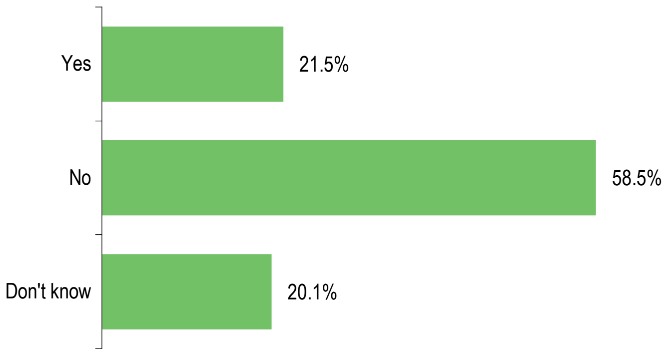
Source: CFA Society United Kingdom, September 2013

Exhibit 7: CFA survey 2013: Would research commission spend go down if sell-side houses priced research or would it be more transparent?



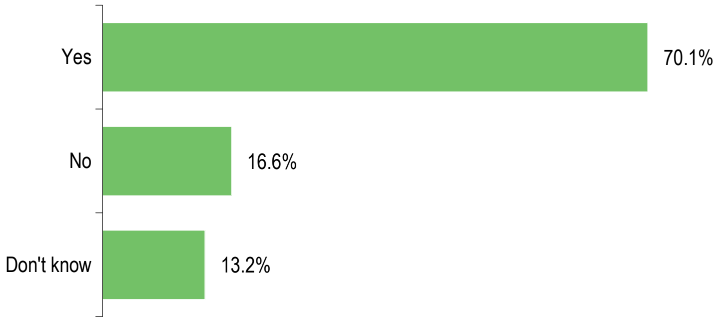
Source: CFA Society United Kingdom, September 2013

Exhibit 8: Does the current research model best serve the investor?



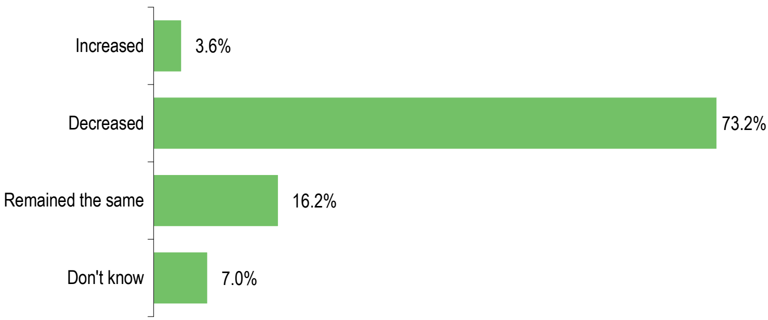
Source: CFA Society United Kingdom, September 2013

Exhibit 9: Do you think that independent research providers and other organisations will take share over time from traditional sell-side research firms (within investment banks) in terms of research payments, via commission unbundling or otherwise?



Source: CFA Society United Kingdom, September 2013

Exhibit 10: Within the next few years, what do you think will have happened to sell-side research analyst numbers?



Source: CFA Society United Kingdom, September 2013

Opportunity for research innovation (at last)

Equity commissions, the small percentage charge added to each equity trade to pay for execution and other services, are the economic currency of the global institutional equity market. Although the commission percentage is very small, the aggregate global commission number is very large.

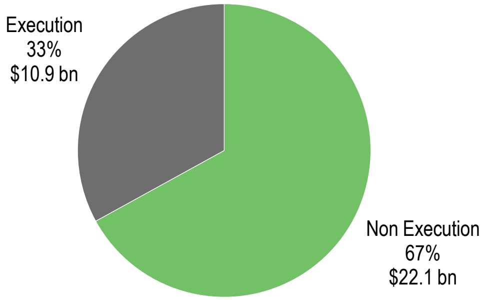
Most commissions have two parts:

- the execution charge, to pay for the trading, clearing and settlement of the equity transaction, and
- a non-execution component to pay for other services (primarily research).

Combined these totalled an estimated US$33bn in 2011. The respective splits are shown in Exhibit 11. Despite it being the smaller component of the pie, the execution side has seen significant innovation and an effective capex war over the last decade with the introduction and development of best execution, direct market access (DMA), algorithmic trading, trade cost analysis (TCA), multilateral trading facilities (MTFs) and dark pools.

While a little tongue in cheek, commentators on the research component of the pie would highlight the invention of the printing press, the move to word processing and the eventual distribution of research via email and the web as the most significant changes to the research industry.

