
**Financial Analysts:
Best practices in an integrated
European financial market**

**Recommendations from the Forum Group
to the European Commission services**

4 September 2003

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CHAIRMAN'S INTRODUCTION

Four themes have influenced the work of the Forum Group that I have been privileged to chair.

The first was a unanimous view that a European approach to perceived global problems in the investment research industry was best tackled with a forward-looking and principles-based regime, emphasising transparency and self-governance, rather than with a rules-based regime. The suggested Principles for European Investment Research, together with related recommendations from the Forum Group, are therefore set out in the Executive Summary of this document.

The second theme was that the path to any regulatory reform should favour a collaborative, segment-focused, and continuing partnership with the private sector. I believe that the composition of our quite large and heterogeneous Group reflects a judicious balance of private sector practitioners, independent consultants, regulators and professional bodies. Forum members have also sought to enrich their own opinions through regional consultation in an effort to reflect the broad diversity of European market practice. We are particularly grateful for the comments we received, but recognise that this informal consultative process was not exhaustive and that it will clearly have failed to obtain comments from all relevant sources. The consultations must continue.

The third theme was that our work should take into account the whole business chain that links the various manifestations of investment research, ranging from subject companies, producers and distributors, to users, performance measurement consultants and beneficiaries. This theme is evidenced not only by the Forum's diverse membership, but also by the content and structure of this Report. Any review of securities analysis invites a review of its applications within its whole marketplace context. However, in the case of this report, given perceived conflicts, there has inevitably been a particular focus on analysts operating within financial conglomerates and serving multiple constituencies in the business chain. Analysts' jobs and output to investors can be complicated as well as enriched by their employers' organisational structures.

The fourth theme in our deliberations became fully apparent only at a relatively late stage in our deliberations and was evidenced by a vigorous debate on what constituted "best practice". Did this mean best without regard to potential market disruption and the effect of immediate radical change on research providers' or investors' costs? Or did it mean best in the sense of the best compromises available to manage the inherent conflicts in modern market structures? Was the imperative the management of conflict or was it the avoidance and prevention of conflict? Was the prognosis treatment of persistent symptoms or was it radical surgery? We have reflected both sides of this debate in our Report. A majority within our Group felt that best practice in the research industry should be encouraged to evolve rather than be legislated abruptly, and that change should be tempered by practical considerations, especially the need to maintain the flow of research in the European marketplace and also the need not to disadvantage European practitioners in a global context. *Festinate lente!* Our consensual long-term commitment to a principles-based approach to these questions is consistent with this conclusion.

I wish to thank sincerely the multinational team of experts and the organisations to which they belong (as well as other contributors, including the Committee of European Securities Regulators) for their unstinting efforts and teamwork over the past six months to investigate one of the many building blocks of the European single financial market. In this context a special thank you should be addressed to the Rapporteur, whose skill greatly facilitated the work of the Group.

A diverse forum group of twenty-one members is not the ideal structure for unanimous decisions. Predictably, on several issues opinions were polarised between radical reform and conservatism. We have referenced major disagreements in the text; for example, whether research should be “unbundled from transaction execution”; whether it should become a “core service” rather than an “ancillary service” within the Investment Services Directive; to what extent analysts’ remuneration should reflect quantitative performance; and whether analyst qualification should become a legal requirement. Even efforts to reach common definitions were often challenging.

In response to various regulatory initiatives, there was ample and encouraging evidence as this Report neared completion that investment research issues were receiving urgent attention and debate from leaders and other stakeholders in the savings industry throughout Europe. If as I believe there is a perception that established practice in investment research is capable of undermining investor confidence, then it is incumbent on the industry itself to deal with that perception as promptly and efficiently as possible.

While European investment research may not currently stand in need of detailed prescriptive rules such as have prevailed in other jurisdictions, it is clear that more detailed rules should be considered in the future if a principles-based approach does not avert or properly control any market failures. The European Union absolutely cannot and should not be complacent with respect to recent or current practice in the industry.

As the Group discovered during its debates, the investment industry in Europe is truly heterogeneous in practice, culture and regulatory style. But all stakeholders must now engage in a common endeavour to re-establish investors’ trust in financial markets and create a comprehensive and globally competitive financial services industry in Europe. Objective and unbiased investment research is a key component of this endeavour.

The Forum Group submits its Report to the Commission in this spirit.

Ian Mackintosh

EXECUTIVE SUMMARY

In April 2002, it was agreed among the European Commission and Economic and Finance Ministers that the Commission should assess the role of financial analysts and possible measures to improve their participation in the market. In November 2002, the European Commission services set up a market-focused Forum Group of experts to research and evaluate current regulatory and market practice issues, with a view to recommending optimal regulatory and best practice options within an integrated European capital market.

In framing its recommendations to the European Commission services, the Forum Group has adopted a principles-based approach. The Group believes that a framework of rules, reflecting core principles, is the best basis on which to foster a culture of compliance based on the spirit and underlying purpose of any regulation. This should be positive both for the advancement of investor protection and for re-establishing investor confidence in the integrity of European financial markets, within which objective investment research plays a key role.

The findings and recommendations of the Group contained in this report constitute a first step in a forward-looking process which we trust will be developed over time by means of continued and thorough consultation involving national regulators, professional bodies and market practitioners. The principles that the Group considers key to achieving these objectives are set out below, together with specifically related recommendations. These recommendations are further developed in the core of the report.

Consistent with the principles-based approach adopted by the Group, the recommendations deliberately concentrate on actions, behaviours and outcomes, rather than the legal means of delivery. They have been framed so that they could be implemented on a pan-European basis – either through Community legislation or by cooperation among regulators and supervisors in the Member States, assisted by professional bodies and market practitioners. It might be possible for the principles to be implemented primarily by means of locally-adopted rules; or through recognition of industry codes of conduct. It is for the Commission to reflect on whether legislative or other action is required at Community level.

Whatever legal means of delivery is chosen, the Group believes strongly that investment research is a key component of the single market in financial services, and that it should be conducted subject to Community-wide standards of ethics and reliability as evidenced by these principles and delivered through the adoption of the related recommendations.

The substance of the report focuses on the avoidance, prevention or management, monitoring and/or disclosure of conflicts of interest within investment banks. The Group has placed great emphasis on the role of senior management in ensuring the proper functioning of robust conflict management systems and on the role of supervisors in ensuring that this happens.

The report particularly covers conflicts of interest resulting from analyst involvement in new issues and other corporate finance work; best practices for issuers; analysts' remuneration and own account dealing in securities. New issues were found to be an area of particular concern to investors and to have high conflict potential. The report also offers recommendations on analyst qualifications; quantitative measurement of analyst performance; and on the specific cases of dissemination to the retail market, fixed income analysis and 'buy-side' analysts.

The Principles drafted by the Group, along with its Recommendations, which constitute the main substance of the report, are detailed below. The Recommendations have been grouped around those Principles to which the Group considers them most relevant (in some cases more than one), rather than presented in the order they appear in the main body of the Report (see Section references after each Recommendation).

Principles and recommendations relating to European securities research

Principle

Clarity: Research should be fair, clear and not misleading.

Recommendations relating to this principle:

1. Integrated firms should put in place mechanisms preventing the capacity of a firm's Investment Banking department, its staff, or a firm's management from influencing research recommendations improperly. (Section 5.3)
2. Companies should not seek to influence an analyst's recommendation or engage in retaliatory action in the event of an unfavourable assessment. (Section 5.6)
3. Companies should be permitted, at the discretion of the research analyst (other than in the case of corporate finance transactions subject to their own set of rules) to review research before publication for factual accuracy, but in no case should companies be informed of the recommendation or valuation. (Section 5.6)
4. Companies should encourage and not restrict the attendance of analysts at financial information meetings organised in connection with an offering (for example by making attendance conditional on agreement not to publish or to submit research for review by the issuer), nor discriminate in terms of provision of information to analysts. (Section 5.6)
5. Companies should develop their own governance rules covering relations with analysts. (Section 5.6)
6. Listing authorities should consider making adherence to issuer best practice codes a listing requirement. (Section 5.6)

Principle

Competence, conduct and personal integrity: Research should be produced by competent analysts with skill, care, diligence and integrity; and it should reflect the opinion of its author(s).

