Testimony Summary of Scott C. Cleland, CEO of The Precursor Group®
"Who's Looking Out for Investors?"
Before the U.S. House of Representatives, Subcommittee on Capital Markets, June 14, 2001

I am Scott Cleland, founder and CEO of the Precursor Group® an <u>independent</u> research broker-dealer, which provides investment research to institutional investors. We've aligned our business' interests with investors' interests, so we avoid conflicts of interest -- *actual and perceived*. We do:

- No investment banking for companies;
- Not manage money or own a stake in any companies;
- Not trade securities for proprietary gain; so we *only trade*, *never own stocks* in companies; and
- Not allow Precursor Group® researchers to personally trade individual stocks.

We are a pure research firm because a company cannot well serve different masters at the same time: investors and companies. Conflicts undermine research; independence improves research.

Our interest in testifying is clear. The powerful investment banking and trading interests that have effectively suffocated the independent research views *within* Wall Street firms have the same economic potential to suffocate independent research *throughout* the industry. Thus we are calling for: more competition in research; less regulation of research; and more disclosure and regulatory oversight of conflicts of interest.

The free and competitive flow of ideas best serves investors and makes markets efficient. A conflict-ridden system profoundly distorts the information the market receives. Investors need a more competitive research market that rewards research that improves investment performance.

The subjugation of investor interests to company interests is reinforced and perpetuated by the structure, economics, compensation, and regulation of the brokerage industry. When markets are going up, no one notices this systemic conflict of interest problem, when markets go down they do.

Recently, American shareholders and pension plan beneficiaries lost roughly four trillion dollars in the NASDAQ in a matter of months and only 1% of analysts' recommendations were "sell." The problem isn't with the analysts' recommendations; they are being made the scapegoat. The problem is with a regulatory system, which favors companies over investors. These analysts and brokerage firms work primarily for companies, so it is unrealistic to expect them to bite the hand that feeds them.

It is clear where this is heading. As investment banking and proprietary trading corner more of the research commission market: research will only become more biased towards company interests and American shareholders and pension plan beneficiaries will be ill served. The current problems with research won't go away until the systemic problem of conflicts of interest is better resolved.

<u>Recommendations</u>:

1. **Encourage fuller disclosure of the *extent* of the financial conflicts of interest.**
2. **Encourage better alignment of interests between research providers and investors.**
3. **Enable market forces to better protect investor interests by reducing unnecessarily burdensome regulations on pure research brokers; one regulatory size does not fit all.**
4. **Ensure that the economics of investment banking and proprietary trading do not suffocate the economics of investment research, because markets and investors need a full competition of ideas and information to operate to their fullest potential.**

Written Testimony of
Scott C. Cleland
Chairman and CEO
The Precursor Group®

"Who's Looking Out for Investors?"

Before the U.S. House of Representatives
Financial Services Committee
Subcommittee on Capital Markets,
Insurance, and Government Sponsored Enterprises

Hearing on

"Analyzing the Analysts:
Are Investors Getting Unbiased Research from Wall Street?"

Thursday, June 14, 2001

I. Introduction

Mr. Chairman, thank you for the honor of testifying before your subcommittee and for the Subcommittee's interest in the business perspective of an *independent investment research broke-dealer*.

My testimony includes:

- An introduction of the Precursor Group® perspective;
- An explanation of our interest in testifying;
- Our assessment of the problem; and
- Our recommendations to help fix the problem.

II. Precursor Group® Perspective

1. I am Scott Cleland, founder and CEO of the Precursor Group®, an independent research broker-dealer, which provides investment research to institutional investors. My partner Bill Whyman and I founded the Precursor Group® a year ago very intentionally as an *independent* firm in order to better serve our investor clients' interests and not to serve companies' interests or investment banking interests.

- **We see a real market opportunity for pure investment research un-compromised by company conflicts of interest.**
- We have learned that the investment research marketplace is thirsting for trust and our business is trying to quench a part of that thirst.

2. **Our business is simple. We work for institutional investors; they pay us research commissions on their trading to the extent that we help improve their investment performance.**

- If our research helps investors identify opportunities or avoid pitfalls, we get paid in trading commissions.
- If our research does not help investors, we do not get paid.
- We have a market-driven, merit-based business model.

3. **We are unusual in that we are a pure research firm** in a business dominated by integrated full-service brokerage firms that bundle investment banking, trading and research.

- **We are exclusively an investors' broker-dealer**, akin to a buyer's broker in real estate.
- We are not the traditional sellers' or company broker-dealer, which tries to represent *both* companies' and investors' interests.