Exhibit 11: Institutional secondary equity commissions



Source: Frost Consulting

Acknowledging the uncertainty and indeed the potential for no change, set out below are a number of the changes we envisage taking place within both the buy side and the sell side.

Change 1: A network of new research inputs

A key issue for asset managers is how to change (in some cases) decades-old research procurement processes to take advantage of the new research spending flexibility. Without doubt this will require cultural and operational changes at asset managers, some of which is already underway.

The generation-old virtual monopoly of investment banks over asset management research spending has stickiness. Most research procurement methodologies of asset managers are geared almost exclusively to purchasing research products/services from investment banks. Altering these models to incorporate a wider variety of 'priced' research alternatives now available via commission may not be a trivial exercise for many.

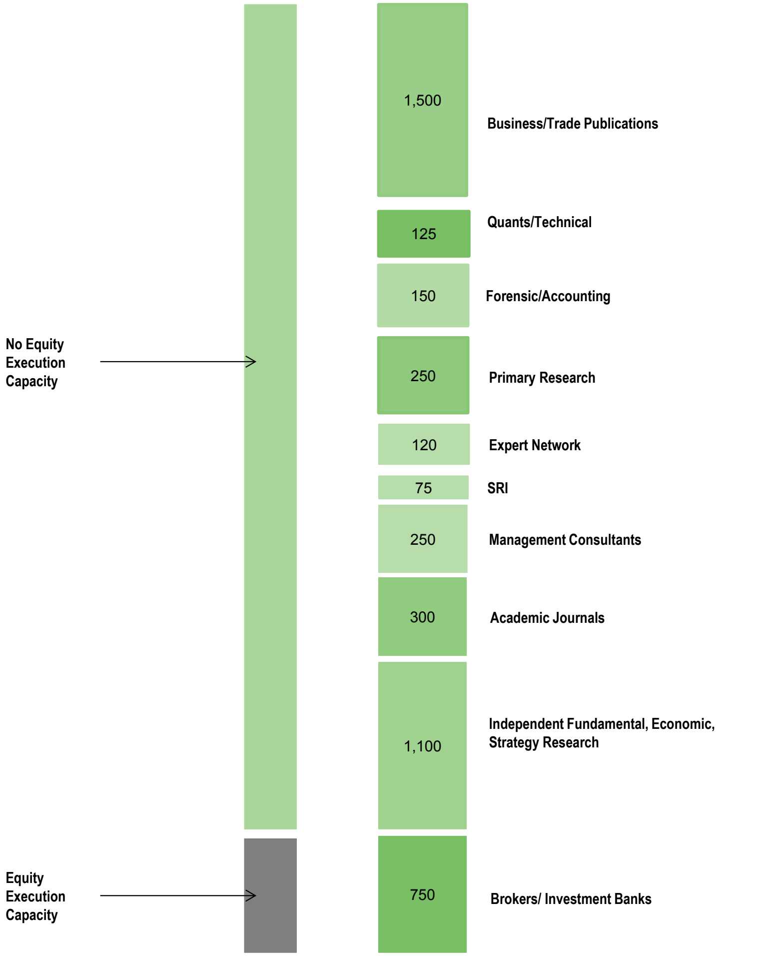
However, there are many asset managers that have embarked on this process. At a recent panel one asset manager explained how he paid an expert on franchises for inputs to his investment decisions on Nestlé.

The potential expansion of the size of the available research universe for asset managers is a challenge in itself. The grey vertical column in Exhibit 12 represents the c 750 investment banks that distribute unpriced research in return for (hopefully) execution commission. The unbundled universe would include the grey and green vertical lines and is much wider – most of these producers have no equity execution capacity as they are not banks. By definition they must price their research products to survive.

A key issue for both asset managers and their clients is the degree to which the asset manager addresses the wider content universe. Some investors believe that the bulk of the alpha opportunities will not emanate from the investment banking research universe for three key reasons:

1. Investment banking research budgets are in decline and there is a strategic risk of building supplier reliance on an industry that looks to be contracting.
2. Because investment banking research products are simultaneously released to all asset management clients, the products are unlikely to be a source of sustainable comparative advantage for any one asset manager.
3. Research products from the non-investment universe may be individually commissioned by asset managers and the results are not subject to any requirement for re-distribution. Some of their value will derive from their proprietary nature.

Exhibit 12: Future alpha generation, leveraging the wider research universe



Source: Frost Consulting

'Differentiated alpha' is more likely to spring from research sources that are not used by virtually all of an asset manager's competitors.

Asset managers that have made the effort to identify and procure alpha-generating content from the unbundled universe will frequently guard the identity of those sources in an attempt to sustain this competitive advantage.