Recommendations relating to this principle:

7. Research analysts should adhere to the highest ethical standards. (Section 7.3)
8. Analysts should receive on-going training in market practice and in relevant regional laws and regulation. (Section 7.3)
9. Integrated firms should review their internal procedures regularly to ensure compliance with relevant regulatory requirements and with the ethical principles set out by relevant professional and industry bodies and to ensure consistency with this report's recommendations. (Section 5.2)

See also Recommendations 1-3 above.

Principle

Suitability and market integrity: Research should be distributed taking into account the different categories of its intended recipients and the need to maintain market integrity.

Recommendations relating to this principle:

10. While respecting all legal requirements on selective disclosure of market sensitive information, disseminators of research should take reasonable care to ensure that research is not distributed to investors other than the intended audience and that market integrity is not compromised. (*Section 5.11*)
11. Producers of research who target both retail and institutional investors should disclose any earlier publication targeting institutional investors. (*Section 5.11*)

Principle

Conflict avoidance, prevention and management: Analysts' firms should have in place systems and controls to identify and avoid, prevent or manage personal and corporate conflicts of interest.

Recommendations relating to this principle:

12. Consistent with either agreed or proposed Community legislation (including the Market Abuse and Investment Services Directives and relevant implementing measures), integrated firms must identify conflicts of interest between investment banking and research departments and, as appropriate, avoid, prevent, manage, disclose, record and monitor such conflicts. (*Section 5.2*)
13. Regulators should ensure that integrated firms' internal procedures for managing conflicts of interest are adequate and effective; and properly implemented and adhered to. (*Section 5.2*)
14. Integrated firms should ensure that they have in place effective and appropriate procedures to control the flow of information between investment banking and research departments, and that analysts, including research management, should never report directly or indirectly to investment banking. (*Section 5.3*)
15. Integrated firms should bring analysts 'over the [Chinese] wall' only in specific circumstances, documented and agreed by the Compliance and Research departments. (*Section 5.4*)
16. Where analysts are involved in investment banking business and are producing published research, strict controls should be in place, in particular to prevent or control the flow of non-public, sensitive information to the analyst. (*Section 5.4*)
17. Where an analyst has access to non-public market sensitive information, s/he should not subsequently publish or otherwise disseminate research, recommendations or opinions on the subject company to investment clients unless and until any non-public information with which s/he has been provided is in the public domain. (*Section 5.4*)
18. Research produced by selling syndicate analysts should be subject to a quiet period immediately after an offering has been priced. Quiet periods should be uniform throughout the EU. (*Section 5.4*)

19. Quiet periods may be waived in certain specific circumstances, in a manner compatible with the Prospectus Directive, to facilitate the discussion of specific material developments that may occur during the offering period and its immediate aftermath. *(Section 5.4)*
20. There should be no restrictions on the provision of written and oral research and recommendations on new issues by unaffiliated and non-syndicate analysts (including the consumer-facing units of universal banks or integrated firms). *(Section 5.4)*
21. Either (a) analysts ('covered employees') and connected persons should not own securities in sectors on which they are producing research; or (b) where analysts or connected persons are permitted to trade or acquire such securities, other than through a managed portfolio or mutual fund, their employers should have in place effective written policies covering such activities, and monitoring and enforcement procedures, to be notified to all covered employees. *(Section 5.7)*
22. Integrated firms should not link analyst remuneration to individual investment banking or other banking transactions. Consideration should be given to the objective measurement of research-related performance. *(Section 5.8)*
23. Investment banking departments should have no involvement in determining analysts' remuneration. *(Section 5.8)*

See also Recommendations 1-4 and 9 above.

Principle

Disclosure: Conflicts of interest, whether corporate or personal, should be prominently disclosed.

Recommendations relating to this principle:

24. Any research distributed by integrated firms that are selling syndicate members, either prior to an offering or during the quiet period after an offering has been priced, must include prominent disclosures of relevant investment banking relationships; and should not contain recommendations or price targets unless previously published. *(Section 5.4)*

See also Recommendations 11 and 12 above.

General Recommendations relating to all five Principles above:

25. Investment research produced and disseminated in the European Union should comply with the principles and standards advocated in this report, regardless of the location of the subject compan(y)(ies) covered in the research. *(See Section 4.4)*
26. Subject to the requirements of Community and national legislation, where relevant, the dissemination of investment research produced under equivalent rules of non-European jurisdictions should be permitted. Where the dissemination of research from third countries that is *not* produced to equivalent standards is permitted, this should be prominently disclosed. *(See Section 4.4)*
27. The European Union should seek acceptance of European standards relating to the production and dissemination of research in other jurisdictions. *(See Section 4.4)*
28. Buy-side analysts and portfolio managers making recommendations to a public audience should be subject to the Group's recommendations drawn up for sell-side analysts. *(Section 5.9)*

29. The same ethical principles and internal rules applying to analysts and firms producing research concerning equity markets should be appropriately observed in fixed income and other non-equity securities markets, with adaptations reflecting market structure and internal organisational differences. (*Section 5.10*)
30. Education of retail investors – and particularly of fiduciaries responsible for retail collective investment vehicles – should be encouraged. (*Section 5.11*)
31. Analysts in independent houses should be required to respect the Principles of this report. (*Section 6*)

1 MANDATE OF THE FORUM GROUP

The European Commission, in April 2002, suggested to the Council of Economic and Finance Ministers (ECOFIN), meeting informally in Oviedo, Spain, that the Commission should assess the role of financial analysts and possible measures to improve their participation in the market. Ministers agreed with this suggestion. As a first step towards fulfilling this mandate, the Commission decided to set up a market-focused Forum Group of experts¹ composed of market practitioners from all relevant constituencies, including those representing the sell-side and buy-side² in securities markets, along with other experts from legal, compliance, accounting, academic and regulatory backgrounds.

The mandate given to the Group was **to research and evaluate current regulatory and market practice issues concerning financial analysis, notably those pertaining to the assessment of securities traded on debt and equity markets, with a view to recommending optimal regulatory and best practice options within an integrated European capital market.**

Accordingly, this Report documents and discusses industry best practice and related regulatory treatment in Europe, taking into account recent developments in other jurisdictions, notably the United States. It also aims to assess whether the regulatory provisions concerning financial analysis contained in the adopted Market Abuse and proposed Investment Services Directives provide a sufficiently comprehensive framework for protecting investors and maintaining market integrity in the European Union.

What the mandate does not cover

The mandate for the Group deliberately *excludes* issues relating to credit rating³ agencies. This decision was taken to reflect the fact that much of the analytical activity that credit rating agencies undertake relates to default risk analysis³ (this activity produces its own potential conflicts of interest) rather than to relative value analysis³ – the main focus of our report. Other specific regulatory issues that arise with regard to rating agencies, such as their role in the framework for regulatory capital, were also deemed to be best considered separately.

¹ A list of members of the Group is attached at Annex 1.

² The 'sell-side' is the segment of the securities market whose primary business is the origination, marketing or sale of securities to both institutional and retail investment clients. The 'buy-side' is the segment of the securities market (generally investing institutions such as mutual funds, pension funds, money managers and insurance firms) who manage investments either for themselves or on behalf of other investors. These terms, along with others, can be found in the Glossary at Annex 2 to this report.

³ See Glossary at Annex 2 for a definition of these terms.

In this context, the Group notes the recent US Securities and Exchange Commission (SEC) Concept Release on credit rating agencies⁴ and the interest shown by the European Parliament on the subject. It also notes that the European Securities Committee (ESC), at its meeting of 23 May 2003, invited the Commission to address this issue⁵.

Nevertheless, the Group considers that analysts employed by credit rating agencies should be subject to ethical principles similar to those recommended in this report.

Likewise, the Group has not considered in any detail the issues relating to the reporting in the media of investment research recommendations, though it notes in Section 5.11 the relevance of Article 6(5) of the Market Abuse Directive (and its related implementing measure) in this context.

⁴ See <http://www.sec.gov/rules/concept/33-8236.htm>

⁵ Further details are available in the minutes of the ESC meeting at http://europa.eu.int/comm/internal_market/en/finances/mobil/docs/esc/meeting-05-2003-report_en.pdf

2 POLITICAL, ECONOMIC AND MARKET CONTEXT

It is useful to set the Oviedo mandate and the role of financial analysis and analysts within a broader political, economic, and market framework before attempting to draw conclusions on any need for, and/or shape of, legislative, regulatory, or industry reform.

