

**CEO ADVISER**

*By John Dutton*



# Small Cap Strategy

*Top Wall Street research coverage doesn't necessarily have to come from elite brokerage firms, but how can you find the right "issuer-paid" firm?*

**A SEA CHANGE** may be on the horizon for CEOs looking for quality research coverage of their companies. CEOs have new opportunities, thanks to the many adjustments occurring in the capital markets. This includes small-cap research coverage, which has been on the decline for many years but is now becoming readily available through "issuer-paid" research firms.

\$185,000 annually to cover a stock, estimates Integrity Research Associates LLC, a leading research industry consultant based in Connecticut.

The ongoing dramatic economic and regulatory changes since 2001 have caused numerous experienced Wall Street analysts to leave brokerage firms, many landing at buy-side firms. Many others, however, enjoyed a sell-side environment, and the issuer-paid research firm was born.

Other than the shifting of regulation for issuer-paid research from NASD to the Securities and Exchange Commission under Section 17(b), top issuer-paid firms have structured their operations to be similar to the best research produced on the brokerage platform. The Chartered Financial Analysts Institute issued guidelines for best practices for issuer-paid research in December 2004, recognizing that a new economic model must be established to provide Wall Street research. These best practices closely parallel NASD Rule 2711 governing brokerage platform research.

**PLAYING SAFELY**

The CEO looking to select an issuer-paid research provider should consider several very basic guidelines in select-

As a CEO or CFO, it's important to understand that selection of a top issuer-paid research firm can provide your company recognized quality research coverage, with the impact once ascribed only to top brokerage-firm research. Statistics and history prove that research coverage of a company is critical to its valuation and trading liquidity. But until now, small-cap companies mostly were locked out of that playing field.

Not anymore. The proverbial research "ball" can now be in the CEO's hands. No more waiting for an analyst to call. It's a new capital markets ball game, one that you can play to your company's advantage.

**LET THE GAME BEGIN**

First, a little background on these changes and the role of a top issuer-paid firm.

A continuing decline in commission rates for stock trades in both the United States and Europe has been further impacted by recent moves toward "unbundling" brokerage commissions into trading and research. For brokerage firms that now must rely on commissions to pay for their research operations, these revenue declines are exacerbated by higher operating costs for brokerage research due to new rules imposed by the NASD in 2002.

Coupled with a prohibition on investment banking revenues being used to directly fund research activities, the result has been financial havoc for brokerage research. The direct consequence has been a continued decline in company research coverage, particularly for micro- and small-cap companies, by traditional brokerage platform analysts. It now costs a brokerage firm between \$165,000 and

ing one or two firms for their coverage. They include reputation, size, analyst experience, third-party performance monitoring, compensation and research distribution. There are two things to avoid: 1) issuing equity or equity-related instruments to a research firm as part of its compensation, and 2) having the selected firm provide any investor relations (IR) function in conjunction with its research. Keep in mind that IR and research are two different sides of the same coin.

Paramount to the selection of an issuer-paid research firm is the quality and background of its analysts and its reputation. An issuer-paid research firm's website should provide its analysts' biographies, background and securities industry experience. Analysts who are effective in their coverage have a long history of making money for their clients and this experience should be evident in their resumes.

Research coverage of a company is about helping a user of that research make money; if the analyst is successful, the benefit will flow through to the covered company. Top issuer-paid firms' research is monitored for performance, just as it is for brokerage firms. You can check their performance through a third-party firm such as Investars ([www.investars.com](http://www.investars.com)), the largest of several monitoring firms. If the issuer-paid firm is serious about research, it will have its research performance monitored—the same standard you would look for in selecting a firm to manage your own money.



Look at the other companies covered by the firm and read the research. This should give you a good sense of quality and competence, particularly its coverage of a company with which you are familiar.

Finally, look at the distribution of a firm's research. Research must be read to be effective. Typically, research distribution is accomplished from a company's website and augmented by several electronic institutional and retail services.

While there are many issuer-paid firms that provide research coverage, only a few closely replicate the breadth and quality of brokerage industry research from which many in the industry came. Those firms enjoy widespread acceptance in the

investment community and their experience and reputation should be paramount in your selection. The right selection for a company that can benefit from research coverage can yield substantial results in higher trading volume and relative price performance. We can argue that economics has led to growth of issuer-paid research, but operation of the model is not different from top brokerage research models. It is people and quality that make the difference.

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