ARANCA RESEARCH STUDIES

THE ROAD AHEAD

Life after the Global Research Settlement Expiry

ARANCA SURVEY REPORT ON INDEPENDENT RESEARCH PROVIDERS | DECEMBER 2009

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Contents

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Preamble and Context

In the backdrop of global financial crisis and recession, the $1.4 billion global research settlement (GRS) reached in 2003 between the regulators and banks ended on Friday, July 31, 2009. The GRS aimed to resolve conflicts of interest between the research departments and investment banking arms of these firms. In order to eliminate bias, the GRS required banks to provide separate independent research in addition to the in-house research to their clients. While the actual beneficiaries of the settlement numbered a little over 60 firms, the move may have contributed to a proliferation of independent research providers (IRPs), with the numbers nudging 2660 odd in 2009, according to estimates published in the Bloomberg Markets magazine.

The GRS expiry coming on the back of the financial turmoil has created doubts about the impact of GRS. While there are a few who think that GRS has been largely successful in creating and maintaining Chinese walls between investment arms and research departments, there are those, too, who believe that GRS has been an complete disappointment. Without GRS though, many of the IRPs face the danger of closure. Those who survive could risk significant loss of revenue, especially in the continued climate of global uncertainty. While buy-side firms could offer some solace, the question is, how many IRPs have the capabilities to service the distinct requirements and highly customized requirements of these firms.

That, the IRP landscape is set to alter, is common consensus. However,

- How will the GRS expiry alter the IRP industry landscape?
- What are the key challenges faced by the IRP industry post GRS expiry?
- Which are the potential services or segments that would help the IRP industry sustain and diversify service offerings?
- Will the Chinese Walls survive in the post GRS era?
- What is the road ahead for the IRP industry?

We asked these and a few other questions to some of the key players in the IRP industry through an extensive and in depth online survey hosted on the Aranca website. A sample of over 200 leading IRPs across the United States was chosen and invited to participate in the survey. The responses thus gathered, generated an overall confidence level of 85% and an overall margin of error of 15%, when generalized. Respondents were of the level of Research Manager, Principal Analyst, Director/ Head of Research or equivalent, CEO/CXO, Senior Vice President Sales & Marketing and Chief Compliance Officer. Nearly two-thirds of the firms focused on the US market alone. About 42% focused on covering large cap stocks, while 38.1% had mid-, small- and micro-caps as their core offerings. Approximately, half of the firms provided fundamental coverage of stocks.

While some of the responses were on expected lines, what surprised us were the opinions on emerging business models, and industry's efforts to gather new skills and remain firm in the face of adversity. In the following pages, we present a brief summary of the findings and our analysis.

We would be happy to receive your feedback.

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Has the GRS served its purpose?

While there are as many proponents as opponents of the Global Research Settlement, the fact remains that it was a watershed event: One that offered the comfort of transparency to the retail investors

The regulator-enforced $1.4 billion global research analyst settlement (GRS) in 2003 was designed largely to:

- Create an effective "fire-wall" between the investment banking and the research departments of the I-banks and other bulge bracket firms to eliminate conflict of interest, and
- Promote independent research to eliminate research provider bias in recommendations.

Initially, GRS helped spawn scores of independent research providers (IRPs) who lured several analysts from leading I-banks and sell-side firms in the hope of cashing in on the impending boom. The number of research providers soared from an estimated 150-odd in 2003 to 1,012 in 2006, and to over 2660 in 2008, according to a report published in the Bloomberg Markets magazine's November 2009 edition. As a result, the supply of independent research far outstripped demand, leading to fierce competition in the marketplace.

The GRS fostered an independent voice in a market that was tainted due to abusive practices such as issuing optimistic research without any reasonable and adequate basis while keeping an eye on the investment banking business. In a recent interview to The Financial Times, the chief architect of GRS, former New York Attorney General Eliot Spitzer had said, "Their (IRPs) very existence was a check. The measure of their success was not how often people went to them. It's like the company that has a 2 percent market share but still provides a real price check on the monopolist."