Over time we expect an asset manager's approach to the wider content universe will become an intrinsic part of its investment strategy, from both an operational and client marketing perspective.

Change 2: Unlocking the pdf

With asset managers facing an expanding research universe, the distribution mechanisms for research are likely to change. In simple terms the distribution of research can be described as push and pull:

1. Push: In a legacy environment where investment bank research has no specific price and its delivery and consumption is not bound by any contract, investment banks have distributed vast quantities of research to asset managers for no charge, in the hope of receiving an unspecified level of commission in return, whether the asset manager wanted the research or not. Asset managers frequently erected effective content firewalls to avoid being unnecessarily distracted by this deluge of content. Portfolio managers and analysts at large asset managers frequently received thousands of emails and hundreds of voicemails per week from the sales and research representatives of banks enjoining them to take some action over equities that may or may not be relevant to the manager at the time.
2. Pull: Most asset managers prefer pulling research as and when they need it. However, given the volume of sell-side research being sent to them, often finding a key piece of information and identifying the author becomes a challenge in itself.

Banks and other research organisations are recognising that before they can become contenders for payment for research, they have to make it easier for asset managers to access the information they want.

A possible vision of the future can be gleaned through Liberum Capital, a London-based firm that recently launched an online portal called Optic. Optic allows fund managers to navigate through Liberum's content online. Short hundred-word summaries on stocks with links to deeper content are available to fund managers. Interested in the ‘US budgetary uncertainty’ hampering a company’s progress? Click on the link and immediately read more about the vagaries of America’s budget.

Simon Stilwell, the CEO of Liberum, went on record in a press interview stating that “Fund managers don’t mind paying for research…but they only want to pay for something that is of value to them.” He noted of the traditional email and pdf distribution mechanisms that “Readership rates are appalling. Something like 3 per cent of the distributed audience were reading it. Either they didn’t value it, it was difficult to use or they were so swamped they couldn’t get through it.”

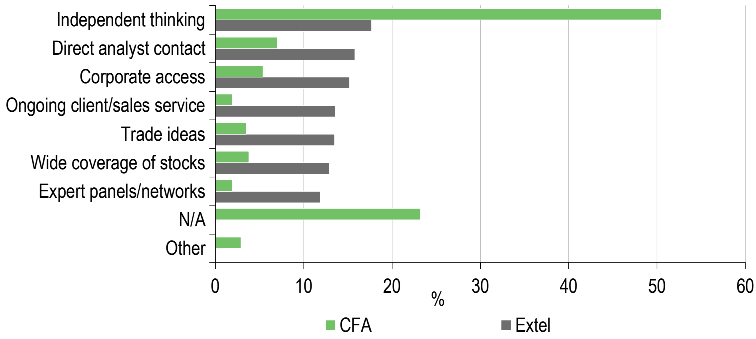
Another bank that has moved in this direction is Morgan Stanley, which in the latter half of 2013 launched its research in a multimedia digital format.

In a world where the default mechanism of finding information is Google, the onus on the research providers will be to create searchable XML documents and sites, moving away from pdfs.

Change 3: Changing research content at banks

In an unpriced research environment, banks do not have good feedback mechanisms as to what asset managers value and what they do not. Asset managers have a wide range of needs. However, as they start to value research inputs and start to allocate a price to them, the profit-maximising firm would look to optimise value to cost. Looking at recent surveys from Extel and the CFA Society UK, asset managers ranked independent thinking as their top priority, followed by direct analyst contact and corporate access.

Exhibit 13: What asset managers value



Source: 2013 Extel and CFA UK Society surveys

Outside of these research inputs, common factors often cited for strategic relationships with banks include access to their:

- IPO pipeline; and
- liquidity.

Managers of cash equities businesses understand the value a good analyst can bring. They create value for their institutional clients through deep industry insight. They attract IPOs (with appropriate chaperoning) and allow banks to provide liquidity to their clients, for example, allowing a bank to price block trades more effectively. And ultimately they probably provide the best corporate access. However, they recognise that such analysts are few in number and that the economics of their business do not sustain in-depth research of a large tail of stocks.

A blueprint for the ‘shrink to fit’ model may have been provided by a large Japanese investment bank that has historically had periodic ambitions to be a global player. The bank recently eliminated European equity coverage of four sectors to concentrate its efforts in sectors of greatest interest to its Asian client base.

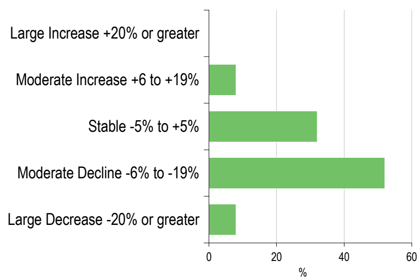
As investment banks prioritise profitable or potentially sustainable segments of their business, research patterns are likely to follow. This may encourage banks to specialise in areas of relative strength, where highly rated sector analyst teams are profitable and naturally generate opportunities on research, execution, corporate access and corporate finance businesses.

