

**Analyze Yourself: Killing Paid-for Equity Research***By Lev Janashvili**(Published in IR Alert – October 27, 2009)***Issuer-sponsored equity research undermines analyst independence and risks misleading investors.  
Why does the practice still exist?**

Not all ethical questions we face in financial markets require us to strike delicate balances, split differences or reach tough compromises. Sometimes, even amid the daunting complexity of capital markets, we find black-and-white, right-and-wrong issues that simply challenge us to act decisively.

Consider the long-running controversy around issuer-sponsored equity research, a practice in which public companies secure positive “analyst” recommendations...by paying for them. Barely regulated, the practice is especially popular on the fringes of equity markets, among micro-cap companies that have not earned the interest of a *bona fide* analyst. Instead, these companies buy coverage in the murky market of paid-for research vendors, who distribute their reports under the guise of real research. Some of these firms even conceal, or inadequately disclose, the monetary inspiration for their research findings.

This practice raises obvious concerns about conflicts of interest and the possibility of misleading investors. However, financial industry groups have generally treated the practice with mild neglect. The National Investor Relations Institute (NIRI) and the CFA Institute issued a joint statement in 2004. But instead of condemning the erosion of analyst independence, the two organizations simply offered non-binding and mildly worded guidelines.

The guidelines suggest, for example, that the analyst should only accept cash compensation and disclose the nature and amount of the compensation. The document also asks the analyst to “refrain [*sic*] from trading in the shares of the subject company in advance of the release of a report or update” and to “refrain from trading in a manner contrary to the firm’s most recent published recommendations or ratings, except in circumstances of unanticipated extreme financial hardship.”

Long ignored by most vendors of paid-for research, these finely balanced conciliatory guidelines actually signal a green light for these analysts and their clients. Having escaped regulatory scrutiny and censure, they continue to generate reams of paid-for opinion presented as independent research. In NIRI’s surveys dating back to 2002, 3% to 10% of the member companies have reported that they have paid for equity research, but this data likely understates the magnitude of the problem, since many of the sponsors of this research are not NIRI members.

Whatever its dimensions now, the problem will probably worsen as traditional brokerage research continues to deteriorate. Ever since the dot-com crash and the crackdown on large brokerages by Attorney General Spitzer, the emasculation of sell-side research has armed paid-for research vendors with a superficially compelling selling point: since it’s getting harder to secure real analyst coverage –

since the quality of coverage has suffered -- why not just pay to get exactly the kind of research you want? Apparently, hundreds of companies find this argument convincing. Many companies also seem to agree with the argument that they always pay for equity research, and it's only the form of payment that varies; in other words, in traditional research too, companies "pay" the brokerage firm by using its underwriting and M&A advisory services.

Nonsense. Wall Street firms have violated many standards of research over the past decade, but they haven't tried to repeal the standards. In fact, brokerage firms have long maintained an extensive system of checks and balances and "Chinese Walls" designed to shield analysts from undue influence. These safeguards haven't worked perfectly, but they have worked well enough to keep traditional brokerage research at a much higher level of credibility and dignity compared to analysts who place their opinions on sale.

The essential elements of paid-for research speak for themselves, and they lead to inescapable conclusions that apply to the vendors of the research, the companies that pay for it and the industry organizations that should speak out against it.

**Public Companies** -- Paying for the opinion of an "analyst" is comparable to paying a doctor to deliver and advertise an optimistic prognosis. What's the point? Any company worthy of investors' trust can frame and communicate its own investment thesis, without pretending that it bears the imprimatur of an independent analyst.

In the dozens of institutional investor surveys I've conducted in my career, investors have spoken clearly about what attracts them to companies, and what convinces them to buy and hold stock. Most investors rely primarily on their in-house research to generate and screen investment ideas. They also continue to accept input from brokerage research they consider credible and helpful. Similarly, they acknowledge the influence of business media on their investment decisions. Perhaps most importantly, they value the unvarnished perspective of senior management teams.

By contrast, I have found no indication that any serious investor takes paid-for research seriously. To be sure, independent endorsements matter now as much as they ever did. But fictitious endorsements can only harm corporate reputations.

Of all the arguments they've advanced to justify their existence, the claim that paid-research vendors produce real analysis that actually helps companies represents the clearest insult to our intelligence. Real research means that the analyst could render a positive or a negative judgment, depending on merits. But what company would actually pay for a "sell" recommendation? And what investor would take seriously the recommendations of an analyst who never met a stock he didn't like?

**Industry Organizations** -- NIRA and the CFA Institute are both respectable and generally effective organizations, but they have erred on the issue of paid-for research. Instead of trying futilely to reform this practice, they and other voices of industry need to muster the will to help end it. This is not the time for soft-handed appeasement, and NIRA and CFA picked the wrong time in history to soften their resolve to the consistency of a milk-dipped cookie. These organizations can help re-shape the behavior of the parties complicit in the continuing abuses. The industry needs to think and speak more boldly and act more decisively. NIRA and CFA need to revise their 2004 guidelines, which represented a lapse of leadership and fortitude, the equivalent of instructing a criminal how to commit a crime "nicely".

**Research Firms** -- The history of financially-inspired stock promotion reveals the absence of any significant redeeming qualities in this practice. The vendors of paid-for research simply need to cease and desist and seek more ethical sources of revenue.

#### Conclusion

We shouldn't have needed the reminder, but recent events showed us again that misleading investment advice not only leads to financial losses, but it also ruins lives. Industry organizations should not equivocate or split hairs in their opposition to issuer-sponsored equity research. Their firm position on this issue can compel analysts and companies to do the right thing as well.