

SNLFinancial

SNL

BANK & THRIFT daily

A Publication of SNL Financial

TM

Monday, July 1, 2002

Investors don't see much help coming from sell-side research reforms

by Paul Henderson

Sell-side researchers, in line with new rules and public sentiment, are making changes to their rating systems, increasing their disclosures and talking about the need for greater clarity.

Firms with a particular focus on the bank and thrift sector are no exception. Three firms — Ryan Beck & Co., Keefe Bruyette & Woods Inc. and Legg Mason Wood Walker — have announced significant changes to their rating systems. While their particulars and benchmarks may vary, all have reduced a more complex rating system to a three-tiered methodology: For Ryan Beck and KBW, the end result was “outperform,” “market perform” and “underperform.” Legg Mason narrowed its ratings to “buy,” “hold” and “sell.” Each firm cited the need for greater clarity.

But the changes are also intended to comply with new rules from the National Association of Securities Dealers, not to mention the reforms that are part of the widely reported settlement between New York Attorney General Eliot Spitzer and Merrill Lynch & Co (MER).

While the new rules and changes are really addressed to the retail investing public, the same research is used on the institutional side as well. And despite the regulatory attention being paid to Wall Street research these days and the publicity attendant to Spitzer's crusade, few institutional investors think that these changes will have any substantive impact either on the value of sell-side coverage to them, or on the oft-criticized relationship between banking and research.

“This industry, the securities industry, is very creative,” said Jon Bruss, with Fortress Partners Capital Management, a financial institutions fund. “It can find all sorts of ways to deal with self-regulation and the [Securities and Exchange Commission], and to — I hate to use this word — manipulate the opinions of investors.”

Unambiguous clarity

The fracas about alleged conflicts of interest between sell-side researcher groups and their investment banking parents is nothing

new. But the controversy reached a new level of intensity when internal Merrill e-mails revealed that analysts often had far more reservations about the equities they covered than they disclosed in their reports.

Spitzer aggressively pursued the firm, and negotiated a \$100M settlement with Merrill. As a consequence, Merrill agreed to adopt a host of reforms intended to put significant restrictions on the relationship between research and investment banking.

Just 11 days before the settlement was reached, the SEC approved National Association of Securities Dealers Rule 2711, "Research Analysts and Research Reports," designed to "improve the objectivity of research and provide investors with more useful and reliable information when making investment decisions." The SEC also approved similar amendments to NYSE Rule 472, which governs research reports and analysts.

The new rules provide for a host of restrictions on the investment banking department's relationship with research, including restricting the supervision of an analyst by an investment banker; providing for compliance officers to scrutinize internal communication between investment banking and research; prohibiting the payment of bonuses and salaries to an analyst based on investment banking services; prohibiting the promise of favorable research; placing restrictions on personal trading by an analyst; requiring a host of disclosures regarding the analyst's financial interest in the stock; and more.

The rules also require that the analyst define the meaning of each rating used, with the definition of the rating "consistent with its plain meaning," or as the NASD puts it, "a 'hold' rating should not mean or imply that investor should sell a security." NASD members must disclose the percentage of covered companies with "buy," "hold," or "sell" ratings, and provide price charts for the period that the analyst has covered the company.

"I think the overarching mandate here is to make the rating system unambiguously clear," said Tony Davis, managing director of financial institutions research at Ryan Beck. "We want the investors to understand precisely what it is we're saying."

Along with the new ratings systems, the number of "sell" reports in the bank and thrift world alone has increased dramatically, often explicitly as a result of the changes. To cite one example, Legg Mason analyst Adam Barkstrom, long dubious of the high valuation of Commerce Bancorp Inc. (CBH), briskly downgraded the stock to "sell" from "market perform" when his firm introduced rating-system changes.

Is that a wing-backed or a lounge chair in the corner?

Institutional investors and buy-side analysts, however, many of whom have long been the biggest critics of sell-side research, are skeptical that the rating system changes and the other upcoming provisions, will do much to change the value of the sell-side research or the system itself, at least in the long term. And it's a system, most say, that still needs changing.

Of the buy-side sources contacted for this article, most were extremely critical of the quality of sell-side research in the financial institutions sector. One referred to a research house that covers hundreds of banks, "all of them strong buys." At another prominent firm in the bank and thrift world, said another, the line between investment banking and research was "a joke." A source spoke of a sell-side analyst who made a "career decision" to be a "cheerleader" for certain banks.

Regardless of the validity or lack thereof of specific allegations, the sentiment behind them demonstrates a clear lack of confidence in the credibility of many research houses among institutional investors.

