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Which matters: "Paying to play" or stable business relationship? Evidence on analyst recommendation and mutual fund commission fee payment☆

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ABSTRACT

This paper investigates the factors that affect the likelihood of maintaining a stable relationship between a brokerage firm and its client funds and the effect of such a stable business relationship on analyst recommendations. We find that young funds, particularly those in small fund families, have more incentives to maintain business ties with their current brokerage firms. A common ownership affiliation between a fund and a brokerage firm or with a third institution further enhances the probability that the brokerage firm and the funds will maintain a stable relationship. More importantly, analysts issue more optimistic recommendations on stocks that are held by their brokerage firms stably related funds (SRFs) than on stocks that are held by other funds. The effect is more pronounced after excluding large firms. The results are robust after controlling for underwriting relation, commission fees, funds' shareholding and other factors.

1. Introduction

Existing business ties with clients are important not only in the retail business but also in finance. Cliff and Denis (2004) find that past underwriting deals with firms are more likely to help investment banks obtain future business from the firms. Ljungqvist et al. (2006) show that the most important factor in determining whether an investment bank wins either debt or equity underwriting mandates is the bank's past dealings (such as prior lending relationships) with the issuer and the strength of the relationship. A seminal paper by Firth et al. (2013) further shows that business ties (measured by commission fee payments) between brokerage firms and mutual fund companies affect analyst recommendations. An analyst provides more favorable recommendations on stocks that are held by the mutual fund clients of the analyst's brokerage firm. The optimism of the analyst recommendation is positively related to the number of shares held by the brokerage's client funds and the amount of the commission the brokerage firm receives from the client funds.

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In the current study, we add to the literature by investigating not only how the amount of commission fees received by brokerage firms affects the recommendation bias of the affiliated analysts but also what additional effect a relatively stable business relationship between brokerage firms and their client funds may have on the recommendation bias. More importantly, we extend our research by identifying the factors that motivate brokerage firms and mutual funds to maintain stable business relationships.

Drawing from the customer relationship management (CRM) literature (Morgan and Hunt, 1994; Richards and Jones, 2008), we conjecture that a stable relationship between brokerage firms and their mutual fund clients is *no less* important than ad hoc commission fees or deal-by-deal "paying to play" in analyst recommendations. Specifically, we argue that analysts are not only more attentive to the concerns of the funds with which their brokerage firms have stable relationships (i.e., "stably related funds", hereinafter SRFs) but are also more acquiescent in their demands because stable relationships reduce the brokerage firms' costs to serve, streamline the brokerage firms' future revenues, improve information sharing, reduce decision-making uncertainty, and enhance customer loyalty.

Given the fact that fund companies care not only about what assets to hold in their portfolios but also the value and performance of their existing portfolios, we expect that analyst recommendations are more positive or more positively biased on stocks held by their SRFs than on stocks held by other funds. This hypothesis is supported by ample evidence showing that sell-side analysts issue more optimistic recommendations because of their brokerage firms and investment banks' economic incentives (Lin and McNichols, 1998; Michaely and Womack, 1999; Bradley et al., 2003; Jackson, 2005; Cowen et al., 2006; Malmendier and Shanthikumar, 2014). In addition, our hypothesis is also consistent with findings in other business areas. For example, Khurana and Raman (2006), Krishnamurthy et al. (2006), and Zhou and Zhu (2012) show that auditors are more likely to compromise their independence to retain key clients. Petersen and Rajan (1994) and Dass and Massa (2011) find that firms enjoy lower costs of borrowing from banks with which they have prior banking relationships.

Furthermore, in the context of corporate governance, Chen et al. (2007) show that only independent institutions with long-term investments and concentrated holdings exert monitoring, whereas for other institutional investors, either their monitoring ability is compromised due to business interests, or they trade on their information for short-term gains instead of monitoring for shared long-term benefits. Although the primary interest of the current study is not how fund companies' long- or short-term investments affect their monitoring in the firms they invest, Chen et al.'s evidence unambiguously indicates that stable relationships between brokerage firms and mutual fund companies affect their economic incentives and need to be considered when analyzing mutual funds' moderating effect in analyst recommendation bias.

We use Chinese open-ended equity funds and brokerage firms to address these issues because the Chinese data contain detailed information on the commission fees paid by each fund to its affiliated brokerage firms, and such detailed information is not available for most other markets. The main results of this study are summarized as follows.

First, the primary factors that motivate brokerage firms and their client funds to maintain stable business relationships are the amount of commission fees, future business potential, and the brokerage firm's resources. Specifically, the proportion of commission fees that a brokerage firm receives from its client funds, fund size, the brokerage firm's net capital, and the number of analysts working for the brokerage firm are positively related to the possibility of maintaining a stable relationship between the brokerage firm and its client funds. In addition, young funds and those in small fund families are more likely to maintain business ties with their current brokerage firms. Furthermore, when a fund company and a brokerage firm are owned by another institution or when a brokerage firm is one of the owners of a fund company, a stable relationship is more likely to be maintained between the brokerage firm and the funds because of additional aligned interests.

Second, consistent with the existing literature, we find that both the amount of commission fees that a brokerage firm receives from its clients and the proportion of stocks held by client funds are positively related to the aggressiveness of the recommendations issued by the brokerage firms' analysts.

Third, analysts make more optimistic recommendations on stocks held by SRFs than on stocks held by other funds. This effect remains consistent under a battery of tests, and the results are robust after controlling for various factors. More importantly, the effect of stable relationships on recommendations varies with economic incentives. When funds do not pay any commission fees, the analysts of SRF brokerage firms actually make less optimistic recommendations than those of "*other*" brokerage firms. In contrast, when the economic stakes are very high, analysts of both SRF brokers and "*other*" brokers issue more optimistic recommendations, and the difference in the recommendations between SRF brokers and "*other*" brokers is not significant.

Fourth, analysts increase (decrease) recommendations on the stocks they cover when these stocks are added in (dropped from) the portfolios of their brokerage firms' SRFs. Consistent with the mixed evidence in corporate governance studies (Shleifer and Vishny, 1986; Kahn and Winton, 1998; Maug, 1998; Borokhovich et al., 2006; Chen et al., 2007), these results further suggest that the effectiveness of a fund's moderating role in recommendation bias is compromised by its own economic incentives.

The current study contributes to the literature in several ways. First, maintaining a stable relationship with key customers has become more important in various industries, and firms spend billions of dollars on CRM each year (Richards and Jones, 2008).[1] However, the effect of stable relationships between brokerage firms and client funds on analyst recommendations has not been fully recognized. The current study provides direct empirical evidence on this important issue and helps fill a gap in the literature. Second, prior studies indicate that institutional investors moderate sell-side analyst recommendation bias; we shed additional light on the literature by noting that this moderating effect is compromised by the institutional investors' own economic incentives and by their ongoing business

[1] A recent Forbes article (June 18, 2013) predicts that spending on CRM software alone will be approximately $36 billion by 2017. http://www.forbes.com/sites/louiscolumbus/2013/06/18/gartner-predicts-crm-will-be-a-36b-market-by-2017/.