4. **We have done our best to align our financial interests with investors' interests.** We are very serious about avoiding conflicts of interest, actual *and perceived*, so we:

- Do no investment banking for companies;
- Do not manage money or own a stake in any companies;
- Do not allow Precursor Group® researchers to trade individual stocks -- as a condition of employment; and

- Do not trade securities for proprietary gain.
    - We get paid through agency trading commissions, which is the primary payment mechanism that institutional investors use to pay for investment research.
    - Our contracted-out agency trading is not a conflict of interest because:
        - We act only as an agent and never as a principal that has capital at risk – so our agents execute stocks for others at their request but we never actually own a stock of a company.
        - Our clients have complete freedom to chose which of our four contracted-out trading clearing firms they want to use.
        - So our institutional investor clients completely control whether and how we get paid with their shareholder or pension fund resources.
        - This arrangement eliminates any financial conflict.

5. **We are a pure research firm because we do not believe one firm can well serve different masters at the same time: investors *and* companies**.
    - We strongly believe true independence yields better research.

III. Why am I testifying?

1. **Our interest in testifying is clear.**
    - The powerful investment banking and trading economic interests that have effectively suffocated the independent research views *within* Wall Street firms, have the same economic potential to suffocate independent research *throughout* the industry.
    - **The contagion of conflicts of interest is systemic; they can spread industry-wide** because the economics of individual firms are the same as the economics of the industry-at-large.

2. **Specifically we believe that:**
    - The regulatory system is heavily biased against independent research broker-dealers like ourselves that avoid conflicts of interest, in favor of full-service broker-dealers laden with financial conflicts of interest, perpetuating the problem;
    - Regulatory barriers to entry effectively prevent market forces from providing adequate economic checks and balances that would better serve investor interests; and
    - Business conflict trends (like bankers allegedly pressuring mutual funds to pay increased research commissions for IPO allocations and for trading liquidity) threaten to concentrate the research commission pool in the hands of only full-service firms snuffing out competitive independent research providers and ill serving shareholders.

3. **Thus we are calling for:**
    - **More competition in research, not less;**
    - **Less regulation of research, not more; and**
    - **More disclosure and regulatory oversight of conflicts of interest, not less.**

IV. <u>The Problem:</u>

1. **All the attention on the independence of analysts and research is somewhat misplaced, because it is only the most obvious symptom of a much more serious underlying malady in the industry.**

- The problem is the structural financial incentives in our current brokerage system that bundles higher-margin banking and trading with research.
  - This structural bias can badly serve investors, as many learned from the "surprise" cratering of the tech sector.
  - This structural bias also produces poor research and increases market volatility.

2. **A serious flaw in the regulatory system is that structurally it does not encourage fierce competition for new ideas and information that benefits investors.**

- Investment banking and proprietary trading has largely co-opted the brokerage research function as an arms length extension of the company represented.
- The cold reality is that the lion's market share of the brokerage research system is structured around the banking business of companies.
  - That's why only ~1% of analyst recommendations are sells.
  - That's why sell side analysts lose their jobs for authoring negative research about a company.
  - That's why so many institutional investors have so heavily beefed up their <u>in house</u> research staffs.
  - That's why the system produces "consensus earnings expectations," which so eerily mirror company "guidance" and why independent or divergent expectations routinely get purged from the "consensus" system as "outliers."

3. **A conflict-ridden system profoundly distorts the amount and type of information the market receives.**

- This means that the market generally gets only the information companies want the market to get and not the information investors need to make sound investments or the full and free flow of information that the market needs to operate best.
- The conflicts of interest are so systemic and economically powerful that they threaten the independence and diversity of the research viewpoints that the marketplace needs to function to its fullest potential.
- This conflict-ridden system also contributes to market volatility by powerfully discouraging distribution of research that is contrary to a company's interest.

4. **It is common sense that you find what you look for**.

- If you have powerful economic and compensation incentives to not look for information that may be negative to companies, the very real tendency is not to look for it and not to find it.
- This incentive system serves companies, but not investors or the market.

5. **There is substantial evidence that there is a problem:** this hearing, the SEC's and other governmental authorities' multiple regulatory and enforcement inquiries, academic research, and recent cover stories in Barron's and Fortune.

