

COMPLIANCE WEEK

Buy-Side, Sell-Side: What's A Company To Do?

By Louis M. Thompson, Jr., *Compliance Week Columnist* — October 24, 2006

It's no longer business as usual in the world of investor relations. And the changes are coming faster than many senior corporate managers realize. For years, most companies could count on sell-side analysts to communicate their story to institutional and individual investors. And in most cases, the securities analysts' research almost always included "buy" recommendations. But that changed after two important developments.

The first was Section 501 of Sarbanes-Oxley, which outlined provisions meant to address conflict of interests that can arise between the research and investment-banking sides of the brokerage firms. The second development was the \$1.4 billion global research settlement with the 10 largest U.S. brokerage firms, which stemmed from charges led by New York Attorney General Eliot Spitzer that the investment firms were issuing biased research that was riddled with conflicts of interest.

These two events resulted in a resurrection of the wall between research and investment banking, which—among other consequences—dramatically lowered the compensation of most sell-side analysts. Some of these analysts had become "rock stars" in their firms, reaping multi-million dollar bonuses for the business they brought to the banking side. Consequently, some of the best and brightest of these analysts left for the buy-side firms, or for the growing hedge-fund business.

During this same period, the money available for research started to dry up. Back in the 1970s, Congress enabled the brokerage firms to include the cost of investment research to institutional clients as part of fully negotiated trading commissions. In other words, the research was paid with "soft dollars" incorporated into trading fees. But some major mutual funds will no longer engage in "soft dollar" transactions for research with the brokerage firms. More importantly, trading commissions have been dropping amid global stock-exchange competition, so brokerage firms have started to "unbundle" their research payments from trade costs. That means that institutional investors need to pay hard-dollar fees for research. And that's something many are unwilling to do, especially when

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they can conduct their own unbiased buy-side research (with those previously mentioned rock-star analysts).

And while hedge funds may be increasing the demand for sell-side research somewhat—in some firms, hedge funds account for up to 40 percent of research funding—the bottom line is that overall dollars for research are drying up. Some experts even question whether the sell-side will exist as we know it three to five years from now.

Integrity Research Associates, for example, is predicting that the buy-side will cut its spending for sell-side research by 28 percent over the next four years. That's probably conservative. Today, 1,200 of the top-tier 3,200 Nasdaq companies and 35 percent of all listed companies on the major exchanges have no sell-side coverage. And the Securities and Exchange Commission reports that 83 percent of companies with a market cap under \$125 million have no research coverage at all.

At the same time, Integrity Research is predicting that the buy-side will more than double its expenditures on internal research over the same period. For those companies with declining sell-side coverage or none at all, there is still a need for investor relations targeted to the buy-side. It's much more difficult to gain entry to buy-side firms if you have no sell-side coverage, but it can be done.

Managing The Shift

The shift in research from the sell-side to the buy-side is creating a major challenge in managing an IR program. Over the last decade or so, many companies have increased their focus on the buy-side, but most are not prepared for the demand that the increase in internal research will place on the chief executive and financial officers who are primary spokespersons to this side of the IR business. And too many CFOs have not empowered their investment relations officer to help with the buy-side; they see the IRO's role as managing the diminishing sell-side.

So, what are some key initiatives that companies should consider in adjusting to the changes in the investment community and the securities industry? Here are seven:

1. **Secure the resources to meet the needs of the buy-side.** CEOs and CFOs need to focus on running their companies instead of trying to meet the increased demand for one-on-one meetings with the buy-side. Now clearly, the CEO and CFO should handle some of these meetings, along with making presentations at investor conferences. But companies must commit to beefing up their investor-relations resources to ensure the company is equipped to meet one-on-one with institutional analysts and portfolio managers in addition to meeting the needs of the sell-side. The buy-side is interested typically in more detailed information than the sell-side (see point number seven, below), and they far outnumber the brokerage firms; that means most companies no longer can adequately handle the IR function with one or two professionals.
2. **Get Wall Street to listen to your IRO, not just your CFO.** It is essential that IROs

have adequate access to senior management and are involved in the strategic decision-making process. This is critical if Wall Street is going to perceive them as fully capable of speaking for the company. The challenge, of course, is that many CFOs covet their role and relationship with the buy-side. That means that IROs are sometimes excluded from key dialogues—75 percent of CFOs manage the investor-relations program. The result: companies fail to equip investor-relations executives with the tools needed to be effective spokespersons with institutional analysts and investors. That has to change; it is simply not scalable for the CFO to manage the entire buy-side effectively and manage the business. And if the CFO is not comfortable delegating this role to the current IRO, then the CFO needs to find a more effective IRO.