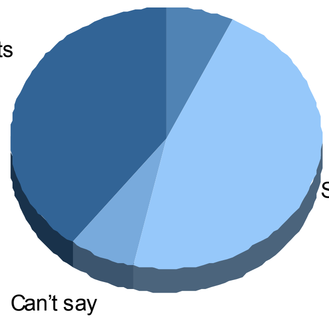
One of the direct results of the settlement has been a significant increase in the "sell" ratings by analysts. Currently, "sell" recommendations are in the range of 10% to 15% of the coverage universe compared to 1% to 2% before the settlement. "It has helped to push sell-side research to become more objective and more focused on quality of recommendations," said one of the survey respondents.

What GRS could not achieve however, is get users to accept and rely on independent research, especially the retail investors for whom the mechanism was put together in the first place. For instance, nearly four million retail investors at Morgan Stanley Smith Barney accessed only about 12,000 reports each month. At another firm, clients viewed just 200 independent research reports over four years costing the firm about $200,000 per view.

Without a proper mandate to communicate availability of such research, independent research could never really emerge as a mainstream alternative. While institutional investors wanted "exclusive" investment ideas to generate market-beating returns, doubts about the quality of independent research persisted even as the IRPs grew in numbers.

In addition, only a small, closed group of firms got access to GRS funds, which is probably why, one respondent even called it a 'dumb idea to begin with' while another had no hesitation in terming the whole exercise as 'political'. Little wonder then, a majority of our survey respondents felt that GRS has been a clear disappointment.

Do you feel that the Global Research Settlement has served its purpose?



About 86% of respondents believed that GRS hasn't fully served its purpose, whereas only 7% thought it has completely served its purpose.

The Impact of GRS Expiry on the IRP industry

hough about 86% of survey respondents said that the GRS hadn't fully served its purpose, the impact of its expiry had left a lot of IRPs reeling. The Aranca survey sought to find out the top challenges for IRPs now, especially in the face of slow market recovery after a bruising global financial crisis

The GRS expiry could not have come at a worse time. The global financial meltdown that began in the US in 2008, not only hurt stock markets but also shook the collective confidence of the global investor community. With liquidity drying up, both stock prices and volumes fell drastically across markets. Bankruptcies among banks rose on an unprecedented scale. The future looked bleak as the worries of financial meltdown turning into a full-blown recession looked real. By the fourth quarter of 2009 though, faint hints of recovery emerged after ambitious programs of liquidity injections, bailouts and other non-financial measures propped up the economy and industries. Yet, there is a long way to go.

The impact of this global turmoil was telling on the IRP industry even as they were bracing for a post-GRS regime of uncertain revenues. GRS expiration meant no regulatory push to make independent research a mandatory requirement anymore, and the IRPs that did not have buy-side clients were at the mercy of market forces. The fear of "Big boys will not support IRPs" looked ominous, with survey respondents predicting that some IRPs will be "adversely affected" and the "pressure on businesses that built model on this will be significant."

Some respondents estimated that about "60 to 70 firms will lose revenue over the short-term." For many of the IRP firms, it is a question of survival. "Without a mandate, there will be no need for many IRPs. They will consolidate or terminate," said one respondent. On the other hand, investment banks and broker firms themselves were struggling with falling commissions and having no means of making research pay. This is leading to a significant cut in the research budgets and stock coverage. Worst hit are the small and micro caps in terms of coverage. "There will be fewer shops offering research on small cap stocks," said one respondent.

At some level therefore, IRPs, especially those which did not receive any direct compensation from GRS, feel the need for some sort of regulatory measure that will allow them to survive. Indeed, one respondent felt that there should be a move to "promote IRP mandate that all IPOs require an IRP report." Another respondent called for making "IRPs more relevant."

However, it is not all gloomy for IRPs yet, as is evidenced by the emergence of several new boutique IRP firms being established by ex-analysts working for the buy- and sell-side. Many IRPs had prepared for the aftermath of GRS expiry. Besides, there is some cheer for IRPs, as some buy-side firms see value in independent research and have reaffirmed their commitment to continue with their IRP relationships.