- But too many are too quick to blame the analysts or individual brokerage firms.
    - I don't think it is right to make them scapegoats.
- Sell-side analysts and full-service broker-dealers are simply doing what the regulatory system encourages them to do – bundle lower-margin research with higher margin banking and trading businesses.
    - **It is common sense that a system naturally produces the behavior that it rewards.**
    - Analysts are generally compensated by the banking business they produce; and many now can also participate in private funds at favorable allocations and prices of companies their firms take public.
    - So it is unfair to criticize behavior that the system condones, encourages and actually perpetuates.
- **The current problems with research won't go away until the systemic problem of conflicts of interest is better resolved.**

6. **Recently, Americans lost roughly four trillion dollars of wealth in the NASDAQ in a matter of months and only 1% of analysts' recommendations were "sell."**

- The problem isn't with the analysts' recommendations; it is with a regulatory system, which so obviously favors company interests over investors'.
- These analysts and brokerage firms work predominantly for companies, to <u>sell</u> companies' stock, so it is unrealistic to expect these analysts and firms to cross their main client -- companies.
    - It's simply not smart to bite the hand that feeds you.

7. **The problem is really the regulatory system overall, that structurally reinforces conflicts of interest in the system.**

- The common and accepted practice of bundling together different lines of business (research, banking and trading) with conflicting goals commingled into one payment stream, begs for trouble.
    - One can't play with fire without getting burned.

8. **Other industries have taken conflicts of interest more seriously and addressed the problem more directly and openly.**

- *Law:* The legal profession is serious about avoiding conflicts of interest. Each side is represented by an advocate working solely for its interests, which serves the ends of justice. The prohibition extends to the <u>appearance</u> of conflicts, so that, even with "full disclosure" one lawyer does not represent both sides.
- *Real Estate:* The real estate industry faced a similar conflict of interest problem to the brokerage industry in that a real estate broker is employed by and represents the financial interests of the seller -- not the buyer. The problem was largely addressed by acknowledging and disclosing that the conflict was real, by informing and encouraging buyers of real estate to employ buyer's brokers to ensure that their interests are adequately represented, and by getting an independent home inspector to research the house's potential problems.

V. Recommendations:

1. **Fuller disclosure.**

Encourage fuller and more practically useful disclosure of conflicts of interest.

- Disclosure today is generally limited to acknowledging that various financial conflicts of interest may or do exist, which is helpful only to a point.
- **What would be more helpful and relevant for consumers of investment research to know is *the* *extent* *of* a broker-dealers' conflicts of interest.** Specifically:
    - o What is the majority or controlling financial interest or compensation behind the research? Or
    - o Who does the researcher mainly work for and what drives their compensation? Companies? Or investors?

2. **Avoid conflicts by allowing for and encouraging an alignment of interests.**

Like in law and real estate, encourage investors to seek research that is more aligned with their interests and ensure that regulations don't discourage the alignment of interests between research and investors.

- Today the investment research system assumes that the investor hens are safe in the same bundle with the investment banking fox, as long as the regulator farmer ensures that the hens are aware the fox is in the henhouse.
    - o Wouldn't it be wiser to encourage hens that want to hire other hens to not be required to hire the investment banking fox too?
    - o The farmer's naïve assumption here is that with enough disclosure, regulatory "chicken wire" and patrolling, the hens have nothing to fear from the fox.

3. **Enable market forces to better protect investor interests.**

Reduce regulatory barriers to entry for investor or buyer brokers, and rely more on market forces and competition to meet investor demand for objective research.

A. Currently the regulatory system believes *one regulatory size fits all broker-dealers*.

- Broker-dealers like us, who only provide research and conduct no banking or proprietary trading business, have the same licensing, regulatory and audit burdens as broker-dealers that do all three lines of business.
- This is a major barrier to entry and operation since most regulations and licensing requirements are focused on preventing problems in investment banking and trading.
    - o Of the roughly 900 pages of regulation we are subjected to, no more than ten pages apply to research.
    - o And only a small percentage of the questions on our licensing exam applied to research.
- This nonsensical situation is akin to requiring an electrician to be licensed and regulated also as a plumber and a carpenter, in order to operate solely an electrician.

B. **The real world impact of this unnecessarily burdensome regulation is to discourage market entry of pure research broker-dealers** like us, and tilt the competitive playing field towards broker-dealers with inherent conflicts of interest.

- Since the regulatory system encourages bundling, it implicitly discourages specialization in research only.
- Having more pure research would result in improved quality and accountability of research.

4. **Ensure the full and diverse competition of research ideas and information in the marketplace.**

Ensure that the economics of investment banking and proprietary trading do not suffocate the economics of investment research and independent research because markets need a full and diverse competition of ideas and information to operate to their fullest potential.

- **More specifically, ensure that institutional brokerage lists (which brokers get paid <u>research</u> commissions) are not cornered and shortened by the banking and trading appetites of the large brokerage firms, at the expense of research firms. This would be to the detriment of the investing public: fund shareholders and pension plan beneficiaries.**

A. To employ another analogy to make the "suffocation" risk more clear here, full-service brokerage (bundled banking, trading and research) is like a delicate and interdependent ecosystem that requires balance to survive and thrive.