3. **See the IRO as the hedge-fund gatekeeper.** Companies are now dealing with the growing role of hedge funds; the latest estimates put the number of hedge funds at more than 8,000, with over \$1.2 trillion in assets. And the hedge funds are all over the map. Some are activists with agendas, while others are specialists in short selling. Some are momentum players that can be in and out of a stock in a heartbeat, while others are longer-term investors, holding a stock for eight months or more (just short of the average holding period for mutual funds). The IRO's role is to be on the front line, providing access to all who need it, and deciding which hedge-fund managers merit access to senior management. And while the company may not love the strategies employed by some of the hedge funds, the IRO ignores them at the company's peril.
4. **Implement an early-warning system for the board of directors.** The IRO today has an important role to play in corporate governance, particularly as the shareholder democracy movement plays a stronger role. Though the SEC has not yet embraced a "proxy access" rule, that hasn't stopped investors from pursuing majority voting. In addition, as of press time, the issue of proxy access had been revitalized after a court ruling in favor of shareholders; the SEC will meet Dec. 13 to consider new rules for submitting shareholder resolutions related to nominating directors in time for the 2007 proxy season. As a result, it is critical that IROs help the board understand who the company's investors are, why the stock behaves as it does, and what investors' perceptions are of the company's strategies and performance. This will give the board early warning that there could be changes in the shareholder mix. For example, momentum investors may emerge when the company is blowing away Wall Street's earnings estimates, and longer-term value investors may step in when earnings stabilize. IROs should be making presentations to the board at each meeting on these issues, bringing to the board the investors' concerns and issues. Independent directors do not like surprises and want to hear directly—not just through written board reports—from the IRO.
5. **Make sure your message is consistent, credible and comprehended.** Most importantly, IROs need to ensure that the corporate strategy is resonating on Wall Street. This will happen when the strategy is articulated clearly over and over again through consistent messaging in investor conference presentations, one-on-one meetings, analyst and investor days, annual reports, and other written communications, including Management's Discussion and Analysis. The strategic message must be understood and credible. The Street must believe that the company

has what it takes to achieve its strategic goals, and has the quality of management to get it done. These are key factors institutional investors use in making investment decisions.

6. **Provide guidance ranges based on corporate-value drivers.** According to the latest survey by the National Investor Relations Institute (which, in full disclosure, was conducted when I was still NIRI's CEO), companies continue to shift away from issuing quarterly guidance, in favor of providing only annual guidance. For example, only 52 percent of the 654 survey respondents provided quarterly guidance, down from 61 percent in the year-prior survey. However, the percentage of respondents furnishing annual earnings guidance increased significantly to 82 percent, up from 61 percent in the previous survey. Importantly, the survey found that companies are communicating both earnings and non-earnings guidance—such as qualitative statements about market conditions, trends, and quantitative industry drivers—to analysts and shareholders. Companies should provide investors a realistic framework for the future by offering guidance in terms of a range of earnings estimates or qualitative and non-financial factors that drive corporate value.
7. **Understand the differences between the buy-side and the sell-side.** The goals of the sell-side and the buy-side are different, and IROs not only need to understand that, but they must act on it. Remember, the sell-side analysts' recommendations are "blanket recommendations," meaning they aren't tailored for each individual client; they're built for the masses. As a result, the sell-side is focused typically on earnings per share and other core financial metrics. But the buy-side analysts are an entirely different breed: Most work for a specific fund and, therefore, are making specific recommendations for managers of that fund. As a result, their information needs are unique, as their decisions are based on the goals of the fund's investment strategy. With the buy-side, IROs can spend more time discussing publicly released information, providing non-material details with respect to the overall value proposition. That's particularly the case with nonfinancial factors that drive long-term value, like human capital in knowledge-based industries, or R&D in others. To those ends, IROs need to take the time to understand the buy-side's investment strategy and criteria. This isn't easy, as the buy-side typically keeps its research to itself. But a good investor-relations department will take the time to understand the funds, deconstruct their strategies, communicate with them regularly, and provide them the valuable and colorful detail that never interested the sell-side.

Companies that take these actions will be much better positioned to deal with the major market changes that are driving the increase in buy-side research. The sell-side isn't dead, but the influence of its research is clearly diminishing; companies that prepare now will avoid playing catch-up later.

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