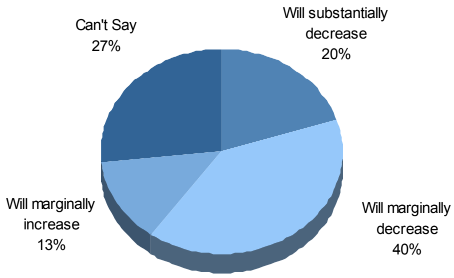
When we probed for respondent's immediate concerns, falling revenues and altering industry landscape emerged as their key issues. But, what also featured prominently, were the genuine fears of collapsing of the Chinese walls between research and advisory/I-banking arms.

FALLING REVENUES

The survey responses confirmed that the proportion of contracted research will decrease post expiration. This could be attributed to several reasons including falling research budgets, lack of regulatory push, and a general lack of awareness for independent research.

In the long run, finding and exploiting niche research segments to help them differentiate themselves from competition is going to be critical for success. One respondent hit the nail on the head when he said that IRPs need to "customize research to various users."

Will the proportion of contracted research conducted by IRPs change due to the expiration of the SEC global settlement?

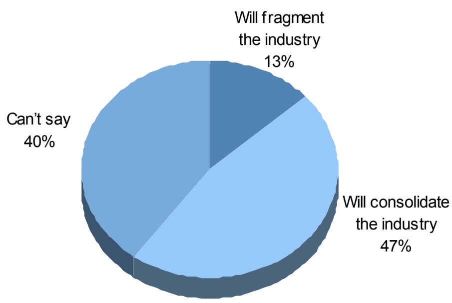


An effective marketing and distribution strategy that catches the attention of prospects and convinces them to pay for research without increasing costs significantly is one of the biggest hurdles facing the industry. One respondent said that the best way to tackle this challenge was to "charge a fixed cost for research." Another respondent said, "Build up sales force." Talking about the need to pool resources, one respondent asserted, "Some joint marketing efforts to promote IRPs are needed. Investor-side is a start, but more needs to be done."

INDUSTRY CONSOLIDATION

One of fallouts of the financial crisis has been many research analysts leaving investment banks and broker firms and joining the IRP ranks by either starting their own businesses or by joining existing players. With all of them chasing limited opportunities and a deteriorating sales outlook, the market is ripe for consolidation. For many players, consolidation could be the only way to survive. Almost 47% of the respondents indicated that consolidation is indeed, a more likely scenario, going forward. "Settlement encouraged the growth of excess capacity. Surviving firms need for capacity to shrink in order for pricing to become sustainable," said one respondent, while another was equivocal with, "Big will get bigger. Many small firms will just fold."

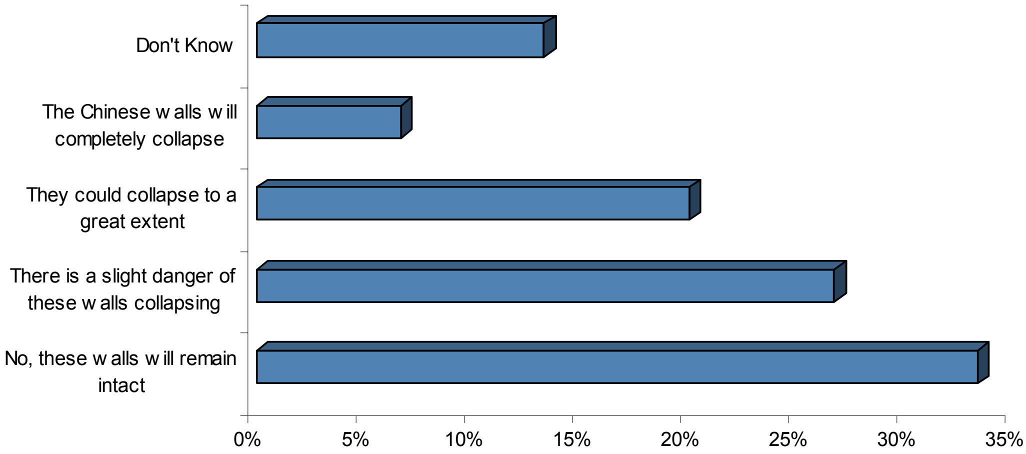
Will the expiration of the SEC global settlement alter the IRP market landscape?



