Understanding equity research ethics

The very real potential for conflicts of interest in traditional equities research is clear to anyone who has worked in the securities industry, says **PETER LEODARITSIS**.

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The extent to which investment banking transactions, such as capital raisings, are influenced by analysts' recommendations should be of great professional concern to us all, as should the common use of analysts' reports and recommendations as marketing tools to sell 'house' stocks and increase stock churn.

While these practices have long compromised our ethical standards, it's fair to say that regulators have largely ignored them. At the same time, such practices have been openly encouraged by industry through the awarding of bonuses to analysts whose work helped to secure lucrative corporate finance deals for investment banks or to generate brokerage commissions for stockbrokers.

It was only a matter of time before the conflicts, and in some cases, corruption of the profession, were exposed.

Even moves by the securities industry itself, such as the SIA/SDIA "Best Practice Guidelines for Research Integrity", are only ideals to which the 'evangelical' subscribe. Like any industry code of practice, they cannot be a binding force on those who choose to ignore ethical standards.

These standards are further compromised because of the difficulty in achieving an agreed position among the securities industry participants—many of whom are brokers or investment bankers and don't want to threaten their existing business relationships.

The quality of the research must be suspect due to potential involvements in IPOs, house stock positions and corporate finance arrangements with the companies being researched. There certainly seems to be an abundance of anecdotal evidence that this is a widespread problem.

Meanwhile reforms on the regulatory front—in particular CLERP 9—have simply not gone far enough in guaranteeing the independence of equities research.

Specifically, it is highly questionable whether stated undertakings to strengthen 'Chinese walls' within large stockbroking firms and investment banks will ever be sufficient to protect the integrity of the research.

Several recent high profile cases illustrate this point all too well:

• recently an analyst in the US who put a sell recommendation on Enron prior to its collapse was fired because of an investment banking relationship which existed;

• an article in the *Australian Financial Review* (31 August 2002) revealed how the career of an analyst was effectively destroyed because he correctly predicted the demise of Pacific Dunlop;

• an investment bank was quoted as saying it lost a lucrative fund raising deal because one of its analysts put a 'hold' recommendation on the company in question which objected to the "tone" of the analyst's report;

• even more appalling was the behaviour of Merrill Lynch (US) which was caught out denigrating stocks while publicly issuing 'buy' recommendations on the same stocks to achieve sales targets.

Ethical misbehaviour

These examples support the view that no real structural changes have taken place in firms where research, corporate finance and execution co-exist. Efforts to date—including full page ads taken out by Charles Schwab in the *New York Times* assuring investors that its researchers are not paid a commission—amount to little more than window dressing. The root cause of conflicts of interest is effectively being swept under the carpet—at least until investor outrage and public scrutiny subsides.

It is particularly disappointing that the US Securities and Exchange Commission under Harvey Pitt's leadership took somewhat of an 'insider's view', avoiding the big thorny issues and instead defending the market's right to set its own house in order. Harvey Pitt has since resigned amid controversy surrounding his own behaviour as SEC chairman.

This may prove to be a self-defeating strategy. The SEC now risks having its hand forced by Congress, state governments and US pension funds who could demand a Merrill Lynch-style undertaking to separate research and investment banking connections.

This commitment from Merrill Lynch followed the highly publicised $100 million settlement of an insider trading case brought by New York State Attorney General, Eliot Spitzer. Spitzer is reportedly investigating a slew of Wall Street firms.

New US legislation requiring CEOs and CFOs to personally vouch for the integrity of their company's financial statements and to strengthen disclosure requirements are a more serious attempt to reform the glaringly obvious conflicts between CEOs, their auditors and investment banks.

Soft lines and kid gloves

It's worth contrasting Pitt's soft line approach (some have accused the ASX of similar kid glove reforms) with the position taken by former SEC chief Arthur Levitt back in the late 1990s.

Levitt's scathing criticism of a US securities industry which he said had become "bloated and overconfident after a decade of boom conditions" referred specifically to the "entrenched conflicts of interest among the rich investment banks and stockbrokers that dominate corporate activity and heavily influence share prices." (*The Bulletin*, Dec 7, 1999.)

Unfortunately, Levitt's commentary—as unnervingly accurate and prophetic as it was—went unheeded by the Wall Street heavies at which it was directed, not to mention the investing public which has had to wear the consequences the SEC had all but spelt out.

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The crucial role played by some of the large accounting firms allowed shareholders, institutional investors and financiers alike, to be deeply drawn into the deception. Investment banks were far from blameless themselves, having devised the 'creative financing' packages which gave companies like Enron the freedom to plunge deeper into unrecoverable debt, leaving thousands of shareholders out of pocket.

