

Opinions for Sale: Take Two*By Lev Janashvili**(Published in IR Alert – November 9, 2009)*

If we succeed in killing paid-for research, what option do we leave for a small company with a solid investment thesis but no analyst coverage? Here's one simple answer.

After my recent article on issuer-commissioned equity research, I continue to hear arguments from people who try to justify the existence of this practice by comparing it to abuses in traditional brokerage research. The apologists for company-sponsored research acknowledge the concerns, but they simply argue: "Well everybody's doing it. Even Goldman Sachs."

Granted, paid-for research firms are not the only problem we face in capital markets, and traditional brokerage firms also find it hard to produce real research at times. They too find it hard to shield analysts from undue influence. Overall, equity research supported by transaction and trading revenues remains a deeply challenged model, and it will need to change to survive. But precisely because we understand the potential for bias in all research, we need to take steps to minimize it. And the failures of brokerage firms can't serve as the de facto standard that excuses even more egregious abuses. After all, we wouldn't exonerate one criminal simply because ten others are committing milder forms of the same crime.

So what makes the lapses in brokerage research less damaging compared to the abuses among paid-for research firms?

Quality of Recommended Stocks, Risk to Investors -- Paid-for research firms promote some of the riskiest investments to the most vulnerable audience. Specifically, they peddle thinly traded, micro-cap companies with unproven investment stories to inexperienced individual investors, the only kind of investor who would take seriously the opinion of an analyst who places his opinion on sale. These investors face unfavorable odds of significant financial losses. By contrast, traditional brokerage firms typically cover more seasoned issuers, and they distribute their research to institutional investors, rather than to Tom, Dick and Harry.

Controlled Environment vs. Anarchy -- However consistently or inconsistently brokerage firms heed the voice of their conscience, they at least hear it...they at least have a conscience, a sense of standards and boundaries. In fact, brokerage firms have long maintained an extensive system of checks and balances and "Chinese Walls" designed to shield analysts from undue influence. When they violated best practices in research, they usually faced the consequences. For example, the Spitzer settlement and countless disciplinary and regulatory actions against offending analysts and firms have penalized and humbled the sell side. By contrast, paid-for research firms have no code of conduct, only whatever rules they choose to impose on themselves.

Perverse Financial Incentives -- I see no reason to doubt that “opinions-for-sale” research firms employ many analysts with the acumen and the desire to produce real research. Unfortunately, the economics of their business will predictably leave these analysts unfulfilled. No issuer would pay for less than a stellar report. Therefore, no vendor of issuer-commissioned research would stay in business very long if it dared to publish a negative opinion on a company that pays the research firm’s bills. These firms have no choice but to publish rosy prose. If you disagree, I challenge you to find even a handful public companies paying for negative ratings. By contrast, plenty of brokerage firms/analysts publish unpopular and honest opinions on the companies and industries they cover. Not all the time, but they do. They at least have the potential to think and write independently.

I don’t think paid-for research is the devil, but I do think it’s bad for public companies, bad for investors, and bad for the market overall. We need to regulate paid-for research out of existence because the practice violates the basic principles of investor protection and market integrity that the SEC was founded to protect.

If we succeed in killing paid-for research, what option do we leave for a small company with a solid investment thesis but no analyst coverage? Here’s one simple answer that would work immediately, at no additional cost, and without any regulatory involvement. Plus, it could apply to all companies, including the ones that already enjoy analyst coverage and the ones still looking for it.

The idea is simple: Public companies, large and small, can do for themselves what they hope their paid or even traditional analysts might do for them. Companies can produce their own “analyst reports”, except these documents would no longer be called analyst reports. Essentially, companies can draw on the resources and intellectual capital of their IR, PR, finance, marketing and strategic planning departments (not to mention senior management) to produce not only stand-alone reports but a steady stream of “self-coverage”.

This initiative would provide an in-depth view of all key facets of the company’s investment thesis – just like a good analyst report, which has become a nearly extinct species. Typical sections in these reports might include: general business overview, history of the company and the industry, competitive landscape, risk factors and performance catalysts, independent endorsements of the products/technologies, historical financials and guidance.

I suspect that what holds companies from producing these reports is not the difficulty of the task, not even resource limitations. It’s just that IR practitioners need to allow themselves to think more creatively about ways to engage the investment community. Nothing in NIRI’s standards of practice says “thou shalt only communicate with investors through the press release, the PPT presentation, the conference call, and the one-on-one meeting”. The market is changing, and we can no longer afford to simply follow pre-established industry practices. Rather, we need to think proactively of new ways to reach and persuade the audience. “Self Coverage” may be one such way, especially for small companies.