Change 4: Accessing the long tail of research

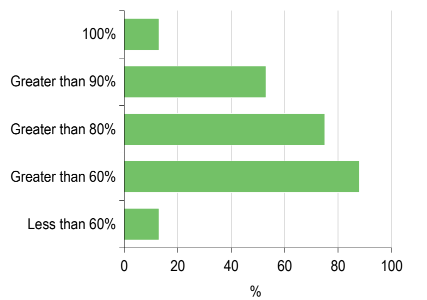
We recognise that the longstanding reliance of asset managers on investment banking research products has created institutional behaviours that may persist. The table below was the result of a survey of c 50 (primarily European) chief investment officers (CIOs) of large asset managers who attended a conference in Amsterdam in March 2012. It reveals that while most CIOs expected investment bank research budgets would be flat or down going forward, the majority of asset managers represented remained significantly dependent on investment bank research products.

Exhibit 14: Dependency on investment banking research

Investment banking research budgets: expected % change through 2015 – asset manager CIO responses



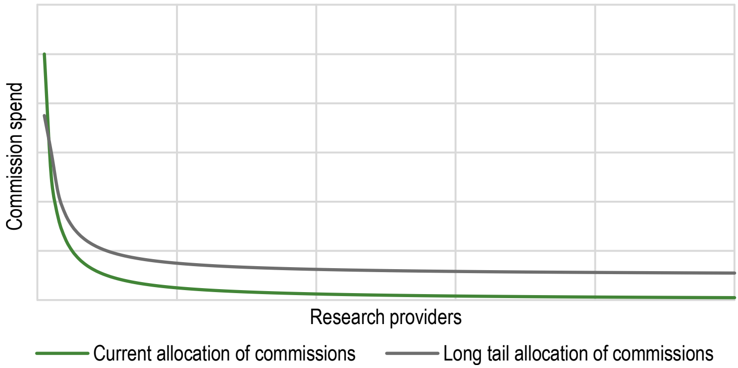
Percentage of total research from investment banks – asset manager CIO responses



Source: 2013 Extel and CFA UK Society surveys

Exhibit 15 below notionally illustrates the current allocation of commission spend among research providers. It is a reflection of the Pareto principle, namely the top 20% probably earn 80% of the commission pool. In practical terms the top-ranked house earns disproportionately more from asset managers than the fifth or 10th ranked research provider.

Exhibit 15: Commission allocation follows a power law distribution



Source: Edison Investment Research and Frost Consulting

In theoretical terms, the distribution of commissions can be described by a power law distribution, reflecting asset managers' preferences in a market where there is a variety of options for them to choose from. The three characteristics typically required for a power curve distribution can be summarised as:

- A large variety of choices being available for consumption. This is worth bearing in mind when considering Exhibit 15, where as a feature of unbundling, the available research content universe for asset managers potentially increases dramatically.
- Inequality among the market participants. Within the context of current asset manager consumption, there are analysts who are better than others and there are bank platforms that provide a louder voice than others for these analysts.
- Network effects tend to amplify the difference in quality. The equity market is driven by sentiment. If the number one ranked technology analyst and a large global bank changed their view on the direction of the sector, most asset managers typically want to know about it.

The counterintuitive thing about power laws are that as the system expands and thereby the number of options expands, rather than the curve flattening, it becomes more extreme as the gap between the number one choice and the median expands.

But all things are not equal. There are changes (both regulatory and technological) that are taking place in the research market place that suggest to us that Chris Anderson's theory on the long tail has many analogues to what we are seeing in the research environment.

Anderson's explains "the theory of the Long Tail can be boiled down to this: Our culture and economy are increasingly shifting away from a focus on a relatively small number of hits (mainstream products and markets) at the head of the demand curve, and moving toward a huge number of niches in the tail."

The physical world of selling a book has the constraints of printing, storage, distribution and the finite shelf space. To make a return, hits or high volume products were desired. In a Kindle world, these costs have virtually disappeared and there are no physical restrictions on shelf space. Amazon now makes significant money from a small number of niche titles across a broad spectrum.

With this in mind, before considering how the market may solve the issue of what asset managers consume and pay for, we make the following four observations or assumptions:

1. Asset manager behaviour, while likely to change in terms of research consumption as a result of regulatory scrutiny, is unlikely to change dramatically.
2. Asset managers have a diverse set of needs. Survey data shows how some value corporate access, while others do not. Some value ratings, others do not.
3. In an unbundled world, the choice available to asset managers for research inputs has dramatically increased compared to the bundled world.