- Think of the brokerage ecosystem as a pond where if too much oxygen or nutrient gets into the pond, the weeds and algae grow out of control and eventually suffocate all other pond life.
- Now think of the brokerage marketplace as a "pond" ecosystem where investment banking is the "weeds," trading is the "algae," research is the "fish," and money is the "nutrients" in the system.
- The destructive dynamic at work here is that the banking weeds and trading algae are threatening to devour all of the pond's money/nutrients, ultimately suffocating the research fish.

B. **This destructive out of balance dynamic is structural.**

- Investment banking and proprietary trading are scale businesses that tend to get more profitable with size and broadest distribution.
- Research does not require scale; one person free of conflicts and economically motivated can discover what hundreds cannot because the hundreds have conflicts that limit them from pursuing certain avenues of inquiry.
- Investment research is a quality not quantity or scale business; it is a *quality of thought* business.
    - Investment research is about new ideas, fresh perspectives and better judgment.
    - Research is about seeking out what is *new* to the market.
- In addition, banking and trading are *product* businesses, shares or bonds, where investment research is a *service* business in the form of advice and information.

C. **This problem manifests itself in buy-side broker lists** (the lists of brokers that a given institutional investor will pay research commissions to in a given quarter or year.)

- The problem is that the large full-service brokerage firms are allegedly demanding more and more of the commissions that are set aside for research, in return for either:
  - preferred access to IPO deal flow, and/or
  - better trading liquidity, the ability to get out of a big position quickly.
- Because commissions tend to be all commingled together, it is problematic to determine how out of balance this system is becoming.
- It is also important to note that the money that is paid in the form of commissions is charged directly to the fund shareholder or pension plan assets, not paid by the fund manager.

D. The conflict of interest problem that has already suffocated the independence of research within most full-service brokerage firms, now threatens to suffocate independent research long term.

- The same imbalance in a brokerage company's economic model exists in the brokerage industry model because *the problem is structural*.

VI. Conclusion

The free and competitive flow of ideas is what best serves investors and makes markets work most efficiently.

- This demands a highly competitive research market, which rewards research that improves investment performance.
- The problems with conflicted research are merely a symptom of a serious structural conflict of interest malady in the system.

The structure, economics, and regulation of the brokerage industry all mutually reinforce the subjugation of investor interests to company interests.

- When markets are going up, no one notices, when markets go down they do.

It does not take a rocket scientist to see where this is heading.

- As investment banking and proprietary trading corner more and more of the research commission market:
  - **Research will only become more and more biased towards company interests;**
  - The economics of independent research may not be sufficient to ensure that markets still enjoy a free and vigorous research debate; and
  - American shareholders and pension plan beneficiaries will be ill served.

Mr. Chairman, thank you again for the honor and opportunity to share the views of an *independent research broker-dealer* before this Subcommittee.

Attachment: "What Ails Investment Research?" Precursor Group®, May 2001

ATTACHMENT

What Ails Investment Research?

The Precursor Group® May 2001

Introduction

Why is there so much market volatility? Why are investors so often surprised by companies? In large part because the "sell-side" investment research system is so biased toward the company view. The Wall Street firms that produce most "investment research" are rife with potential financial conflicts of interest. There is precious little quality, independent investment research that serves as a source of new ideas or as a check and balance on the "Street/Company" spin.

What Ails Investment Research?

Bundled Services*:* Most investment research is not sold separately, but as part of a bundle of services including access to investment banking and trading liquidity. As part of a financial bundle, research functions largely as advertising for other more profitable lines of business — banking and proprietary trading. Without separate pricing, low quality research is concealed in the bundle of services. Consequently, there is little accountability or measure of research value in the marketplace, and little incentive to improve the quality and objectivity of research. This suggests the current research system simply does not value research much.

Conflicts of Interest*:* Investment research is compromised by financial dependence on other lines of business with very different masters than investors. Investment banking and proprietary trading heavily subsidize Wall Street research, creating both real and perceived financial conflicts of interest. Since a research analyst's compensation is often largely driven by investment banking deals, there exists a stark conflict between the analyst's responsibility to investors and responsibility to the firm's corporate finance clients. The evidence of this conflict of interest is powerful: according to First Call, of the 28,000 U.S. stock recommendations, only ~1% are "sells." This suggests it is not in the interest of most investment research to warn investors in advance of problems.