BREAKDOWN OF “CHINESE WALLS”

As one of the primary objectives of the settlement was to ensure that the Chinese Walls between the investment banking and research departments remain intact, the survey tried to gauge the potential impact of the expiration on these walls. Interestingly, more than half of the respondents had reason to believe that there is a danger of these walls collapsing. Indeed, one buy-side portfolio manager said in an interview to Aranca, "To the extent that Chinese walls exist at big banks, I don't think that there will be any impact on how strong or weak they are."

Do you think the expiration of the Global Settlement may collapse 'Chinese Walls' between research and I-banking relationships?

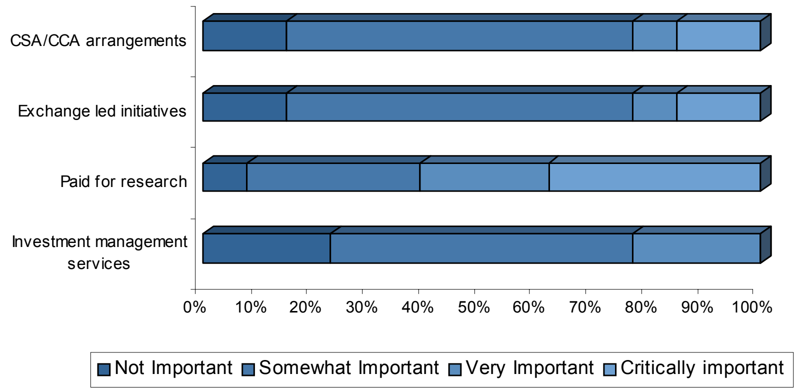


The Hunt for New Revenue Channels

With survival at stake, IRPs are on the look out for alternative revenue channels, additional skill sets, besides hoping for the economy to turn around

Even before the GRS expiry, research reports indicated that IRPs were aggressively looking to diversify and build new revenue streams. However, the double whammy of GRS expiry and global slowdown not only accelerated that process but also forced the industry players to rethink their entire business models. Aranca asked the survey respondents to list and rank their new strategies in order of priority.

In order to augment the fall in some existing revenue streams, what are the alternate revenue streams for IRPs in order of importance? Please rate.

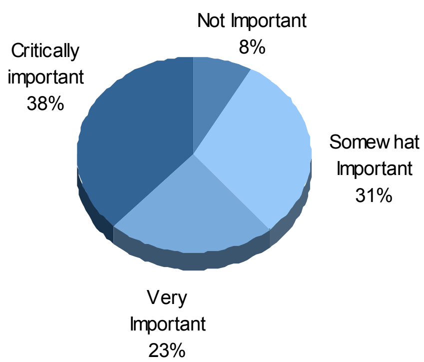


ISSUER PAID-FOR RESEARCH MODEL

The issuer paid-for Research model remains popular with small-caps and those companies that do not enjoy adequate analyst stock coverage. In order to enhance their visibility and improve stock trading volumes, such companies often rely on IRPs with strong distribution channels for coverage and for reaching out to potential investors.

Often, the compensation for such coverage is fixed in advance and has no bearing on the eventual recommendation of a stock or its performance. However, due to the nature of the model, investors remain wary of an inherent bias in the recommendations. But given the twin reasons of shrinking business opportunities and declining coverage of small- and micro-cap companies, issuer paid-for research model has emerged as an important option for IRPs. The survey indicates that amongst all the alternate revenue streams, issuer paid-for research model is the most promising alternative.

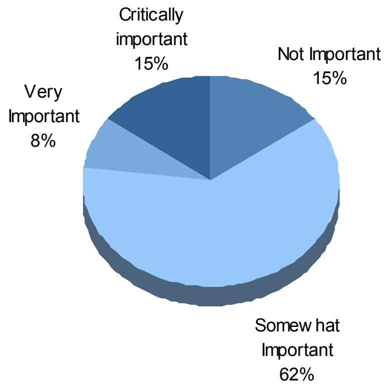
How important is the ‘issuer paid-for research model’ to augment/generate revenues?



PARTNERSHIP WITH STOCK EXCHANGES

Since 2002, analyst coverage of small- and mid-cap companies has been dwindling. This has been further exacerbated by the economic crisis. Post GRS, the coverage is expected to fall further. With little or no coverage, the prices of such stocks could suffer and in turn impact the exchange's business negatively. Realizing this, some of the leading global exchanges such as NASDAQ OMX, NYSE EuroNext and London Stock Exchange have entered into partnerships with various research providers for stock coverage, which are made available on their platform.