4. The distribution costs of research have changed in a digital world. No longer are asset managers beholden to large sales teams filtering and alerting them to daily content being produced from their respective banks. In an unbundled, digital world where research content is made searchable, they can pull and pay for the inputs they want from a long tail.

The biggest winners in this space are likely to be those aggregators that can marry up supply and demand in the same way Amazon, iTunes and Netflix have in books, music and films.

One firm that has done just that is Gerson Lehrman Group, which filled the research gap by providing timely and proprietary insights from a long tail of expertise that was difficult for broking firms to provide.

Research providers in the long tail will need to think about how to optimise their business models for this world. Those that are to succeed are likely to have the following long-tail strategies:

1. **Make everything available.** The broader the offering, the more likely you are to find a buyer in a world where people are seeking niche inputs. In particular, be aware that the more global the offering, the better, as asset manager flows are shifting towards global funds. The power of the archive also cannot be understated here, particularly when considering how Google search engine optimisation works.
2. **Price it to overcome the psychological 'not worth it moment'.** For example, if an asset manager wants to access a two-year-old detailed analysis of the Dutch mortgage market, but finds it is priced at US$100,000 or is required to fill in five forms to access it, chances are said asset manager would move on to the next problem of their day.
3. **Help asset managers find your content.** Content has to be searchable. We have already discussed unlocking the pdf. However, there are steps beyond that. Modern digital content distributors understand their audience and can push personalised content based

on previous preference compatible with the device (PC, mobile or tablet) that the content is being consumed on.

4. **Brand and reputation matter.** The asset management industry is heavily regulated. Asset managers will want to ensure that the content being produced has credibility, the analysis is reliable, and the firm they are dealing with has systems and processes that ensure they are producing content that fits within a compliance regime. The expert network industry is finding out to its cost the issues of supplying confidential inside information to the asset management community.
5. **Be aware of network effects**. Anderson gave the example of how John Krakauer's bestseller *Into Thin Air* led to the revival *of Touching the Void*, a book written 10 years earlier by Joe Simpson. The prize on offer to research providers through the long tail is discovery. If a leading global bank changes its tune on oil stocks because of a Middle East risk view, while you happen to be smart enough to promote your relevant content or expert network at the same time, and your work is impressive enough to make a difference, you can climb through the rankings. The asset manager may well come back for more.

Change 5: Exchanges facilitating research

The long tail research model suggests that the commissions will continue to be concentrated among the large, global investment banks that can give asset managers capital markets insights, access to the best analysts, liquidity, IPO pipelines and corporate access. The smaller sell-side houses are faced with increased competition for commission dollars from a broader spectrum of research providers.

With the larger banks recognising that provision of detailed research on a large tail of securities is no longer commercially viable, and more and more sell-side houses exiting the cash equities business, few market participants would suggest we are going to see a reversal of the trend of diminishing sell-side coverage of stocks.

Stock exchanges around the world have started to recognise that this paucity of coverage on stocks listed on their exchanges is not in their best interest. Exchanges derive listing, data, and transaction fees based on the listing and trading of these equity issues and are now starting to allocate budget to respond to the demise of stock coverage from the investment banking community.

Stock exchanges also recognise that volume is generated not just by the institutional investment community, but also by the private wealth and retail community, which lack access to reliable data and high-quality research.

This is a process that is just starting, but we are seeing increasingly larger budgets by exchanges being allocated to the provision of research as they compete with each other to be an attractive listing venue. Set out below are a number of the exchange schemes in operation:

- **ASX:** The ASX has started a trial equity research scheme, initially allocating A$1m, which has now increased to A$2m. In total this is expected to increase to A$10m. The scheme provides fact sheets for companies below A$50m in market capitalisation, retail research reports for companies in the A$50m to A$200m market capitalisation range and full institutional research for companies with market capitalisation greater than A$200m.
- **Alternext**: NYSE's Euronext's junior market Alternext has contracted Edison Investment Research to produce a semi-annual profile book in both English and French on 150 companies listed on Alternext.
- **Deutsche Börse**: for the last decade the Deutsche Börse has hosted the Deutsches Eigenkapitalforum, a three-day conference for small- and mid-cap stocks attracting over 180 companies, which present to investors and sell-side analysts.
- **LSE**: The London Stock Exchange initially launched PSQ Analytics to provide listed companies with an independent research service. It has since started to promote the wider issuer paid-for research service available from a variety of providers to issuers coming to their market.