In Europe, the objectives set out in the Declaration by Heads of State and Government at the Lisbon European Council⁶ in March 2000, the successful introduction of the euro in 12 of the EU member states, and progress towards completion of the Financial Services Action Plan⁷ by 2005, are key elements in setting the main trends for future European developments and provide an important context for the Group's work.

Globally, the major downturn in equity markets since their peak in 2000 has shaken the confidence of investors, in particular retail investors, and has contributed significantly to the exposure of market abuses that have undermined faith in the integrity and proper functioning of financial markets as a whole. As these abuses have been uncovered and investigated, public attention has been focussed on the conduct of many constituencies in the investment business chain, including corporate executives, auditors, accountants, intermediaries and indeed the investors themselves.

Among these constituencies, sell-side analysts employed by integrated firms⁸ have come under scrutiny because of allegations that in some cases in the United States they have misled investors through misrepresenting their own views on whether to buy, sell, or hold securities. This has affected investor confidence in the efficiency and effectiveness of global capital markets.

The restoration of investor trust and confidence in financial markets is vital for the future economic development of Europe. Where abuses are proven, appropriate sanctions must be implemented. However, it is vital that public and private stakeholders in the investment research industry should understand the nature of potential abuses and should initiate credible measures designed to prevent their recurrence.

Investment banks⁷, and the analyst teams they employ, as well as independent research providers (in other words, providers that are not affiliated to integrated firms), play a key role in the proper functioning of markets and the maintenance of their liquidity and efficiency. Research produced by financial analysts provides investors with interpretation of financial and economic data on traded securities. It also serves the interests of the companies they cover, including small and medium-sized issuers, and can thus facilitate the raising of capital. It is critical to ensure that such research is reliable and objective. Therefore, in seeking to deal with potentially abusive practices, it will be important that regulators do not discourage or prevent the provision of research.

⁶ More information can be found on the European Commission's website at http://europa.eu.int/comm/internal_market/en/finances/actionplan/index.htm

⁷ More information can be found on the European Commission's website at http://europa.eu.int/comm/internal_market/en/finances/actionplan/index.htm

⁸ See Glossary at Annex 2.

Recommendations and solutions relating to the maintenance of analyst objectivity in Europe should respect and reflect the nature, structure and practices of European financial markets. But European markets are part of a global marketplace and cannot be treated in isolation. So in the Group's work there should be due regard for decisions elsewhere which bear on the role of analysts and the objectivity and integrity of research. In the USA, for example, one outcome of recent investigations has been an out-of-court settlement, without admission of liability, between a number of large integrated firms and the SEC. Comprehensive regulatory reforms have also been implemented in the US. While primarily relevant to the US market place, such developments will necessarily have some global impact because the firms they affect are globally active, including in Europe, and in the interests of expediency and efficiency, these firms may well decide to adhere to US rules in other jurisdictions.

Against this background of changing practice, the Group considers that its advice to the European Commission in fulfilment of the mandate should be to follow a principles-based approach. It seeks to combine a high level of self-governance, sound ethical codes of practice, regulatory supervision and compliance with a set of clear principles of conduct covering conflicts of interest and other issues relevant to the analyst's role.

3 A PRINCIPLES-BASED APPROACH

The Group has sought to identify principles-based guidelines that could be implemented on a pan-European basis – either through changes to European law or by cooperation among regulators and supervisors, working closely with professional bodies and practitioners in the Member States – to govern the conduct and ethical standards of analysts and of those who manage their endeavours. We believe that a principles-based approach to regulation (combined with self-regulation, implemented by the boards and management of firms employing analysts), is more likely to protect the interests of investors than one based predominantly on detailed rules. It is also the approach that is most likely to lead to global convergence.

The Group therefore recommends the avoidance of prescriptive legislation or regulation that might cause markets to function less efficiently, stifling analytical efforts and disadvantaging Europe in the global marketplace; or might lead to a regime based on superficial probity, allowing unscrupulous market participants to circumvent the rules. A basic framework of rules, reflecting core principles, is more likely to result in compliance based on the spirit and underlying purpose of any regulation. That should be positive both for the integrity of European markets and for the advancement of investor protection.

The Group considers that European regulatory frameworks should be consistent with the principles and recommendations contained in this report. In order for such an approach to be effective, it would be incumbent on regulators to monitor effectively – both at the licensing stage and on an on-going supervisory basis – the existence of documented procedures and guidelines, as determined by each regulated entity, in order to ensure compliance with such frameworks. Regulators also need to ensure that, where necessary, corrective or enforcement action is taken, including, where appropriate, the application of sanctions.

The Group recognises the commercial reality that many investment firms are operating within a global marketplace for investment research, and that incremental costs can result from divergent regulation in different jurisdictions⁹. We therefore suggest that the EU should attempt to reach policy solutions that are not only pan-European but also, as far as possible, compatible with those being developed in the US. A principles-based approach is more likely to achieve this, whilst reflecting distinctive European market practices.

The Group has therefore agreed a set of principles for the production and dissemination of research, set out below. Together with the recommendations in this report, the Group believes that they provide a sound basis for ethical practices that effectively manage and/or disclose the most important conflicts of interest. In some jurisdictions, self-regulatory or professional bodies already have a role in ensuring the ethical conduct of individual analysts. Whatever method of delivery is adopted, European regulators will need to work in tandem with relevant regulatory or professional bodies, and with practitioners, senior managements and compliance officers in the private sector to ensure that these principles are reflected in market practice.

⁹ Annex 3 provides information on the regulatory position in the existing and new Member States.

Principles relating to European securities research

Clarity: Research should be fair, clear and not misleading.

Competence, conduct and personal integrity: Research should be produced by competent analysts with skill, care, diligence and integrity; and it should reflect the opinion of its author(s).

Suitability and market integrity: Research should be distributed taking into account the different categories of its intended recipients and the need to maintain market integrity.

Conflict avoidance, prevention and management: Analysts' firms should have in place systems and controls to identify and avoid, prevent or manage personal and corporate conflicts of interest.

Disclosure: Conflicts of interest, whether corporate or personal, should be prominently disclosed.

The Group believes that, in general, analysts and firms complying with the spirit of the principles set out above are unlikely to embark on the type of fraudulent and unethical practices such as those alleged and recently highlighted in the Global Settlement in the US.

In this context, the Group notes with approval the declaration by the G8 countries at their recent summit in Evian¹⁰, which highlighted the importance of integrity, quality and accessibility of reliable financial information; and called on financial analysts and other market participants to abide by these principles. The Group also awaits with interest the forthcoming IOSCO principles.

The Group is also supportive of the work of the European Federation of Financial Analysts Societies (EFFAS) and of the Association of Investment Management and Research (AIMR)¹¹. It recognises the importance of continuous training and a sustained commitment to codes of ethics for research analysts, accompanied by enforcement measures as needed from regulators and/or professional bodies.

¹⁰ 1-3 June 2003. See G8 declaration on Fostering Growth and Promoting a Responsible Market Economy:
http://www.g8.fr/evian/english/navigation/2003_g8_summit/summit_documents/fostering_growth_and_promoting_a_responsible_market_economy_-_a_g8_declaration.html

¹¹ More information can be found in Annex 4 and at <http://www.effas.com/> and <http://www.aimr.org/>

4 RESEARCH IN THE EUROPEAN CONTEXT

4.1 What do we mean by 'investment research'?

The term '**investment research**' can cover a variety of products whose primary objective is to provide analysis and recommendations to assist in the taking of investment decisions.

The Group did not seek to produce a strict definition of investment research for the purposes of this document. It notes the existence of a number of different definitions used by different bodies and in legal instruments.

For example, the European Commission services (DG Internal Market), in a working document¹² relating to the implementation of Article 6(5) of the Market Abuse Directive use the following formulation, to a large extent based on advice received from the Committee of European Securities Regulators (CESR)¹³:

“Research or other information recommending or suggesting investment strategy’ means:

- (a) information produced by an independent analyst, an investment firm, a credit institution, a credit rating agency or an individual employed by such a person that, directly or indirectly, expresses a particular investment recommendation in respect of a financial instrument or an issuer of financial instruments;
- (b) information produced by persons other than the persons referred to in (a) which directly recommends a particular investment decision in respect of a financial instrument.”

This Group is focusing on information produced by research analysts, that is to say a sub-set of the issues mentioned in the first bullet point above.

The proposed Investment Services Directive, which, if adopted, will for the first time include “investment research and financial analysis or other forms of general recommendation relating to transactions in financial instruments” as an ancillary service (see Section 7.2), does not currently provide for a definition of investment research as such.