How important is the 'Partnership with Stock Exchanges' to augment/generate revenues?

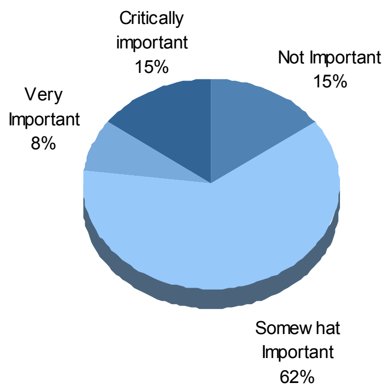


Our survey respondents acknowledge the importance of exchange led initiatives with only 15.4% not convinced about its significance. This small amount of skepticism might be attributed to the fact that these initiatives are in their nascent stage. Their success depends on how well they are received by issuers, investors and ultimately how profitable they turn out to be for research providers.

COMMISSION SHARING ARRANGEMENT

In the absence of GRS money and a drop in institutional spending on research, IRPs are now looking forward to a commission sharing arrangement (CSA) model as a way to get compensated. The recent trends, however, present a mixed bag for independent research. Though the institutions already using CSA have increased their preference for CSA as the desired mode of commission payments, overall, the number of institutions adopting CSA has remained fairly flat. Incidentally, most of the survey respondents believed that CSAs would only be marginally important in making up for the loss of revenues due to the expiration of GRS.

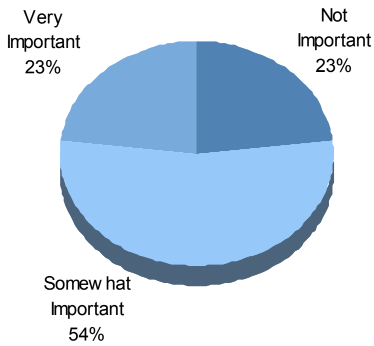
How important is ‘CSA model’ to augment/generate revenues?



INVESTMENT MANAGEMENT

Following issuer paid-for research, investment management seems to be the other popular business segment that IRPs wish to venture into, with 77% of respondents thinking that this would be important for their future revenues. IRPs can use their own research to manage money for institutions and high net-worth individuals. Many IRPs have already been providing investment management services to complement their research dollars.

How important is 'investment management model' to augment/generate revenues?



Nurturing Buy-side's Interest

With sell-side forced to cut research costs, the IRPs are increasingly looking to buy-side firms to bail them out. For that to happen, IRPs need to augment their skill sets first

Among the few silver linings that have come into focus after GRS expiry are buy-side's renewed interest in IRP research and the willingness of IRPs to expand their skill sets.

BUY-SIDE FIRMS

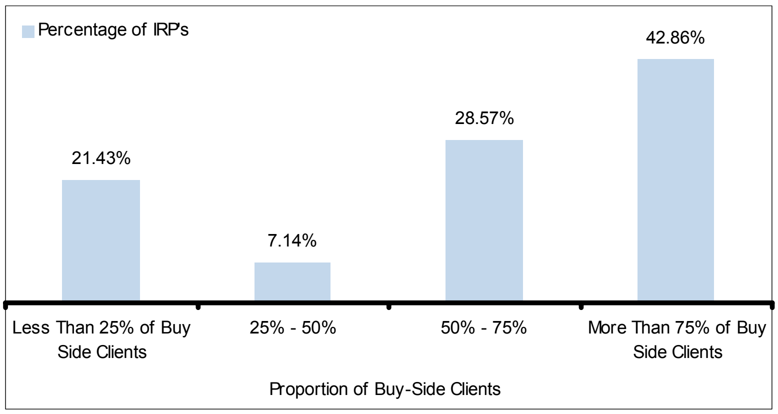
Buy-side firms have been extremely important for IRPs for two reasons: 1) they are the biggest consumers of research, and 2) they require customized and exclusive research. While they are inundated with research, their need for innovative analysis and insights continues to grow as the pressure to deliver high returns increases.