- **NYSE Euronext**: Partnering with Virtua Research, a technology firm that provides modelling tools, the exchange makes available interactive financial models on NYSE and NYSE-Amex listed companies for all investors.
- **NZX:** The New Zealand stock exchange has trialled a co-funded research programme where it pays part of the fees and the issuer pays part of the fees to an independent research provider to provide coverage, with the issuer paying the rest. In a response to feedback and to treat all investors fairly, the NZX is also looking at providing independent research on a series of upcoming state privatisations.
- **Nasdaq OMX:** Nasdaq OMX offers basic profile reports through Morningstar on 3,600 Nasdaq- and Nordic-listed companies. From January 2010, qualifying companies could also contract with Nasdaq OMX for the provision of a more detailed Morningstar Institutional Equity report.
- **SGX:** Through the SGX Research Insights (SERI) programme the Singapore Stock Exchange funds the production of detailed research on a number of companies via Standard & Poor's and also funds the production of sector research using DnB Nor Markets.
- **Bursa Malaysia:** Bursa Malaysia in partnership with the Capital Markets Development Fund has a co-funded research scheme for companies listed in Malaysia. Regulated research providers are chosen by the exchange to provide research for a two-year period to companies that elect to pay a RM15,000 fee, matched by the Capital Markets Development Fund.
- **BSE and NSE:** The respective Indian stock exchanges both have schemes funded through their investor protection funds to provide research. The NSE's research is provided by CRISIL, a subsidiary of Standard & Poor's.
- **TASE:** The Tel Aviv Stock Exchange is looking at starting a scheme where issuers can start paying locally registered firms to provide research. The trial is expected to focus on the biotech sector and research would be required to be produced in Hebrew with English translation being optional.

Change 6: Issuer-sponsored research growing

As sell-side coverage diminishes, there has been growth in the number of firms or issuers commissioning a research provider to produce equity research. While many sell-side firms were retrenching between 2007 and 2012 as a result of the financial crisis, Edison Investment Research, one of the largest issuer sponsored research houses, saw its coverage grow at a 22% CAGR.

The primary criticism of this model has been one that has been voiced for over a decade: the conflict of interest. The concern was that paid-for analysts would be overly optimistic to encourage clients to renew or continue with their coverage. Beyond the funding conflict, the question also being asked was whether paid-for analysts have the ability or experience to bring forward any new insight or experience to the market.

The proponents of the model cite that the conflict is no greater than an issuer paying a bond ratings agency to rate its paper or an auditor to sign off on its account. Both ratings agencies and auditors have their own reputations to think of and being credible matters. The impact of Enron on Anderson is perhaps the best example of what can go wrong. Furthermore as long as the relationship was made transparent, it was far less opaque than the traditional sell-side model where there may be a hidden and a larger monetary incentive to facilitate a fund raise, complete an M&A deal or facilitate a block trade.

In his paper *Research for sale: Determinants and consequences of paid-for analyst research* in the Journal of Finance Economics, April 2011, Assistant Professor Mark Kirk of the University of Florida examined whether an issuer procuring research services had any benefit. His data set examined more than 500 firms in the US who paid for analyst coverage between 1999 and 2006. His findings can be summarised as:

- **Paid-for research** does provide information content for investors, evidenced by two days of abnormal returns after research reports were issued.
- **After initiation** companies experience an increase in institutional ownership, additional analyst coverage and improved liquidity.

- **These results were much stronger for credible issuer sponsored research firms.** Firms with stronger policies on in dealing with conflicts of interest were found to have a greater impact on the stock.

What is being shown is that as traditional sell-side research retrenches due to the regulatory and structural changes being imposed in the market, the issuer-sponsored research model is starting to fill the void.

What is also apparent is that compared to the traditional sell side there appear to be competitive structural advantages for the issuer paid-for research houses:

- **Independent:** As the issuer paid-for research industry has matured, once-sceptical asset managers are starting to understand the business and appreciate the independence from trading flow and corporate finance work. Edison is being paid through CSAs by fund managers; as one put it: “Feels like you push what you think are good ideas as opposed to commission ideas”.
- **Highly visible, contracted and recurring revenue.** The big difference between a sell-side research desk and the issuer-sponsored research desk is that at the start of a financial year, one has no commitments in terms of commission spend, the other has annual contracted revenues with a history of repeatability.
- **No single customer dependency.** As issuer-sponsored research houses have grown their coverage, they are less and less dependent on any single customer. Not only does this make them less susceptible to economic shocks, they also can be firm in protecting their credibility and independence.
- **Clear focus and a transparent revenue model attracting talent.** Issuer-sponsored research houses have started to grow large analytical teams. One of the principal attractions for analysts is that revenue attribution is very transparent. Within the sell-side a single commission dollar can be fought over by analysts in different sectors, a salesperson, a sales trader and a trader. Within an issuer paid-for research model, if 10 issuers are paying an analyst to cover

their stock, the revenue is easily attributable. Analysts have also cited that there are no conflicting demands on their time between investment banking and cash equities.