¹² See http://europa.eu.int/comm/internal_market/en/finances/mobil/marketabuse/insider_dealing/art-5_en.pdf

¹³ Dated 31 December 2002.
See <http://www.europefesco.org/DOCUMENTS/RECENTPUB/02-089d.pdf>

4.2 What do we mean by 'analyst'?

The Group has attempted to define 'analyst' (referred to in certain markets as 'research analysts', in others as 'financial analysts') as follows.

"Subject to high standards of integrity, an analyst is a suitably-qualified investment professional, typically employed by an integrated firm or investment bank, independent research firm, brokerage firm, fund management house or institutional investor, possessing either acknowledged competence or professional qualifications in the field of financial analysis. An analyst may also be self-employed or act as a consultant.

S/he provides third parties (ie an analyst's employer or its clients) with verbal and written analyses based on established financial analytical techniques. S/he is primarily responsible for, contributes to, or is connected with, the interpretation of economic, strategic, accounting, financial and non-financial data relating to securities issued by companies and/or public sector issuers, and/or industry sectors, in order to forecast their results and assess the securities' value for use in taking investment decisions."

This definition, which does not include financial journalists, reflects the view in the Group that the term 'analyst' should imply a certain depth and quality of written work; and investors should be entitled to expect minimum standards of qualification and integrity. The Group has not sought to define the term for use in any regulatory text. Such a definition would need to be very precise; otherwise there is a risk that it might capture functions (for example, the production of internal sales notes to the trading department that are not published) where conflicts of interest may not be relevant. That said, it is clear that the principles set out in this report would also have relevance for other types of investment professional, including those working in corporate finance (see below) and sales.

The different functions attributed to research analysts that fit within the overall definition above¹⁴ depend on the nature of the clients served. Some of the main types of analyst are:

- **Sell-side equity analyst:** a research analyst covering one or more economic sectors on a national, European, or global scale, employed by an intermediary such as a brokerage firm. Sell-side analysts' investment recommendations are often published to a sell-side firm's investment clients or, in some circumstances or jurisdictions, are made available to the public.
- **Buy-side equity analyst:** a research analyst employed by an institutional investor, such as a mutual fund. Like sell-side analysts, buy-side analysts usually follow one or more sectors on a national, European or global basis. They typically focus on whether an investment is suitable for the firm's investment strategy and managed portfolio(s). Consequently, unlike sell-side analysts employed by brokerage firms, research produced by buy-side analysts is not usually published or made available outside the firm. Buy-side analysts often source research from sell-side analysts, and then use this information as a base for their own research. Some buy-side analysts are also directly involved in fund management.

¹⁴ See Figure 1 below, which attempts to illustrate the various stakeholders in investment research, including different types of analyst.

- **Fixed income analyst:** evaluates and provides recommendations on the value of fixed income securities, including an analysis of an issuer's ability to service debt over the life of the debt instrument. These analysts, who often take part in the development of investment strategies in fixed income products and in portfolio monitoring, are employed by various types of institutions on both the sell-side and the buy-side, as well as by credit rating agencies.

The overall definitions of analysts given above should also encompass supervisory analysts and research management. The Group considers that research management has an important role to play, particularly within financial conglomerates, in managing and mitigating the conflicts of interest faced by analysts.

The term 'analyst' is at times used to describe a variety of other professionals employed in the financial services industry, including corporate finance professionals. In this report, such professionals are not considered to be 'analysts', except to the extent that they are performing the functions of a research analyst, as described throughout this report, in which case the Report's Principles and Recommendations are relevant also to such professionals. Corporate finance professionals can be categorised thus:

- **Corporate finance professional (new issues):** advises the Investment Banking department on whether or not to underwrite issues of stocks or bonds, or engage in other corporate finance activity. They tend not to follow specific sectors (of either quoted or private companies), and their research and recommendations are normally intended only for their employer and/or issuing companies.
- **Corporate finance professional (mergers and acquisitions):** assists the corporate finance department in seeking and implementing mandates for mergers, acquisitions or transfers of ownership. Their research analyses and develops subject companies' industrial and financial strategies. Such analysts often lead or take part in negotiations between the various parties to an M&A transaction.
- **Corporate finance professional (private equity):** analyses non-quoted companies with a view to the acquisition of holdings financed in part by own funds and/or managed third party funds. Research will cover initial investment, development of the acquired assets and options for their future disposal. Such analysts tend not to cover specific sectors and may take part, as a representative of their investment clients, in the management of the companies in which the investment bank has acquired a holding.

4.3 The European market for investment research

In Europe the majority of investment research is produced for an institutional audience. Most financial institutions that receive research are sufficiently knowledgeable to make relative value judgements concerning the research they receive.

Many European retail investors choose to use portfolio managers employed by financial institutions to manage their accounts. In such cases, their contractual arrangements are covered by other areas of Community and national regulation (such as the Investment Services or UCITS¹⁵ Directives). However, retail investors also receive what they often perceive as investment recommendations from secondary sources such as the media and then trade on an execution-only basis through a broker.

4.4 Jurisdictional focus

In the increasingly global environment for investment research, there is pressure, as with other spheres of financial market activity, for convergence of regulatory practices, not just within Europe, but more generally. Some large firms that operate in many jurisdictions will choose, for business reasons, to implement a single compliance regime.

The Group notes the relevance of the developing body of Community level regulation applicable to the investment research industry (see Section 7.2). It believes that the underlying principles of the Group's recommendations are relevant wherever research is produced; and that they are broadly consistent with developments in other jurisdictions, including the US. Nonetheless, the Group has debated the scope of the application of any recommendations for rules and their territorial reach. Our deliberations have focused on:

- investor protection considerations;
- protecting the integrity of European markets;
- creating an environment conducive to ensuring that analysts within Europe produce objective research of a high standard.

There are three potentially different ways of segmenting territorial reach:

- from the perspective of the recipient of investment research;
- from the perspective of the producer/disseminator of investment research; or
- from the perspective of the issuers covered by the research.

¹⁵ Undertakings for Collective Investment in Transferable Securities. UCITS are mutual funds that conform to certain criteria set out in Directive 85/611/EEC as amended, most recently by Directives 2001/107/EC and 2001/108/EC. See http://europa.eu.int/comm/internal_market/en/finances/mobil/ucits/2002-consult/index_en.htm#legislation

The Forum Group **recommends**¹⁶ that:

- Investment research produced and disseminated in the European Union should comply with the principles and standards advocated in this report, regardless of the location of the subject compan(y)(ies) covered in the research. (*Recommendation 25*)
- Subject to the requirements of Community and national legislation, where relevant, the dissemination of investment research produced under equivalent rules of non-European jurisdictions should be permitted. Where the dissemination of research from third countries that is *not* produced to equivalent standards is permitted, this should be prominently disclosed. (*Recommendation 26*)
- The European Union should seek acceptance of European standards relating to the production and dissemination of research in other jurisdictions. (*Recommendation 27*)

