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FINANCE

Research Revolution?

Outside experts are set to pick independent data outfits for brokerages

Laura S. Unger has been a hot commodity ever since she left the Securities & Exchange Commission three years ago. As both a Wall Street and Washington insider, she has been in demand to help with big bankruptcy cases, serve on corporate boards, and appear on CNBC. Her latest gig has given her special prominence: She is one of ten $500-an-hour consultants charged by regulators to overhaul Wall Street research.

Unger is a key figure in implementing the government's $1.4 billion settlement with the 10 largest Wall Street firms over allegations of tainted research. The April, 2003, pact resolved allegations from enforcers that the firms slanted their stock analysis to favor their investment banking clients. The SEC and New York Attorney General Eliot Spitzer are forcing the firms to spend more than $430 million to distribute independent analysts' reports along with their own. Spitzer and the SEC picked an independent consultant for each firm and charged them with turning an untested idea into reality.

Their efforts could redefine the research industry. Many of the independent shops have labored behind the scenes for years, catering to high-end hedge funds and institutional investors. Now they will get their first full-blown exposure to retail investors -- and possibly a big lift for their business. "For me, implementing this part of the settlement meant simply working to create a demand for unbiased research," says Unger. "It artificially creates a robust marketplace for independent research [that] did not happen naturally before."

An artificial market maybe, but one that needed hard work and a lot of shoe leather to fashion. Unger, a former SEC acting chair, has $25 million to spend on independent suppliers over the next five years. She met with at least 40 firms and called many more in her quest to pick the independent researchers for J.P. Morgan Chase & Co. Early in the process she decided to base her choices on the researchers' credibility, the quality of their work, the breadth of their stock coverage, and how much they would charge. Over 13 months, she peppered them with questions: Why did you start your business? Where do you see it going in five years? She studied their sources of revenue and their clients -- from tiny hedge funds to big pension and mutual funds. Most important, she examined how their stock picks fared.

Finally, decision day has arrived. Unger is close to inking contracts with three firms -- BOE Securities in Philadelphia, Chicago's Morningstar, and Greenwich (Conn.)-based Renaissance Capital -- to provide stock research to J.P. Morgan's customers. The other nine consultants are also finalizing picks for Wall Street giants. From July 26, some 20 million investors who are clients of the 10 firms will get independent opinions on stocks along with their statements.

Each consultant offers expertise in some aspect of the securities industry. Some hail from money-management or research outfits; others came from boutique investment banks or mutual funds. But the 43-year-old Unger is by far the best-known. Because of her regulatory savvy, she was asked to serve as a corporate governance monitor in the WorldCom bankruptcy and as a Justice Dept. trustee in the Enron bankruptcy, but declined. She's now a board member at Ambac Financial (ABK), Borland Software

(BORL), and MBNA (KRB) and gets $20,000 a pop for speaking engagements. It was her CNBC commentary last year on the ImClone Systems Inc. (IMCL) insider-trading scandal that caught Spitzer's eye. The minute the spot was over, CNBC called with a message: Spitzer is looking for you. "I thought it may have been a practical joker," Unger says. It was no joke -- Spitzer was calling with an offer she couldn't refuse.

The independent consultants' labors are far from complete. Unger and her cohorts continue to slog through a swamp of tricky issues. They meet regularly in New York with officials from the SEC, the New York Stock Exchange, and Spitzer's office (he hasn't attended any meetings), and the questions have been endless: how to develop the technology, for example, to ensure the 10 firms deliver the outside research simultaneously with their own reports? If more than one outside shop covers a stock, which recommendation does the Wall Street firm send out to customers? How to evaluate each independent firm's performance, since the few companies that track this use different yardsticks? "We've been together a year and every time we [meet], some other question comes up," says Piper Jaffray Cos.' (PJC) consultant Thomas Brakke. Says another: "We've been working our buns off."

The enforcers did set some ground rules. Technology upgrades to gather and disseminate the outside reports will be on the Wall Street firms' nickel, not paid for out of settlement dollars. And each firm is stuck with the consultant assigned to it. In other words, no meddling: "They can't fire us," says one consultant. "They can't overrule us."

The selection process, as well as judgments on what defines good research, was left to each expert. "The beauty of this process is that everyone has their own way; this is a grand experiment," says Michael J. Downey, hired to pick outside research sources on 800 companies covered by Bear, Stearns & Co. (BSC). He interviewed about 60 firms and chose 22. He and Michael A. Dritz, the consultant for UBS Warburg Inc. (UBS), also hired a third-party consultant, finance professor Fernando Diz of Syracuse University's Martin J. Whitman School of Management, to evaluate the independent firms' research.

For all the lobbying, not many of the outside firms could afford to roll out the red carpet. "Many of these shops are very small, with one or two people," Unger says. Many are housed in nondescript buildings far from the best addresses. Only one took Unger out to dinner. She eventually began bringing her own water bottle to meetings.

MAKING CONCESSIONS

Unger expected the research shops to cater to her wishes in other ways. If they accepted initial public offering stakes in lieu of cash payments, they had to stop. BOE Securities. Chief Executive Bufus Outlaw promised Unger that he'd get out of investment banking to win the J.P. Morgan job (though he had done only four deals since his firm's 1997 launch). BOE, a minority-owned firm, also agreed to start analyzing 180 stocks that Unger considered her "orphans" because her other two choices for J.P. Morgan didn't cover them. "It wasn't a difficult decision," he says. "Our niche is to hustle when our competitors are unwilling to."

Some research houses decided it was all too much trouble. Independent, after all, often means sending reports only when there's something to say. And in order to earn settlement dollars, it means writing pieces that everyday investors can digest. "Our institutional research is written at a very high level," says Bruce A. Gulliver, president of Jefferson Research & Management in Portland, Ore., who was interviewed by several consultants but not selected. "In order to communicate with the average investor, we had to simplify the concepts. It was extremely difficult."

Other firms pursued the business aggressively. For instance, Unger met four times with Standard & Poor's Equity Research Services -- like BusinessWeek, part of The McGraw-Hill Companies (MHP) --

but she passed it over. Citigroup, Goldman Sachs, and some others did choose S&P, though. She says S&P'S research certainly looked "glossy" but choosing a dominant market player didn't sit right with her. "The spirit of the settlement is to foster innovation and competition," she says. S&P says it is already well-represented among the picks for the other Wall Street firms.

Despite her best efforts, the independent firms could be vulnerable. Institutional investors will get free access to the outside research, too, and that's often information they're paying for now. So Unger and her counterparts worry that the independents' main source of income could end up being cannibalized. Some of the independent experts wonder whether the new research will be used at all. Mark Fichtel, the consultant for Lehman Brothers, says: "What happens if nobody cares? I worry about that a lot."

No one knows what will become of this grand experiment in side-by-side research after the five years are ended and Wall Street no longer is required to pony up. "Regulators are hoping [that] the seed money will give independent research a foothold that will last beyond five years," says Scott Cleland, co-founder of Washington (D.C.)'s Investorside Research Assn., which certifies that research shops are free of conflicts. "The question is, will it change the course of history?" Even if it doesn't, Unger and her colleagues are determined to try.

By Mara Der Hovanesian in New York