OCTOBER 14, 2002

DAILY BRIEFING
Today's News
News Archive

Markets
Stocks
Funds
Sectors
Economy & Bonds
Investing Glossary

LIFESTYLE
COLUMNS
FORUMS & CHATS
NEWSLETTERS
PERSONAL FINANCE
SEARCH & BROWSE
SPECIAL REPORTS
TOOLS & SCOREBOARDS
VIDEO VIEWS

TECH Fact of the Week
What percentage of businesses were cyber attacked in 2001?
a. 5% c. 30%
b. 15% d. 50%
In-Stat MDR

Customer Service
Contact Us
Advertising
Media Kit
Special Ad Sections
Conferences
Permissions & Reprints
Marketplace

STREET WISE

By Amey Stone

A Chinese Wall -- or Several Fences?

Strictly dividing Wall Street research from investment banking may be too painful. However, smaller but still useful steps can be taken

Amey Stone is an associate editor of BusinessWeek Online

Printer-Friendly Version
E-Mail This Story

It sounds like a no-brainer: The best way to end conflicts of interest between research and investment banking would be for firms to separate the two divisions, right? If research operates independently, the theory goes, analysts could express their true views on stocks without fear of cramping the style of investment bankers, who typically earn the bulk of most firms' income.

Are the U.S. Markets Overvalued?

Do you believe the US markets are now:

Overvalued
Undervalued
Appropriately valued

submit

The problem is that this obvious solution creates a lot of problems. Wall Street research operations are so costly that firms couldn't keep as many analysts on staff or cover as many companies if their work wasn't subsidized to some extent by investment banking. Most analysts would end up either paid a lot less or be out of a job. Even then, the new research boutiques would probably still need to charge a

OCTOBER

MARKET
DJIA
Nasdaq
S&P 500
Create / Che
Launch Pop

Stock Looku
Enter name

RELATED ITEMS
Street Wise Archive
• Find More Stories Like This

TODAY'S HEADLINES
A Chinese Wall -- or Several Fences?
The Tax-Cut Tonic Tokyo Needs
Japan: Anatomy of a Crackdown
Prices Just Keep Plunging
Bankruptcy Reform Won't Fix Telecom
Merrill's Marriage of Inconvenience
AOL 8.0's Worthwhile Bells and Whistles
ImClone, Round 2: One Hit, One

lot more for their reports (see BW, 10/21/02, "Wall Street's Research Conundrum"). "At the end of the day, individual investors would probably suffer," says John Eagleton, president of Investars, a research firm that tracks analyst performance.

Plus, newly public companies would have a tough time attracting analyst coverage, which would inhibit their ability to raise capital. That could have serious ramifications for the U.S. economy. After all, Wall Street's main purpose is to provide capital, Eli Lustgarten, head of research at HC Wainwright & Co., reminded everyone at a recent conference put on by the analysts' professional group, the Association for Investment Management & Research (AIMR).

Miss
The Makings of a Vicious Debt Cycle
Now *Knockaround Guys* Has Diesel Power
Two Gems Amid Tech's Dross
Funds: September Caps a Horrid Quarter
The Land of 44 Million Cell Phones?
My Dysfunctional Extended Family
What's the Business of the Board?
E-Biz Whizzes with Staying Power
The Surplus in Storage
• More Headlines

INTE
E
Given to
turmoil, I
more inte
income c
investme

Subm

PRESSURE POINTS. Fully separating research and investment banking would actually be such a painful process for Wall Street and investors that it probably won't happen. As AIMR President Thomas Bowman is fond of pointing out, it wouldn't do anything to eliminate other conflicts of interest that analysts fall prey to -- such as pressure from the companies they cover to maintain positive outlooks and pressure from money-management clients who read their research not to downgrade the stocks they own. "These are pressures that have not been addressed," he says.

Instead of full separation of investment banking and research, investors will probably have to settle for incremental reforms, some of which are already being put in place. The bad news is that a piecemeal approach will take a lot longer to restore investor confidence and the reforms would be easy to shrug off once again when boom times return to the Street. The good news is that these remedies are likely to resolve many of the conflicts ailing research departments and will be much less bitter medicine to swallow for all involved.

W
YOU

Of the reforms already lined up, the most significant is a requirement that analysts' compensation be based solely on the quality of research and the accuracy of recommendations. The way it works now, a bonus pool is generated by investment-banking business. Analysts get a portion of it already based on performance, but they might also get a chunk for "other contributions" to the firm. That's where the analysts who helped out investment banking were rewarded.

TRACKING BIAS. New rules would require analysts to be paid solely on performance. This isn't easy to do, but new independent research firms, such as Investars and Starmine, are already springing up that track analyst performance and can be used to reward the ones that have the most accurate earnings forecasts and make clients the most money. Investars notes improved performance among analyst recommendations since

April, 2001, when the issue of conflicts of interest in research first started to emerge. AIMR has asked firms to let analysts participate in the large bonus pool but recommends they use only performance to carve up the pie. Critics say that would still give analysts ample incentive to help out with investment-banking any way they can.

Another key reform: Regulators are requiring analysts and firms to disclose conflicts of interest in research reports and even public appearances. For example, if the firm does investment-banking business with the company, or the analyst owns the stock being discussed, the analyst has to mention it as a disclaimer in the report. While that may sound simple enough, better disclosure goes a long way toward helping individual investors evaluate the information in the report and understand the biases that may be at work.

These reforms have one weakness: They don't do anything to bolster analysts' standing within the firm or fortify the Chinese Walls between research and investment banking that were always supposed to exist. Without those steps, analysts could still find themselves being asked to do "favors" for the investment-banking arm that might be hard to refuse.

ETHICS CHECK. These problems have solutions, however, most of which require CEOs at Wall Street firms to take the lead, says the AIMR's Bowman. CEOs need to keep investment bankers off the analysts' backs. Plus, they have to put in place strong research directors who'll stick up for analysts who make a tough call. "That would give them backbone," says Jeffrey Lane, president of investment advisory firm Neuberger Berman.

Most important, firms need to hire and train analysts who have integrity. "We need analysts with ethics," says Lane. "If you don't have ethics, you can always figure out a way to cheat. If you do have ethics, you're always going to be honest, regardless of the conflicts." Many analysts at the October conference felt AIMR could help by doing more to enforce its own code of ethics, stripping analysts who violated the code of their Chartered Financial Analyst (CFA) credential. Bowman says the association is now investigating about 100 cases involving analyst-objectivity issues.

Will this be enough to win back the confidence of individual investors? Not right away. Fully separating research and investment banking would do the job quicker. "Natural selection would come into play," and only the best research firms would survive, predicts Michael Painchaud, a principal at Market Profile Theorums, a research boutique that tracks insider purchases.

Still, piecemeal reforms that make analysts less conflicted should also lead to better research calls -- and they have a greater chance of actually being implemented. Such reforms -- and an end to the bear market -- will eventually bring individual investors back to stocks. Making money is still the name of the game for everyone, not just Wall Street firms.