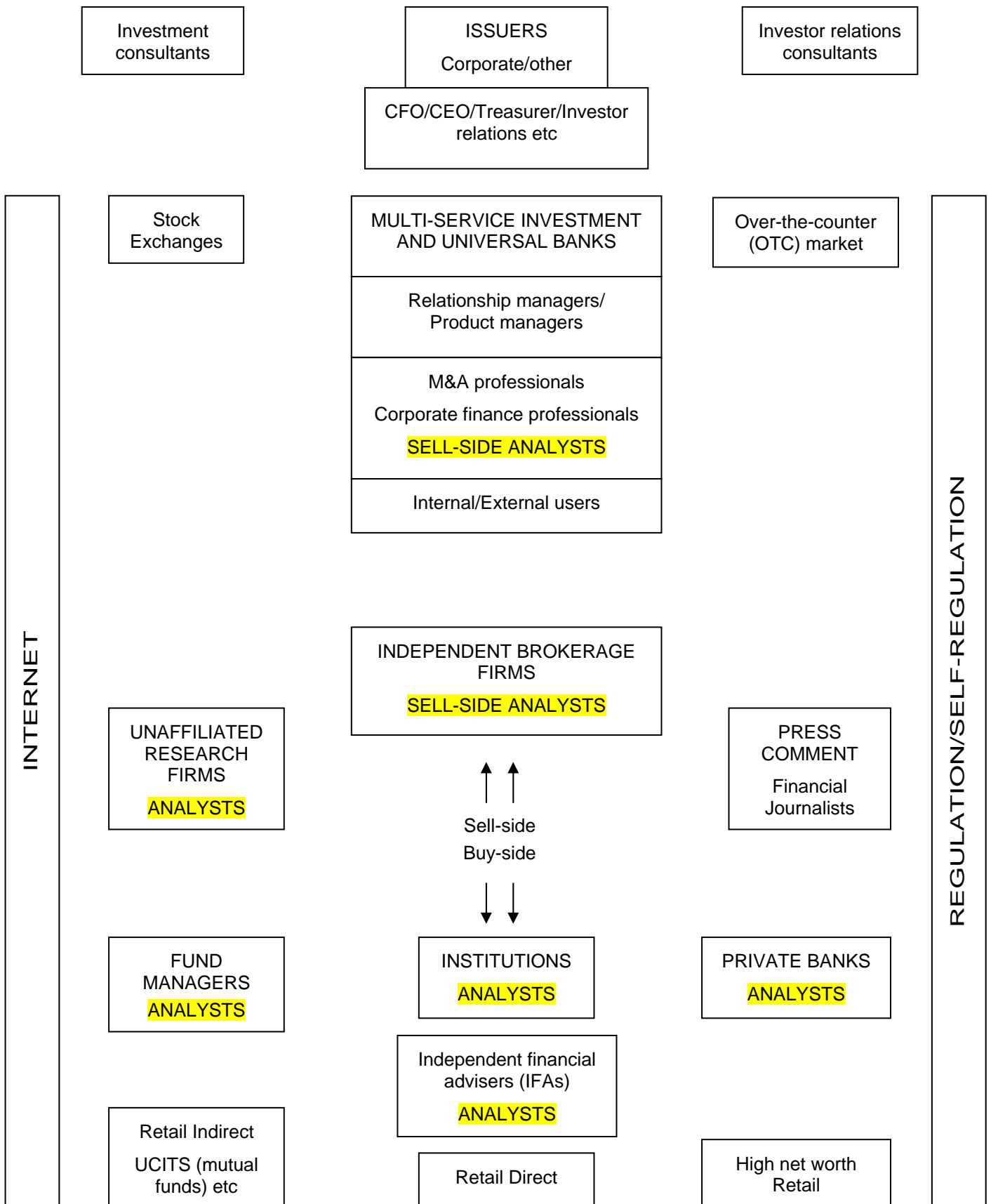
4.5 Stakeholders in the European research market

In fulfilling its mandate, the Group has set out to explore and examine the investment research industry and the different interests of its various stakeholders. We have attempted to consider the whole business chain of the industry, covering the production, dissemination and management of investment research, and including issuers, investment banks, brokers, investors, performance measurement consultants and regulators. Each constituency has the potential to influence or be influenced by other elements in the business chain.

The simplified chart on the following page (Figure 1) attempts to display the principal stakeholders involved. It is not exhaustive and is intended merely as a generic guide. Practices in individual regional market-places will often differ substantially from this generic pattern.

¹⁶ Throughout the text, Recommendations are numbered in line with the numbering used in the Executive Summary.

Figure 1: Investment research stakeholders



4.6 Coverage of SMEs

The maintenance of adequate provision of research covering small and medium-sized enterprises (SMEs) was an area of particular focus for the Group. It merits specific consideration because trading volumes in the secondary market are, in certain instances, insufficient to justify, in economic terms, the on-going costs of research coverage of SMEs.

Traditionally, in several European countries (and especially the UK), SMEs have received coverage from their corporate broker or from a local investment bank in the context of a stock market and/or debt market relationship with either or both of these. However, in many cases, only one or two firms might cover a particular SME. The reduction of the number of analysts and reduced trading volumes in small and medium cap stocks, a result of tougher market conditions, have affected the research coverage of SME issuers.

The perception of corporate broker research as not independent can also reduce its impact and value. However, the Group still considers the corporate broker formula extremely valuable to both the issuer and the investor, so long as investors understand the relationship that exists between the corporate and the corporate broker, and so long as the research provider's role is appropriately disclosed.

There appear to be cases where there is sufficient shareholder demand for coverage that may no longer be available from an appointed corporate broker, and where contact with analysts does not deliver additional coverage. In such cases, the challenge of securing adequate research coverage for investors will require attention from the issuer, the exchange(s) on which such securities are listed and, possibly, from the managers of their initial distribution. To address such cases, some specific ideas, which do not form part of the Group's core recommendations, are explored in Annex 5.

5 CONFLICTS OF INTEREST

5.1 Background and scope

Over the last two decades, the growth of financial conglomerates and integrated firms (principally universal banks and investment banks) has been a particularly important factor in the investment industry. For example, in the United Kingdom, as a consequence of 'Big Bang' reforms in 1986, ownership of London Stock Exchange member firms by non-member financial institutions was permitted for the first time. These "integrated" firms were able to act in a dual capacity as both a broker and a dealer.

The expanding range of activities undertaken by many such integrated firms has increased the potential for conflicts of interests between different constituencies of clients, on the one hand, and between the client and the firm, on the other hand. In integrated firms, corporate finance and other activities often provide a funding contribution that finances a portion of the research budget.

Such developments have significantly increased the necessity for such firms to put in place systems and controls designed to identify, avoid, prevent or manage, and monitor, both actual and potential conflicts of interest, and to ensure, where appropriate, effective disclosure of such conflicts to the market. *However, even where such procedures are in place, they must not be assumed to reduce the ultimate responsibility of senior management in overseeing compliance, applying the standards imposed by each firm's own rules.*

Examples of areas of potential conflict include:

- the involvement of analysts in initial public offerings (IPOs), securities offerings generally and in other investment banking and trading business;
- access to confidential non-public information;
- analyst remuneration practices;
- the ownership of securities by analysts (or their close relations);
- the relationship of a firm or analyst with issuers;
- internal reporting structures.

5.2 Management of conflicts of interest within integrated firms: the role of firms and regulators

The Group notes that the specific practices adopted for the avoidance/prevention and/or management of conflicts of interest vary between firms and Member States. Market practice in this area is also in many cases undergoing review and evolutionary change. In common with its overall approach, the Group does not seek to recommend particular rules with regard to the exact types of arrangements financial institutions should have in place to manage any conflicts.

Moreover, with respect to the following discussion of the role of analysts within integrated firms in the context of public offerings and other investment banking business, the Group notes that practices differ within and between financial centres. The Group does not consider it part of its mandate to produce recommendations on best practices in relation to the distribution of securities, except with regard to the role of analysts in such distributions.

Every firm will tend to have a distinct approach with respect to the avoidance/prevention and management of conflict, designed to suit its mix of business activities, and a solution that is appropriate for one firm may not be appropriate for another. It should be incumbent on the management of each firm to ensure that internal controls are robust and address appropriately the disclosure and monitoring requirements relevant to areas of unavoidable conflict. Regulators should verify the existence and implementation of, and adherence to, such procedures. The Group notes, however, that disclosure alone may not suffice in many conflict situations and makes recommendations later on in this chapter.

The objectives of internal controls will include:

- ensuring that no improper influence is exerted on analysts or the substance or recommendations of published research, from either within or outside the firm; and
- establishing effective internal procedures that protect firms' investment clients' interests by identifying, avoiding, preventing or managing, monitoring and appropriately disclosing any conflicts that arise.

If such procedures are to operate successfully in practice, they will necessarily embody high standards of corporate governance and ethical conduct, thereby safeguarding the objectivity and independence of analysts' opinions. Firms should apply clear and effective sanctions in cases of breach of the rules. Where firms fail to establish and enforce effective procedures, the relevant regulator can be expected to apply sanctions appropriate to the breach in question.

The Group **recommends** that:

- Consistent with either agreed or proposed Community legislation (including the Market Abuse and Investment Services Directives and relevant implementing measures), integrated firms must identify conflicts of interest between investment banking and research departments and, as appropriate, avoid, prevent, manage, disclose, record and monitor such conflicts. (*Recommendation 12*)
- Integrated firms should review their internal procedures regularly to ensure compliance with relevant regulatory requirements and with the ethical principles set out by relevant professional and industry bodies and to ensure consistency with this report's recommendations. (*Recommendation 9*)
- Regulators should ensure that integrated firms' internal procedures for managing conflicts of interest are adequate and effective; and properly implemented and adhered to. (*Recommendation 13*)

5.3 Management of conflicts of interest within integrated firms: management and reporting structures

Investment banking activity, such as underwriting issues of securities, and in particular initial public offerings (but also other primary and secondary offerings)¹⁷ and advising on other types of corporate finance transactions (including mergers and acquisitions) has the potential to create significant conflicts of interest relating to the production and dissemination of research.