That the situation managed to get so completely out of hand is also an indictment on the lack of fearlessness and objectivity of the analysts. They could, and should, have sounded the alarm bells.

Certainly the Australian Government's 2003 Corporate Law Economic Reform Program (CLERP) does very little to rectify the underlying weaknesses which allow inaccurate 'research information' to be misused.

The Government seems to be backing away from the legislated structural changes needed to separate research and investment banking and brokerage-linked remuneration.

Instead, the onus has been placed on industry, with a focus on self-regulation and improved disclosure of material conflicts. Obviously, these measures can do little to prevent bias in research reports designed to win business or encourage share trading in particular pet stocks.

> In Australia, the high profile financial collapse of companies such as One Tel, HIH and FAI have badly shaken investor confidence. Regulators and the investing public want retribution, but it is too early to tell if our corporate laws are up to the test, particularly in terms of penalties.

Leadership needed

Now is the time for the securities industry in Australia to show some real leadership by providing informed, rational and non-partisan input to the CLERP process for corporate law reform.

It is imperative that any industry initiative be backed by appropriately strong and enforceable sanctions against those analysts who profit from their conflicts and bring so much discredit to the industry.

While there is a strong argument for 'principles-based' guidelines rather than 'black letter law', such guidelines should not be so loose as to be ineffective. Furthermore, Financial Services Reform (FSR) regulations should reinforce the requirement for objectivity and independence of recommendations made by brokers, financial planners and private client advisers when advising individual investors.

However, merely disclosing conflicts does not eliminate bias. The generic 'disclaimers' now appearing on some research reports stating that an investment banking relationship 'may exist' with the firm being analysed are virtually meaningless. They do not clearly identify where a material conflict exists and will probably be ignored, much like government health warnings.

More empirical research on how our financial markets operate is necessary to expose industry

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inefficiencies and distortions. Learning how to read the signs of insider trading, and the way in which share allocations are handled during IPOs is essential in determining both independence and collusion.

A May 2000 Sydney University study revealed a strong link between broker recommendations, share prices and abnormal trading activity. Citing a 1999 Reuters survey, it rather ironically pointed to "research strength" as the most important criteria for institutions in deciding which brokers receive which amount of brokerage business.

Studies in the US such as Michaely and Womack (1996) have found that analysts affiliated with underwriters of IPOs issued 50% more 'buy' recommendations than did non-affiliated analysts.

Given the evidence, it seems strange that the Government opposes the separation of research and investment banking activities because it could "impede access to client companies with which the analyst firm has a relationship". This is tantamount to condoning selective briefings.

The Sydney University study also stated that brokers' recommendations had greater impact and more perceived value than other sources because they reflected both public and private information—a fact clearly in conflict with the ASX's continuous disclosure regime.

'Buy' recommendations were found to affect trading activity more than 'sell' recommendations. The study found that recommending brokers gained market share in those stocks issued with 'speculative buy', 'strong buy', 'buy' and 'hold' recommendations, but lost market share in 'sell' and 'strong sell' recommendation stocks.

Questionable research

Significantly, the study showed that "brokers are reluctant to issue pessimistic recommendations on companies with which they have a potential or ongoing relationship". An alternative explanation put forward was that 'sell' recommendations did not generate as much brokerage business as' buy' recommendations and brokers are thus likely to issue less of them.

This study illuminates the kind of questionable research which is now being implicated in high profile corporate collapses. While Merrill Lynch in the US is the outstanding example of impropriety in analyst conduct, similar bullish recommendations on dubious stocks continue to occur in Australia.

This is borne out by the Sydney University study, in which 'buy' type recommendations comprised 53% of the total, 'hold' recommendations were 31%, (N.B. 'hold' recommendations were interpreted as more of a 'buy' signal), with 'sell' recommendations accounting for a meagre 16%.

Adding the buys and holds amounts to 84% of all recommendations being favourable. The study also questioned research quality, suggesting a possible 'consensus view' of analysis where recommendations simply follow trends or published opinion rather than shaping it.

The facts both here and overseas paint an alarming picture of collusion, compromise, even criminality.

As an industry we need nothing less than objectivity underpinned by independence. With freedom from bias and the appropriate rigour in stock valuations, investment decisions can then be made on their economic merits, not because of improper influences or inducements to those selling.

Hopefully, there are still enough analysts out there willing to push for ethical reform. Nothing less can make a difference. J