Can Issuer-Paid Research Overcome Conflicts?

All forms of research have conflicts, but credible issuer-paid firms can still provide a valuable service

BY BRIAN TANG, CFA

Can issuer-paid research be done right and add value for investors? An article in the January/February issue of CFA Magazine described issuer-paid research as “fraught with potential conflicts of interests” and discussed how the CFA Institute Code of Ethics and Standards of Professional Conduct apply to members conducting this kind of research. In my experience, although conflicts exist, with the right approach, issuer-paid research can overcome difficulties and serve clients and investors effectively.

Since 2003, our firm, Fundamental Research Corporation, has successfully engaged in issuer-paid research. In our opinion, all research is paid for in one way or another. All types of research, including purely subscription-based models, have conflicts that must be managed. Given that all forms of research have some conflict, issuer-paid research is arguably the most transparent and easy for investors to understand. If managed properly, the end product of issuer-paid research is no different from other forms of research. For example, in the traditional brokerage model, corporate finance and research need to be separated. In the issuer-paid model, business development and research need to be separated. It all comes down to management. Just as one would not rely on research produced by a firm where investment banking and research had close ties, one should not rely on research produced by an issuer-paid firm with poor internal controls. But if management at the issuer-paid research firm is committed to high-quality independent research, it will be reflected throughout the firm and in the firm’s research. After all, in the end, the point of research is to make money for the person who reads it, regardless of how it was funded (although research also serves other intermediate functions, such as contributing to market efficiency by increasing information flow).

Getting paid by an issuer should not necessarily result in a biased report. In many cases, one party pays another for an independent rating. The most obvious example is bond ratings. Issuers also pay fees to auditors for an independent opinion. Stretching the example, a university is paid a fee by a student to “rate” the student. If these entities care about their reputation, they will issue honest ratings.

Even though I believe in the issuer-paid model, I am not naive. Obvious conflicts are involved. The industry is still new, and some less-than-credible firms are popping up. This article is meant to share some of our firm’s best practices for managing conflicts, which ultimately has led to our success. I hope the following points will guide investors—and analysts who want to work at issuer-paid firms—about what to look for in the issuer-paid firm so they can make an informed decision about whether to rely on such research or help produce it.

1. The firm must be paid in cash up front and must not accept stock or options; the fee must be disclosed—no exceptions.

All our reports disclose that we have been paid a fee by the issuer (or, in some cases, by an investor or broker). Prior to our analysts commencing due diligence on a company, we require payment up front in the form of cash. Payment up front in cash (or post-dated checks in a minority of cases) is essential to ensure that the company cannot withhold money if it is unhappy with the conclusions of a report. Furthermore, we believe that a firm cannot maintain an analyst’s independence if it holds stock or options in an issuer it is covering. When our firm launched in 2003, we noticed a lot of firms refused to accept stock and options. During the 2008-09 downturn, many firms changed their policies, and we noticed more of them disclosing that they accepted stock and options.

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2. The issuer must sign an agreement protecting an analyst’s independence.

Aside from collecting cash up front, we require an issuer to sign an agreement before we start due diligence. This agreement specifies that once we are engaged, we will continue to cover the company for the coverage period (usually four reports) and that the issuer has no right to prevent dissemination of any reports, delay updates, or interfere with our analysts. These provisions are extremely important. We have often seen cases in which an issuer-paid firm allows issuers to order reports on a piecemeal basis. With such an arrangement, an issuer can order reports only when things are going well, thus avoiding negative reports.

Further, we own all copyrights, and the issuer has no right to edit or censor. Another important clause in our contracts stipulates that “In no event will the Analyst be liable whether in contract Court or otherwise for inciden-

tal, special, indirect, consequential, or punitive damages including, but not limited to, damages for any loss arising from a negative Report.”

3. **The firm should employ full-time analysts.**

Many issuer-paid firms outsource their research to analysts on contract. As the January/February 2011 article says, “Some members and candidates view issuer-paid research as a temporary opportunity to supplement their incomes and develop or maintain their skills and knowledge base while they look for permanent work with a traditional research provider.” When our firm first started in 2003, we outsourced some of the research, but we stopped this practice as soon as we could because there are a number of problems with it.

First, the analysts cannot be supervised, and we found that research quality and timing of updates suffered. The result is not true analyst coverage.

Second, because outsourced analysts are not full-time employees, they cannot perform traditional analyst roles, such as speaking at conferences, conducting site visits, and speaking to the media and investors. These roles help make sure that the analysts know the company they are covering inside-out and thus can write reports that give investors the best insight possible.

Third, when analysts are not full-time employees but rather contractors they do not feel a connection to the firm or the users of its research, and performance suffers. By employing full-time analysts, we can base part of their compensation on how their picks have performed. As far as I know, we are one of the only issuer-paid firms that employs full-time analysts and industry experts (for example, we have a geologist on staff).

4. **The firm should have paid subscribers.**

Because our firm also charges investors to subscribe to use the research, we are more accountable and aware of what we put out. Knowing that a paying subscriber is going to take our reports seriously is another reason not to issue poor-quality research. Having paid subscribers also shows that there is value in what we produce. As they say, free advice is probably worth just that—zero.

5. **What is the distribution of the firm’s ratings?**

Many firms are required to publish the distribution of their ratings. At our firm, about 70 percent of what we issue are “buys” and the rest are “hold,” “sell,” or “suspend.” The ultimate testament to the commitment to independence can be seen by asking an analyst (whether issuer paid or brokerage) one question: “Have you ever initiated coverage at sell?” (In our case, in July 2007, we collected US$25,000 from Hemis Corporation. In October 2007, we initiated coverage at a “sell.”)

When we started out in 2003, many people were understandably skeptical of the issuer-paid model. Since then, we have come a long way, and a number of stock exchanges around the world have endorsed issuer-paid research in some form. The London Stock Exchange has a section on its website explaining fee-based research and encouraging its issuers to hire analysts. The Canadian National Stock Exchange (CNSX) lists issuer-paid research firms, including Fundamental Research, as service providers to its issuers. Singapore Exchange uses a model in which companies can obtain coverage through a number of issuer-paid firms participating in the SGX Equity Research Insights (SERI) program.

NASDAQ formed a venture with Reuters in which companies could pay for research through an intermediary, but this venture is no longer operating. NASDAQ does have a new agreement with Morningstar to provide coverage on smaller NASDAQ listed companies.

**What Are the Benefits to Investors?**

Even though issuer-paid firms have made a lot of progress, much work remains to be done in educating people about the differences between credible and non-credible issuer-paid firms (or any type of research provider for that matter) and getting firms to operate under uniform standards. Separating credible and non-credible issuer-paid firms is clearly very important. Marcus Kirk, assistant professor at University of Florida’s Warrington College of Business Administration, studied the question of whether companies can buy credible analyst research and concluded that “results are strongest for fee-based research firms with ex ante policies that reduce potential conflicts of interest and enhance credibility.”

What are the benefits to investors of issuer-paid research done right? We believe issuer-paid firms can add value to an investor’s portfolio by focusing on neglected, undiscovered, and less-followed smaller-cap names. Internally, we have a saying that we cannot add value to our subscribers by being the 30th-plus analyst following Wal-Mart, but in many cases, we can add value by being the first analyst to follow a company.

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