An investment banking department's interests lie in securing and executing corporate finance mandates. An investment bank's effectiveness in competing for such mandates may be enhanced if it has expressed a positive research view on a company's prospects. The interests of a firm's securities sales and fund management departments, and of the firm's investment clients (both institutional and private), as recipients of a firm's research, are best served by the production of reliable and objective research reports and recommendations, upon which clients can rely on in taking appropriate investment decisions.

Divergent interests within investment banks were recently highlighted in the US research settlement (commonly referred to as the 'global settlement')¹⁸, where it was argued that some investment bankers put analysts under pressure to publish biased recommendations in order to enhance the flow of investment banking mandates. In these cases, it was argued that the research distributed to clients did not meet appropriate standards of reliability.

A sell-side analyst, as the person within a firm who may be the most knowledgeable about a particular sector, regional market or company, may also contribute to a firm's overall business effort by identifying opportunities for investment banking business. It has been common practice for analysts to assist a bank in its structuring, solicitation, due diligence and execution of both issuance and, in some instances, mergers and acquisition transactions. Analysts may also make an important contribution to the firm's internal screening and risk commitment process. The analyst's objective knowledge is useful, both to the firm and to the company, as it may serve to inform them of the likely market reaction to a proposed transaction.

Sell-side analysts should not, however, be present when market sensitive information relating to a new issue or other transaction is being discussed (this would take the analyst "over the wall") unless either (i) that information becomes public before those analysts provide investment advice (written or oral) on the company in question or (ii) the analysts refrain from disseminating research opinions for as long as they remain 'insiders'. The Group believes that analysts should continue to be allowed to make this valuable contribution to the identification, solicitation and execution of investment banking business, provided that research objectivity is not compromised.

¹⁷ See Glossary at Annex 2 for definitions of these terms.

¹⁸ The settlement resulted in financial penalties and comprehensive regulatory actions against a number of investment banks, designed to reinforce the separation of research from investment banking. See joint SEC/NYAG/NASAA/NASD/NYSE press release at <http://www.sec.gov/news/press/2003-54.htm>

It is the Group's understanding that many integrated firms operating in Europe have put in place "Chinese wall" arrangements and other controls which have the effect of insulating investment banking from research activity and are intended to avoid, prevent or manage conflicts of interest that could jeopardise research objectivity. This would, in any event become a requirement under Article 16 of the proposed Investment Services Directive, if the relevant provision of the Commission's proposal were adopted (see section 7.2).

The most obvious potential conflicts could be mitigated through the adoption of management and organisational structures insulating both sell-side and in-house buy-side research from investment banking.

Such structures could range from radical compulsory separation of research and investment banking, resulting in distinct legal entities, to the establishment of systems within the same legal entity to enhance the operational independence of research. The recent US research settlement stopped short of requiring legal separation of research; however, it does impose a separation of the physical location, management and compensation of research analysts from investment banking and it prohibits analysts from assisting in the solicitation for, and marketing of, new issues and other investment banking business. Furthermore, research budgets must be determined without regard to specific revenues or results derived from investment banking.

Prior to the US settlement, at least one firm moved to a structure in which the research department is operated out of a separate legal entity from that which houses its investment banking businesses.

The Group doubts whether compulsory legal separation of research would be universally appropriate in Europe. While firms would naturally want to analyse the costs and benefits of such a model, the Group believes that it would be likely to reduce the amount of research available. Moreover, small firms might find separation impractical. And, in any event, separation may not necessarily result in better quality research or research that is guaranteed to be free from all improper influence.

In related discussions about the possible reduction or elimination of bundling and soft commission¹⁹ arrangements, particularly in the UK, it has been suggested that a proportion of the research produced by sell-side integrated houses, mainly in the framework of these arrangements, is not of great value to the larger buy-side financial institutions. It was argued that some reduction in the volume of research produced and greater transparency on its true costs, resulting in more specific payments for desired research into targeted sectors or companies, might not be undesirable. Indeed, transparency over pricing should be promoted. Equally, under conditions in which research is paid for separately and not subsidised by the investment banking activities of integrated houses, independent research might more readily provide value.

However, in this regard, we have not yet seen material changes in the structure of the financial services industry, therefore currently the ability of independent stand-alone research firms to operate with full effect has not been proven, despite some successes. If bundling and/or investment banking subsidies were to be discontinued (and if more stringent rules on softing were adopted, further reducing fund managers' budgets for spending on research), there is a danger that the volume of independent research produced might not immediately compensate for the reduced research output from integrated houses. This could also detrimentally reduce the level of information available to the retail market.

¹⁹ See Glossary at Annex 2 for a definition of these terms.

Similarly, most members of the Group do not recommend for the European market a ban on the participation of analysts in the solicitation for, and execution of, new-issue and other investment banking business, provided that this participation is subject to the Chinese wall conditions and other controls as above. A minority of members does however believe that best practice would be served by insulating analysts from pressures favouring positively biased research by prohibiting analyst participation in the selling and marketing of new issues. However, the Group generally recognises that the role of the analyst in IPOs, for example, forms a valuable part of the process of price formation and that this is essential to the risk assessment of the transaction by the underwriters.

All agree that, in all circumstances, measures must be taken, through full disclosure and in other ways, to ensure that the relationship between research and investment banking is properly managed, especially by preventing the investment banking side from influencing research and its recommendations.

In particular, the Group recommends that research analysts, including Research management, should never report directly or indirectly to Investment Banking. Nor should other departments, in particular the Investment Banking department or the firm's management, be in a position to influence research – and especially recommendations – prior to publication. Some firms may decide – or be required if subject to US rules – to channel communications between such units through legal/compliance departments; the Group suggests that this may be a useful way of managing conflicts²⁰. It is not, however, the only way of setting up an effective conflict management system. And, as detailed in Section 5.8 below, analysts' compensation should not be directly or indirectly linked to Investment Banking revenues.

It should be noted that, despite these measures (and others, detailed below) intended to limit analyst conflicts, there is still scope for analysts' objectivity to be compromised. For, although analysts' compensation might be disconnected from Investment Banking, research as a whole within integrated houses will still rely on an effective subsidy from Investment Banking (as noted above). And, if analysts are allowed to assist, Chinese walls permitting, in Investment Banking business, there remains a potential that they may feel under pressure to slant their views in line with the objectives of Investment Banking. A minority of members believes that the recommendations below are falling short of best practice, which should aim to avoid and prevent rather than merely manage conflicts wherever possible. However, all members of the Group consider that for new issues (see below), where there is a high risk of analysts' objectivity being compromised, very high standards of disclosure to investors are needed.

The Group **recommends** that:

- Integrated firms should ensure that they have in place effective and appropriate procedures to control the flow of information between investment banking and research departments, and that analysts, including research management, should never report directly or indirectly to investment banking. (*Recommendation 14*)
- Integrated firms should put in place mechanisms preventing the capacity of a firm's Investment Banking department, its staff, or a firm's management from influencing research recommendations improperly. (*Recommendation 1*)

²⁰ A minority of members consider such arrangements to be best practice.

5.4 Publication of research by analysts involved in investment banking transactions: management and disclosure of conflicts of interest

With respect to sell-side analysts' involvement in investment banking transactions, the Group considers it best practice that analysts should be "brought over the Chinese Wall"²¹ only in accordance with fully documented procedures, whereby any request for a "wall crossing" (or return) must be approved by legal/compliance and/or research management.

In the context of initial public offerings (IPOs), the practice in Europe has been for firms that are members of selling syndicates to distribute to their institutional clients (ahead of a short 'black-out' period prior to a public offering), pre-deal research reports on the issuer, prepared by their respective research departments. Black-out periods are typically imposed to manage a firm's prospectus liability.

Institutional investors and the consumer-facing units of integrated firms have found that pre-deal research reports assist them in their assessment of an IPO as they can convey an analyst's opinions and insight, in addition to material contained in the prospectus which, as the key information vehicle on which investor decisions are based, must meet legal requirements. For example, any *factual* information material to an investor's decision on whether or not to invest in an offering should, in all circumstances, be contained in the prospectus²². Firms should ensure internal management controls are in place to provide for an appropriate review of consistency between research and the draft prospectus.