Expedient to Depend on Company Information*:* Companies are the easiest source of information, and are also highly sophisticated in managing their investment "story" through investor-public relations and lobbying firms. Because original research is difficult, time-consuming, costly and risky, it is simply easier to adopt the company's worldview and version of the facts. Securities & Exchange Commission (SEC) fair disclosure regulations also give companies wide latitude to manage information flow tightly — as long as they are equally stingy to all parties. This suggests the investment research system implicitly re-enforces the incorrect assumption that companies know all, see all and share all.

Rehash Rather than Research*:* Since an underlying purpose of most investment research is to sell companies to investors, Wall Street markets the positive and does not fully research the negative. The large conflict between company and investor interests tends to produce a superficial rehash of public company information or benign commentary on industry developments. The result is a Wall Street system focusing more on "re" than "search" — more backward-looking reporting and reformating, and not much forward-looking searching for what is new and original in the market, the core value of research to investors. This suggests most investment research has become an echo chamber for the company line.

Conclusion

Former SEC Chairman, Arthur Levitt calls the problem with investment research a "web of dysfunctional relationships." The result of a dysfunctional research system is biased and poor investment research. This increases market volatility and surprises that blindside investors, skews the market toward investment banking at the expense of investor interests, and doesn't fully help investors anticipate change, capture opportunities and avoid risk.

<u>Quotes from the Industry & Academics</u>

What Ails Investment Research?

The Precursor Group® May 2001

Bundled Services

"*Research analysts have become integral members of the investment banking units….[t]heir compensation is tied importantly to the fee revenue that they generate for the investment-banking unit.*"
Samuel Hayes, professor emeritus at Harvard Business School, June 20, 2000, <u>Wall Street Journal</u>

"*Research analysts have become either touts for their firm's corporate finance departments or the distribution system for the party line of the companies they follow*." Stefan D. Abrams, Chief Investment Officer for Asset Allocation, Trust Company of the West, December 31, 2000, <u>New York Times</u>

"[Y]ou can't get paid for research anymore, because the commissions have been whittled down; you have to look elsewhere for money….Today, it's investment banking – looking for deals to do."
Chuck Hill, Research Director, First Call Thompson Financial, August 14, 2000, <u>Interactive Week</u>

Conflicts of Interest

"I see… a web of dysfunctional relationships – where…the analyst attempts to walk the tightrope of fairly assessing a company's performance without upsetting his firm's investment banking relationships."
<u>Arthur Levitt</u>, Former SEC Chairman, April 6, 2000, Remarks at the Economic Club of Washington

"Analysts must bring in deals, and there is an inherent conflict of interest….Quality becomes a function of the deal calendar. It's only natural that the credibility of sell-side research falls as banking steps up."
Andrew Barth, U.S. Research Director, Capital Guardian Trust Co., October 1, 2000, <u>Institutional Investor</u>

"[A]nalysts affiliated with the lead underwriter of an offering tend to issue more optimistic growth forecasts than unaffiliated analysts….[T]he magnitude of the affiliated analysts' growth forecasts is positively related to fee basis paid to lead underwriters." Patricia Dechow & Richard Sloan, <u>University of Michigan</u>; and Amy Hutton, <u>Harvard Business School</u>, June 1999, Research Paper:"The Relation Between Analysts' Forecasts of Long-Term Earnings Growth and Stock Performance Following Equity Offerings."

"*[T]he way an analyst can get fired is to damage an existing investment banking relationship with a company or sour a future investment banking relationship*."
Mitch Zacks, Vice President of Zacks Investment Research, December 31, 2000, <u>New York Times</u>

Expedient to Depend on Company Information

"*They (analysts) get spoon-fed the information by investor relations officers and they have a very strong tendency to put a positive swing or twist on everything….And like sheep they follow*."
Hugh Johnson, Chief Investment Officer, First Albany Corporation, September 24, 2000, <u>Reuters</u>

With the SEC Fair Disclosure regulations, "nobody's going to have the inside dope. Analysts now will distinguish themselves more on scholarship and analytical ability rather than connections and relationships." Ted Pincus, CEO, Financial Relations Board, October 1, 2000, <u>Institutional Investor</u>

Rehash Rather Than Research

"[*W]e find there's a lack of initiative; they rarely really aggressively question what the company is telling them. What we get instead of research is reporting*."
Gary Langbaum, Fund Manager, Kemper Total Return Fund, December 11, 1997, <u>Wall Street Journal</u>

"Our findings….[suggest] that analysts mostly react to changes in market values rather than cause them."
Eli Amir, <u>Tel Aviv University</u>; Baruch Lev, <u>New York University</u> and Theodore Sougiannis, <u>University of Illinois</u>, September 2000, Research Paper: "What Value Analysts?"

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What Ails Investment Research?
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