Buy-side firms pay significant amounts in commission to the sell-side for research and to bulge-bracket firms because they receive allocations in IPOs and secondaries. According to estimates published in a recent report in The Financial Times, asset managers will have spent about $1.67 billion on research from IRPs in 2009, down about 18% from $2.05 billion in 2008. In comparison, the investment banks are expected to generate an estimated $9.7 billion from selling research in 2009, down just 10%. Jay Bennett, a consultant with Greenwich Associates was quoted in the Bloomberg Markets magazine as saying, "There is a symbiotic relationship between the bulge-bracket bank and the typical institutional investor, and I can't see that being displaced."

Given this, understanding what the institutional investors want and developing capabilities to customize research for such users within the available resources poses an important challenge for the IRP industry. According to a respondent, "(focusing) on getting good people, good process and creating product that institutional investors want," is the way to go.

Even though the retail investors saw more of independent research from the mass producers like ValueLine, S&P and Morningstar, the institutional investors have always leaned more towards boutique research firms to get exclusive investment ideas. Post GRS, "...one can already see commitments from buy-side firms to continue with support of IRPs despite the end of GRS," said one respondent.

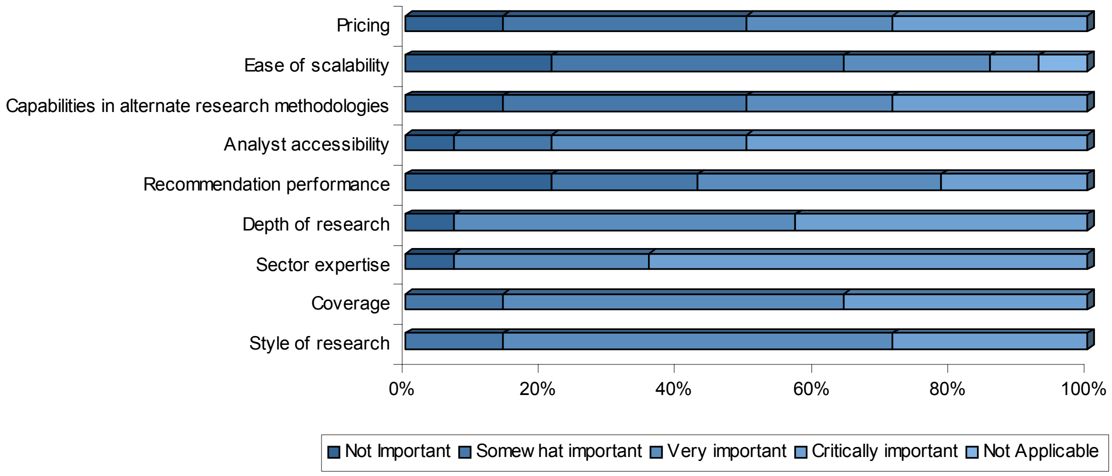
What is the proportion of your current buy-side clients?



The fact that nearly 70% of the respondents have more than 50% of their revenues coming from the buy-side in spite of the dominance of research from bulge-bracket firms is heartening. "We would be happy to allocate a significant amount to IRPs if they can demonstrably make us money," said one buy-side portfolio manager in an interview to Aranca. In a way, if IRPs can hold their nerve, enhance their capabilities and look to customize their offerings, then the future may not be all that dark.

Besides exclusive ideas and innovative research, there are several other attributes that buy-side firms look for in IRPs. We asked our respondents what they think.

What do you feel are the important factors that buy-side clients consider while evaluating an IRP?