In any research published before the pricing of an offering by members of a selling syndicate, the Group considers that firms that produce pre-deal research should ensure that it contains appropriate disclosure of the relationship that exists between the firm producing the research and the issuer²³. In addition, firms should consider the use of:

- disclaimers/legends displayed in a prominent position in the research, including:
 - a clear reference indicating that any investment decision should be based only on the prospectus;
 - a disclaimer indicating where dissemination of such research may be unlawful;
- the prohibition of an explicit investment recommendation and of price targets; and
- a clear indication of when and where the prospectus will be available. All subscribers to an offering should have received a copy of the prospectus.

²¹ In other words, where an analyst receives price sensitive or other market sensitive/confidential information related to an investment banking transaction.

²² A requirement under existing Community Legislation (Directive 2001/34/EC, see http://europa.eu.int/eur-lex/pri/en/oj/dat/2001/l_184/l_18420010706en00010066.pdf) and the recently adopted Prospectus Directive, see http://europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.gettxt=gt&doc=IP/03/1018|0|RAPID&lg=EN&display=

²³ Notwithstanding that the research may be produced by a firm involved in an offering of securities, in any case it must still be objective and any statements therein must reflect the honestly-held opinion of an analyst, ie the report must still be "fair, clear and not misleading".

Reports falling into the category of pre-deal research should necessarily comply with all the standards of objectivity, truthfulness and other requirements put forth in this report. The Group further considers that such research should be prominently labelled as being produced by – and under the sole responsibility of – the relevant member of the selling syndicate; and that it has not been endorsed by the issuer or any other members of the syndicate.

The Group notes proposed regulation²⁴ concerning black-out periods and ‘quiet periods’ in the context of offerings of securities, which to some extent reflects existing market practice. Under such arrangements, participants in the underwriting syndicate are restricted with regard to the publication of research during a predetermined period immediately before and after the distribution of a prospectus. This practice has been developed to ensure that the prospectus is the relevant document on which investors base their investment decisions, and to meet related legal requirements.

In order to contribute to the development of an integrated European capital market and to reduce the compliance monitoring burden, the Group recommends that rules on the dissemination of research in connection with securities offerings be applicable uniformly throughout the EU; and notes that they must also be consistent with the requirements of the Prospectus Directive²⁵.

In light of the foregoing discussion, a majority of the Group considers that current European practice should be allowed to continue, subject to proper compliance monitoring by the firm. The majority view is that restrictions on the publication of research by syndicate members may be waived in specific circumstances, for example, where material new information becomes available.

The Group as a whole would support the imposition of a regulatory quiet period, once an offer has been priced, for investor protection reasons. Such a period might be harmonised throughout the EU and cover the time between the pricing and the settlement of the offering. The Group notes that US rules require a quiet period of 40 days in the case of initial public offerings, and 10 days in the case of primary or secondary offerings.

A majority of the Group would not support any restrictions on the use of analysts in marketing an offering, provided that appropriate compliance controls are in place.

²⁴ The UK Financial Services Authority has made a proposal, currently subject to consultation, for a quiet period running from the time the prospectus is published until the securities are admitted to trading, and for 30 days thereafter. See CP171, available on the FSA’s website: <http://www.fsa.gov.uk/pubs/cp/171/index.html>

²⁵ See http://europa.eu.int/comm/internal_market/en/finances/mobil/prospectus_en.htm for links to the Commission’s original proposal and to amendments by the Council of Ministers and the European Parliament.

A minority of members disagreed and considered that investors would be better protected through avoidance and prevention of such conflicts, rather than managing them through disclosure²⁶. In essence, this minority considered that best practice would require selling syndicate member firms to be prohibited from publishing research before the pricing of an offering and to prevent their research analysts from marketing new issues. As a minimum, this minority considers that, where firms do permit research analysts to participate in marketing activities, this participation and its implications should be fully disclosed by research analysts and other relevant personnel in all related interviews and public appearances. Nor would the minority support the waiver on restrictions regarding syndicate members proposed above.

The Group **recommends** that:

- Integrated firms should bring analysts ‘over the [Chinese] wall’ only in specific circumstances, documented and agreed by the Compliance and Research departments. (*Recommendation 15*)
- Where analysts are involved in investment banking business and are producing published research, strict controls should be in place, in particular to prevent or control the flow of non-public, sensitive information to the analyst. (*Recommendation 16*)
- Where an analyst has access to non-public, market sensitive information, s/he should not subsequently publish or otherwise disseminate research, recommendations or opinions on the subject company to investment clients unless and until any non-public information with which s/he has been provided is in the public domain. (*Recommendation 17*)
- Research produced by selling syndicate analysts should be subject to a quiet period immediately after an offering has been priced. Quiet periods should be uniform throughout the EU. (*Recommendation 18*)
- Quiet periods may be waived in certain specific circumstances, in a manner compatible with the Prospectus Directive, to facilitate the discussion of specific material developments that may occur during the offering period and its immediate aftermath. (*Recommendation 19*)
- Any research distributed by integrated firms that are selling syndicate members, either prior to an offering or during the quiet period after an offering has been priced, must include prominent disclosures of relevant investment banking relationships; and should not contain recommendations or price targets unless previously published. (*Recommendation 24*)
- There should be no restrictions on the provision of written and oral research and recommendations on new issues by unaffiliated and non-syndicate analysts (including the consumer-facing units of universal banks or integrated firms). (*Recommendation 20*)

²⁶ The view that it is best practice to avoid and prevent, rather than manage, conflicts of interest, is widely held and has been documented in the Global Settlement and within the UK FSA’s consultation paper CP 171.

5.5 Key disclosures

The Group recognises that in IPOs and other equity offerings, the objectivity of the analyst has the potential to be compromised. While it is true that it might be against the long-term interests of investment banks to oversell IPOs through unduly positive research, recent cases in the US and market soundings in Europe confirm the view that, in the past, IPO research did not always present impartial investment advice.

For this reason, the above sections on management of conflicts of interest within investment banks emphasised the importance of a rigorous avoidance, prevention or disclosure regime covering all relevant potential conflicts of interest involving analysts. The appropriate mix of procedures designed to avoid, prevent, manage or disclose a conflict of interest will depend on the client base and the seriousness of the conflict in question.

It is essential, however, that all conflict situations that cannot be adequately avoided or prevented are appropriately managed, including via disclosure. Any disclosure must be meaningful and readily understandable by investors. The Group considers that key disclosures – such as clearly labelling research aimed solely at the institutional market and research published by firms engaged in an issue or corporate finance transaction – should be prominently displayed on published research documents, with a specific reference, where appropriate, to further disclosures available on the firm's website or from other sources.

Some members consider that it would assist regulators, clients, and other market participants, as well as helping the firm in its relationships with them and in its internal management procedures, if firms were to develop and keep up-to-date a formal written policy on how they maintain the independence and objectivity of research. This would be made available on request to clients and prospective clients (both retail and corporate), disseminated to all firm employees, and posted on the firm's website. A number of members also favour similar disclosure of sell-side firms' prevailing policies on conflict management and remuneration (see also Section 5.8 below).

5.6 Conflicts of interest involving relations with issuers and other investment banking clients

Investment banking contains areas of potential inherent conflict involving research and corporate finance, typified by the offering process for new issues. It has contributed to some biases experienced in both European and US markets in recent years, when there has been much competition for business between the investment banking departments of integrated firms.

Companies will understandably expect research coverage from selling syndicate firms. For this reason, companies may wish to determine a research analyst's views on the company at the point where the investment bankers are competing for their business. The views expressed in the past (or those expected to be expressed after an offering) by a firm's research department may therefore weigh heavily in the award of a mandate, with the potential result that firms whose analysts do not have a sufficiently positive view could be excluded from the transaction. In addition, issuers may seek to vet research reports produced by both syndicate and non-syndicate analysts prior to publication, and may seek to influence analysts so that they adopt a more positive stance.

As a separate matter, research departments have their own interests to protect, with a view to maintaining their relationship and dialogue with companies they follow. Despite their natural desire to be the subject of favourable research coverage, it is in companies' own long-term interest to establish a relationship of trust with analysts so that the latter can adequately fulfil their responsibilities to investors. So whilst, clearly, an issuing company has a commercial freedom to place its corporate business wherever it chooses, consistent with its fiduciary obligations, explicit threats to limit analyst access to management or to analyst briefings, or to place the business elsewhere, either in the context of an offering or in the ordinary course of business, have the potential to undermine analyst objectivity.