As for the new rating systems, fund managers say they've never been particularly concerned about a stock's rating anyway. Rather, they look for worthwhile insights that a sell-side analyst might provide.

"The process I follow is this," Bruss said. "I generally come to my own conclusion, and then if there are any sell-side reports out there, I'll take a look at them. But they will not get anywhere near equal weighting with my own opinion."

Eric Hovde, CFO of Hovde Financial Inc., also a financial institutions fund, said sell-side "investment ratings, frankly, are meaningless to me. It is the fact that they may have some piece of information, some observation on the company, that I'm not aware of, that can factor into my investment decision."

Kevin Hart, a buy-side analyst with Cadence Capital, a fund heavily involved in banks, thrifts and brokers, said, "You're talking to a group on the sell-side that in some cases follow less than 10 companies, or 10 to 20 companies. The average analyst on the buy side has a much larger universe and doesn't have the time to dedicate solely to spending time with one small group of stocks. The sell-side gains their value-added by contacts, connections to the company and a real information pipeline into those companies if you don't have them yourself."

Hart added, "The reality of those ratings systems is that a lot of the 'buys' were nothing more than banking relationships — banking 'buys.' And anybody who's been in the institutional world of investing was well aware of that."

Or, as Bruss put it, "We're talking about the same analyst, the same analyst supervisor, the same firm management, just moving the chairs around a little bit and calling this chair over in the corner a wing-backed chair rather than a lounge chair."

Research is a business decision

Achieving greater clarity, of course, is only part of the agenda for sell-side research departments. Nobody who has read the paper in the past few months could have missed the critical beating that sellside analysts have taken, and firms are anxious to clear that air of impropriety. But many feel that can't be done.

"I think [a rating changes] help in the short-term, [and] maybe has some long-term benefits, but I still think that when the equity markets come back, and things start getting robust, I think sell-side analysts always have a desire to look at things in a rosy view," Hovde said.

Investor Jeffrey Gendell, unlike many of his colleagues on the buy side, told SNL Financial he thinks the abuses between sell-side research and investment banking in the bank and thrift world are far less severe than in other sectors. However, he too agrees that new rating systems and the other attendant regulations will ultimately accomplish little of substance in any sector.

"The whole thing that's going on isn't going to change anything, and I think people are kidding themselves if they think it will," he said. "It will keep some of the excess from happening, but it's not going to change the basic [structure]."

Bruss pointed to a recent Charles Schwab ad that has been getting a lot of airplay, in which a sales manager instructs his research and sales force to push a piece of stock, despite the fact that the fundamentals of the company are unsound. The realistic tenor of the ad, which ostensibly shows how reliable Schwab's research is by comparison to that of other big retail brokerages, annoyed many

investment banks, Bruss said.

"I don't see that sort of stuff really changing," he said. "A lot of securities are sold — they're not bought."

It is, of course, that latter sentiment that is at the crux of the entire debate about sell-side research, and the so-called "Chinese Wall" between the research and investment-banking sides of firms, acknowledges Lisa Schultz, an executive vice president and head of research at Ryan Beck. She feels there is only so much you can do about it if you expect the system to function.

While Ryan Beck — a firm that several sources who were contacted for this story praised with regard to the historical quality of its research — is planning to implement all the changes covered by the NASD regulation on schedule, Schultz was frank about her expectations, and her hopes, regarding the end result.

"Look, research is a business decision," Schultz said. "The decision to cover a security is a business decision and needs to be, because the cost of research is a significant investment for any firm to make, and you've got to have an economic reason to cover companies. I wouldn't want the regulations to make it non-economic for firms to have research, because at the end of the day the individual investor would suffer from the lack of objective research out there."

In one sense, then, the skepticism on the buy-side about the efficacy of many of these changes is perhaps justified because, as Schultz points out, if the results match the rhetoric, many firms could have serious problems on their hands.

"Yeah, I do think that the regulators are trying to recognize that," Schultz said, "and they may have to make some modifications going forward, because in not compensating an analyst directly for research on investment banking clients or for deals, we're either going to have to find a different way to compensate research analysts, decide not to compensate research analysts, or come up with a different accounting methodology to do the same thing that firms have been doing in the past."

pahenderson@snl.com

SNL BANK & THRIFT DAILY Monday, July 1, 2002

321 East Main Street, P.O. Box 2124, Charlottesville, VA 22902 Phone: 434.977.1600 News fax: 434.293.0407 snl.com
© 2002, SNL Financial LC. All Rights Reserved. Proprietary and Confidential. Use limited and subject to SNL license.

SNLFinancial