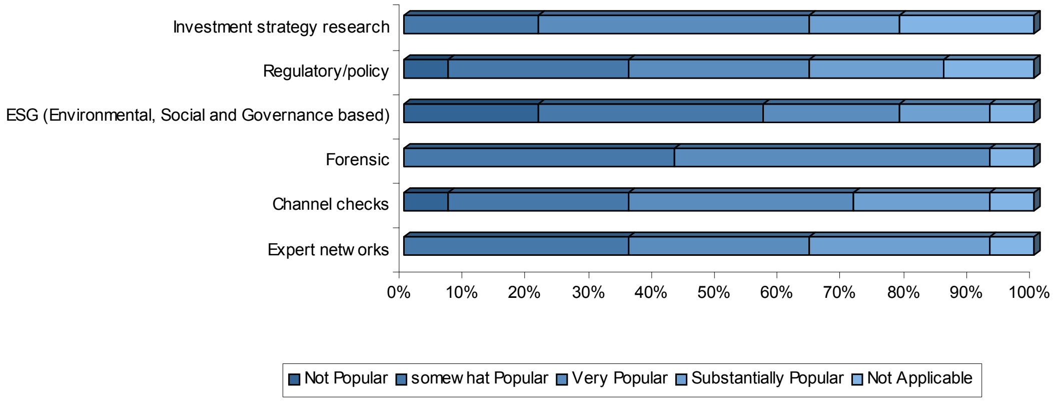
According to the survey, sector expertise, depth of research and analyst accessibility seem to be the most critical factors for buy-side firms.

ALTERNATE RESEARCH CAPABILITIES

The battering received by financial markets saw a record 1,471 hedge funds close shop in 2008. Several banks and asset management firms, too, went under. Market commentators feel that the survivors of the crash are driving the alternative research industry. The growing appeal of alternative research is evident from recent trends at many bulge bracket firms, which provide a platform for such research. Most notable amongst these are Goldman Sachs' Hudson Street and the UBS platforms.

There is ample supply of research from providers following conventional research methodologies such as fundamental, quantitative and technical, especially from investment banks. However, independent research providers could add value to the buy-side through alternative research methodologies. These methodologies include primary (expert networks, channel checks), specialized (forensic, ESG, policy, patents, regulatory), economic and investment strategy. The survey tried to measure the popularity of these methodologies with institutional players.

Please rate the following alternative research methodologies based on their popularity, as opposed to conventional research?

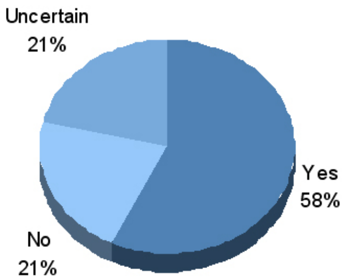


Respondents felt that expert networks, channel checks and investment strategy research are most popular research approaches preferred by the buy-side firms.

OUTSOURCING RESEARCH

With falling revenues and dropping demand for independent research, most IRPs are faced with a Hobson's choice: cut costs or perish. Outsourcing equity research has emerged as a viable option in the recent times to extend coverage, shrink costs, improve operational flexibility and augment skill-sets.

Under current circumstances, do you feel that outsourcing research could help the IRP industry?



A significant 57.1% of the respondents felt that outsourcing research could help them going forward. Interestingly, 21.4% felt that such a strategy would have no bearing on their growth, while the remaining were ambivalent. Exactly half of the respondents felt that outsourcing was 'Critically Important' to help expand their current coverage universe. Another 33.3% felt it was 'Somewhat Important'. Interestingly, none of the respondents felt that outsourcing was not important to improve their coverage. When it came to lowering cost, the response was a little more emphatic, with 57.1% claiming outsourcing was 'Critically Important' to save costs, while another 28.6% felt it was 'Very Important'. But, 14.3% said that outsourcing was not important at all to save costs.

Almost all respondents agreed that outsourcing would provide them with access to a wider set of services. Nearly two-thirds felt that having an outsourcing strategy would help them improve their operational flexibility.

Conclusion

With GRS becoming history and consumers of independent research getting more demanding, IRPs have their task cut out. If they get their game right, it could be business as usual, GRS or no GRS

The Aranca IRP Survey 2009 threw up several interesting insights. While the GRS expiry will continue to hurt the IRPs in the short terms, firms with niche offerings and specialized skill sets will continue to be in demand. Given the fact that several buy-side firms and hedge funds have seen a significant of erosion of their assets under management, they will aggressively seek alpha returns, going forward. What's more, many of them are willing to pay top dollars for research that can make money for them. They would also demand solutions that are not limited to the standard confines of valuations and research notes.

The survey respondents have been unequivocal in their opinion that GRS has not created a platform for IRPs to emerge as a serious mainstream research alternative that is accessible, affordable and unbiased across stock universes. Though, one of the objectives of the GRS may have been to create a market for uncovered or under-covered securities, it was not fully realized. Moreover, the norms on increased disclosures have only added to the deluge of paperwork with investors more often then not, skimming through them. Indeed, the fact that IRP research found so few takers over the course of settlement points to the fact that investor education, particularly in the retail category, did not really work.