- **Lower cost base.** Issuer-sponsored houses do not incur the significant overhead costs that come with building M&A and trading departments. Earlier we noted that the cost of producing research from the sell-side can be as high as US$60k per stock. Currently a house such as Edison charges US$45k for annual coverage.

We cannot help draw a parallel from the bond market, where there are three dominant information providers on bond ratings: S&P, Moody's and Fitch. Their information, paid for by issuers, is relied on as a base case by investment banks and asset managers. These market participants are free to take a different view from the ratings agencies (and profit from it if they are right). However, a lot of the groundwork in providing that information has already been done by the ratings agencies.

As the cash equities business becomes increasingly commoditised, and asset managers remain reluctant to take on the cost of research onto their own P&Ls, there is a possible market solution in the provision of information from a number of issuer sponsored houses. Instead of regulators facilitating this push, increasingly it seems that the world's stock exchanges are providing the impetus for this.

As with the bond world, these houses will sit alongside the inputs from the teams at global investment banks and from niche research providers (the long tail). If the industry has the appetite for change, far from losing research inputs, the asset manager faces a world with a greater degree of choice, which is provided at a more transparent and lower cost. Better for the asset manager, better for the consumer. The alternative, of course, is that we do nothing and nothing changes.

The importance of equity research

While the issues of which alternative is better is likely to be debated, it is worth remembering the benefits that research brings to capital markets and why it is important an enduring solution is found. Equity research does play a vital role in capital markets through influencing and enhancing:

1. Price formation and evaluation of the cost of capital.
2. New issuance and capital formation.
3. Public/political awareness of the capital market function globally.

Price formation

Equity research allows investors of all types to make more informed investment choices by increasing their understanding of the absolute and relative attractiveness of investment alternatives, based on asset classes, geographies, sectors, industries and individual companies.

While research produced by a wide variety of manufacturers may be useful in investment decision making, investment research produced by investment banks and other investment-oriented research firms is particularly relevant to institutional asset managers. This is because it fuses industry analysis with company analysis, and ultimately the analysis of the securities of that company with a view to an investment conclusion. Industry journals, for example, may inform on industry fundamentals but are not designed to analyse the investment merits of particular companies operating in that industry on either an absolute or relative basis.

The table below is a schematic of the research universe used by many institutional investors. By combining the analysis of research providers at multiple levels and from multiple angles, a more nuanced understanding of the risk/reward relationship of a given security may be derived.

Exhibit 16: Use of research by asset managers

TOP DOWN

BOTTOM UP

Research Producers	Category	Type of Analysis	Level of Analysis	Selection
Investment Banks Independent Strategists	Macro/Strategy	Economic Top-Down Quantitative Risk/Resturn by Asset Class	Asset Class	Equities
Investment Banks Independent Analysts Industry Consultants Sponsored Research	Macro/Strategy	Region/Country Risk/Reward - Political - Economic - Other	Geography	United States
Investment Banks Independent Analysts Industry Consultants Sponsored Research	Industry Analysis	Industry Dynamics/ Competition Cyclicality/Risk Earnings/Valuation Outlook/Valuation/Projected Return	Industry	Energy
Investment Banks Independent Analysts Industry Consultants Sponsored Research	Sector Analysis	Industry Dynamics/ Competition Cyclicality/Risk Earnings/Valuation Outlook/Valuation/Projected Return	Sector	Oil & Gas
Investment Banks Independent Analysts Industry Consultants Sponsored Research	Sub-Sector Analysis	Industry Dynamics/ Competition Cyclicality/Risk Earnings/Valuation Outlook/Valuation/Projected Return	Sub-Sector	Oil & Gas- Integrated
Investment Banks Independent Analysts Industry Consultants Sponsored Research	Company Analysis	Competitive Positioning Corporate Strategy/Management Operating/Financial Leverage Outlook/Valuation/Projected Return	Company	Exxon-Mobil

Source: Frost Consulting

These types of investment research play several vital roles in price formation:

1. **Establishing market context**, by creating consensus for industry and company earnings and valuation expectations. They consider current and future conditions in light of historical ranges of valuation and earnings volatility.
2. **Context allows relative valuation**, by comparing sectors/industries/companies to one another and to their joint and individual respective histories.
3. **Capturing operating leverage**, at the individual company level and analysing changes over time.

Ultimately, to the degree this research informs investors, it creates more efficient (and liquid) markets by disseminating (1) information and (2) expectations. In the absence of those two factors more events would be a surprise, thus increasing equity volatility, and likely lowering both equity valuation and confidence in the equity markets. Equity valuation determines the cost of equity capital, with significant implications for the operation of the economy as a whole.

New issuance and capital formation

The new issuance of equity, and the cost of it, is critically dependent on the market context described above. More efficient equity markets are likely to have higher levels of valuation and liquidity, thereby lowering the cost of equity capital and easing the task of capital formation.

This is most readily illustrated by comparing the valuation and market characteristics of open, liquid, developed markets with frontier markets (examples might include countries such as Nigeria and Iran) where valuations, liquidity and new issue activity is low. This explains why many Russian companies, despite a high level of investor interest in their industries, have chosen to list in London rather than in Moscow. Obviously the transparency of the legal system and protection for minority investors is also an important consideration.

Efficient markets are central to funding growth industries. Of all the asset classes, equities are by far the best suited to funding new (and sometimes) speculative ventures. Fixed income, given its necessity for regular and recurring payouts, is very unsuited to the needs of capital consumptive growth companies, whose prospects may be open-ended, but whose immediate cash flow does not lend itself to bond payments, particularly when the alternative is to reinvest in their rapidly growing businesses.

This tendency remains even after (historic) growth companies are effectively self-financing, which explains why companies such as Microsoft, Google and Apple, despite ample (apparently unneeded) cash on their balance sheets, pay de minimis dividends.

Equity markets, in which there is a historic context for growth stocks and valuation techniques to balance short-term losses with long-term company valuation, can lower the cost of capital for growth companies.

Research plays a vital role for growth companies, particularly in new industries whose characteristics and future potential may not be well understood by all investors. For investors to take the risk of investing in loss-making growth companies, research provides critical perspectives on the ultimate reward (market size/profitability) that may balance the short-term risk.

Even in developed markets, long-term attitudes to the 'price of growth' can have a significant impact on the cost of capital. Historically, German companies (even publically quoted ones) have been heavily reliant on bank rather than equity financing. In the French CAC 40 Index only three companies are less than 50 years old, with the average age 117 years and the eldest 355. By contrast, three of the largest 10 US (and global) companies are considerably younger: Apple and Microsoft are less than 40 years old, and Google was founded in 1998.

Public awareness of capital markets' function

Efficient, transparent and regulated equity markets increase wealth by lowering the cost of capital and funding growth in both corporate profitability and the economy as a whole, and ultimately, employment. The role of research in this process cannot be understated.

The transformation of the world economy since 1979 has been staggering. At that time major components of today's global economy (China, Brazil and Russia) were essentially outside the world economic system. Capital markets have been a key mechanism by which these economies have been integrated into the global system. Policymakers in these countries ultimately recognised the central role of liberalised financial markets in fostering the growth necessary to transform their economies.

The capital required to fund this growth, at least in the early stages, had to come from abroad. Again research played a vital role. Forty years ago the bulk of equity investments were benchmarked against a series of domestic equity indices whose constituent companies were well known to local analysts and portfolio managers. The move to global and emerging market indices was a quantum leap in terms of the amount and complexity of information and investment factors that asset managers had to digest. Not even the largest asset managers can economically provide continuous internal coverage of more than 10,000 companies in over 100 countries. External research from a multitude of providers (global/regional/local) created an investment context that allowed asset managers to make investment decisions in a far more complex global investment environment.

Notes

Edison, the investment intelligence firm, is the future of investor interaction with corporates. Our team of over 100 analysts and investment professionals work with leading companies, fund managers and investment banks worldwide to support their capital markets activity. We provide services to more than 400 retained corporate and investor clients from our offices in London, New York, Frankfurt, Sydney and Wellington. Edison is authorised and regulated by the Financial Conduct Authority (www.fsa.gov.uk/register/firmBasicDetails.do?sid=181584). Edison Investment Research (NZ) Limited (Edison NZ) is the New Zealand subsidiary of Edison. Edison NZ is registered on the New Zealand Financial Service Providers Register (FSP number 247505) and is registered to provide wholesale and/or generic financial adviser services only. Edison Investment Research Inc (Edison US) is the US subsidiary of Edison and is not regulated by the Securities and Exchange Commission. Edison Investment Research Limited (Edison Aus) [46085869] is the Australian subsidiary of Edison and is not regulated by the Australian Securities and Investment Commission. Edison Germany is a branch entity of Edison Investment Research Limited [4794244]. www.edisongroup.com

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