A good thing that came out was the fact that IRPs are cognizant of GRS expiry and its aftermath. Many of them have prepared themselves well in advance. Yet, shrinking pie even as participants increase in numbers, means smaller pieces for everyone. In that sense, the industry is ripe for a wave of consolidation. The GRS expiry and weak financial markets may place a significant role in speeding up the consolidation process.

With abundant and proven talent available in the marketplace, IRPs would do well to strengthen their skill sets and diversify offerings even as they explore cost-saving strategies. Unless IRPs differentiate their products and are able to justify their pricing, they will find few takers. Those firms which are weak on marketing and distribution fronts, could consider aligning themselves with players that do. The global downturn is likely to speed up consolidation in the IRP industry. Firms that have not formulated their future growth strategies could find themselves on fringes very quickly.

Exchanges and regulators have a strong role to play in molding the post GRS era. They need to realize that without action on their side, the current trends point to research becoming more biased as:

- There will likely to be fewer IRPs,
- IRPs themselves are likely to depend more on research with conflicts of interest, as for the majority of respondents, issuer paid-for research is very important or even critically important, and

While the risks of Chinese walls getting porous by the day exist, IRP research could form an effective counterweight if exchanges were to provide a platform for research distribution. Otherwise, there is a real risk of unwanted excesses of pre-2001 days returning to haunt them once again.

Our view is, the stage is set for IRP 2.0, where, while the Darwinian mantra of survival of the fittest might still hold true, we may see a twist in the tale. Firms that stay ahead on capabilities, are open to new strategies of building and augmenting product basket, exploring newer avenues for both revenue generation as well as cost-savings, will thrive. It could very well be the survival of the smartest.

About Aranca

Aranca is a global provider of end-to-end, customized and on-demand investment and business research, valuation services and intellectual property research services. Established in Mumbai in 2003, Aranca has quickly emerged as a trusted research partner for a variety of global clients. Our diverse capabilities, cross-disciplinary expertise, in-depth market knowledge of several industry sectors and flexible engagement models help us provide cost-effective yet world-class research services to our clients. Aranca functions from six offices, one each in San Francisco, New York, London, Brussels and two global delivery centers in Mumbai.

We provide customized research services with flexible engagement models under four practices:

Investment Research
In the investment research practice space, sell-side firms, IRPs, hedge funds and investment banks among others, use our services across a variety of assignments including equity research, earnings analysis, earnings quality analysis, IPO research, industry overviews, company descriptions and so on. In addition, Aranca has delivered support in complex areas such as quantitative modeling for top line and bottom line metrics, credit research, stock screening, sector analysis and company profiles among others.

Business Research
Aranca provides a range of actionable business research services for Corporate Strategy & Planning, M&A, Corporate Finance, Business Plan Development, Due Diligence, Feasibility Studies and Investor Relations. We deliver Company Profiles, Industry Analysis, Competitive Landscape, Market Entry Strategeies, Valuation, IP Research and other Business Research services for Corporates, Private Equity/Venture Capital firms, Research & Consulting firms, and Start Ups.

Valuation & Due Diligence
As part of our Valuation & Due Diligence practice, Aranca provides comprehensive tax compliance and financial reporting services to privately-held companies, Start Ups, portfolio companies of Private Equity/ Venture Capital firms, clients of Law firms and so on. Whether it is IRC 409A Valuation, FAS123R Valuation, FAS 141 and FAS 142 Valuation or Fairness Opinions, we have served several hundred firms.

Intellectual Property Research
Aranca's Intellectual Property (IP) Research and Analytics practice offers a gamut of high quality and customized research & analytics services covering the entire spectrum of patent, technology and product lifecycle. Our services can help save significant costs of between 40-70%. And our scale allows for rapid turnarounds of research projects. Our clients include IP Research clients include corporates, law firms, IP consulting firms, universities, independent research centers and incubation centers of diverse size and types across the world.

For more information, visit: http://www.aranca.com or write to info@aranca.com