And whilst it seems inevitable and natural that a financial institution should legitimately benefit from respected relationships that their sell-side analysts may have established with company officials and senior management, as previously noted, this must be balanced by strict controls on any involvement of analysts beyond their simply providing introductions to issuer officials for their corporate finance experts.

To the extent that they are solicited, companies should limit comments on research reports to matters of factual accuracy. Analysts should not subject their valuation or recommendation to review by subject companies. Where they do not review research before publication for factual accuracy, there is no reason why, subject to the agreement of the analyst and/or his/her employer, companies should not receive a copy of the produced research at the same time as investors in the market.

Companies should also refrain from bringing pressure on, or retaliating against, analysts through linking the content of reports to other corporate business that may be under consideration for analysts' firms. Furthermore, when approached by analysts requesting information, or at financial information meetings organised in connection with an issue or otherwise, corporates should not discriminate in favour of particular analysts and should avoid selective disclosure of material price sensitive information²⁷.

Where financial information meetings are organised in connection with an issue or by analysts' professional bodies²⁸, no restrictions should be placed on the attendance of sell-side analysts who are not members of a selling syndicate, or on analysts who work for unaffiliated research organisations. There should be no obligations on these analysts to agree not to publish research on the issuer, and no requirement that any such research be cleared by an appointed lead manager.

The Group considers that unaffiliated analysts should be permitted and encouraged (by listing authorities and by relevant market participants such as syndicate members and issuers) to publish independent research as a means of ensuring the dissemination of a balanced perspective on the issuer²⁹.

²⁷ This would, in any event, be contrary to Article 6(3) of the Market Abuse Directive, if the information concerned is 'inside information' within the meaning of Article 1(1) of the Market Abuse Directive. Article 6(3) makes clear that such information must be publicly disclosed promptly. This contrasts with the position in the US, which exempts credit rating agencies and the media.

²⁸ As is the case, for example, in France, where meetings are organised with issuers and la Société Française des Analystes Financiers (SFAF).

²⁹ In Annex 5, the Group explores possible arrangements that might be taken by regulatory and analyst professional bodies to promote coverage of SMEs, that might also encourage the production of independent research during an offering.

In many jurisdictions, the financial supervisory authorities do not have significant oversight over issuers, with the notable exception of financial institutions³⁰. It is therefore difficult to dictate any specific regulatory action that might be taken in this context.

However, the Group notes that a number of authoritative organisations³¹ have produced, or are in the process of drafting, codes of conduct setting out guidelines or principles for issuer behaviour in this context. The Group suggests that listing authorities might want to consider making adherence to such guidelines a listing requirement. The Group also suggests that companies may wish to include a section on research analysts in their published corporate governance policies.

The Group **recommends** that **companies** should:

- Not seek to influence an analyst's recommendation or engage in retaliatory action in the event of an unfavourable assessment. (*Recommendation 2*)
- Be permitted, at the discretion of the research analyst (other than in the case of corporate finance transactions subject to their own set of rules) to review research before publication for factual accuracy, but in no case should companies be informed of the recommendation or valuation. (*Recommendation 3*)
- Encourage and not restrict the attendance of analysts at financial information meetings organised in connection with an offering (for example by making attendance conditional on agreement not to publish or to submit research for review by the issuer), nor discriminate in terms of provision of information to analysts. (*Recommendation 4*)
- Develop their own governance rules covering relations with analysts. (*Recommendation 5*)

The Group recommends that **listing authorities** should:

- Consider making adherence to issuer best practice codes a listing requirement. (*Recommendation 6*)

³⁰ In France, the Commission des opérations de bourse (COB) places on issuers an equality of treatment obligation: the same information should be provided to all entities (analysts, institutional investors, shareholders, journalists etc).
See http://www.cob.fr/Styles/Default/affiche_page.asp?urldoc=obligation_information.htm.

³¹ Such as the UK Listing Authority (UKLA guidance on the dissemination of price sensitive information is available on the Internet at http://www.fsa.gov.uk/pubs/ukla/lr_guidance-app2-3.pdf), Investor Relations Society in the UK, SFAF and CLIFF in France, DVFA in Germany, AIMR, Ref-IRS and the new AIAF code of conduct in Italy, etc.

5.7 Securities ownership

Analysts' securities holdings and their trading activity – or that of their immediate families – can be a further source of conflict. This mainly arises with respect to securities in the sectors covered by the analyst. If an analyst holds such securities in his/her portfolio (or that of a 'connected person'³²) then, potentially, a buy or a sell recommendation could benefit the analyst's personal risk position (or that of a connected person).

An alternative view is that permitting research analysts to invest and trade in the securities of subject companies and industries may better align their personal interests with the interests of investing clients, provided that precautions are taken to ensure that the interests of investing clients are always placed before the interests of the employee, members of their immediate families, and the firm.

The Group suggests two main options for avoiding, preventing or managing potential conflicts in this area and thus protecting clients' interests:

- The simplest way for analysts to avoid or prevent potential conflicts of interest is for them not to have personal account positions in securities of the sectors on which they are issuing research. A variant of this solution is to require analysts to have an independently-managed portfolio; or to be restricted to holding mutual funds or other forms of pooled investments. Many firms – investment banks, brokers and fund managers – have adopted this approach and make available suitable investment vehicles for their analysts and for other employees.
- Where analysts *are* permitted to acquire or trade personal holdings in securities of sectors on which they are publishing research, other than through managed portfolios or mutual funds, such conflicts should be effectively identified, managed, disclosed and monitored. Their employers should ensure that effective written policies and procedures are in place covering investments by both employees and connected persons, and notified to all 'covered employees'³³, including analysts. Compliance with such policies should be monitored by the relevant department, and sanctions applied by the employer in case of breach. Systems and policies will no doubt vary from employer to employer, but the Group expects that, at a minimum, they will involve routine disclosure of acquisition and trading of covered securities by analysts and connected persons. A number of members also favour appropriate prior approval by the employer of trading of covered securities. Others, however, take the view that it should be sufficient if analysts' personal securities transactions take place only through accounts held by, or known to, the employer (with copies of transactions and statements sent to the compliance department on a regular basis).

Other possible features of employer policies might include:

- firms having specific policies and procedures that adequately prevent "front running" of investment client trades;
- restrictions on trading for determined periods before and after a change in opinion or publication of a report;

³² Any person who is associated with a covered employee by reason of a domestic relationship (ie the spouse, partner and children under the age of 18 of a covered employee) such that the covered employee has influence over that person's judgement as to how to invest his/her funds or exercise any rights attaching to his/her investments.

³³ Broadly speaking, research analysts and other employees that influence research recommendations.

- prohibition of trading inconsistent with the firm’s published recommendations (except in cases where a research analyst might suffer “extreme financial hardship” if s/he could not liquidate these securities, for example in order to purchase medical care);
- prohibition of purchase or receipt of securities prior to an IPO for covered securities.

The Group **recommends** that:

- Either
 - a) analysts (‘covered employees’) and connected persons should not own securities in sectors on which they are producing research; or
 - b) where analysts or connected persons are permitted to trade or acquire such securities, other than through a managed portfolio or mutual fund, their employers should have in place effective written policies covering such activities, and monitoring and enforcement procedures, to be notified to all covered employees..
(Recommendation 21)

5.8 Analyst remuneration

The way in which an analyst is paid can also be a potential source of conflict. There have been a very small number of highly-publicised cases in the US, where such a conflict of interest was clearly evident.

The Group notes that, whilst many investment banks and financial conglomerates will wish to use analysts to assist in the solicitation and execution of corporate finance transactions, it has not been past or current European practice to link analysts’ pay to individual financing transactions. The Group considers that such practices, including the involvement of investment banking departments in the determination of analyst compensation, have the potential to compromise analysts’ objectivity.

In order to reinforce the objectivity of analysts, the Group suggests that, in determining analysts’ remuneration, firms should consider the performance of their recommendations, in addition to all other relevant considerations, such as the quality or originality of the content of their research reports. Section 7.4 explains how quantitative performance measurement systems might be applied to this end. A minority within the Group considered that such performance measurement should be the primary factor in determining analyst compensation. Moreover, some members considered that it would be helpful market practice if firms disclosed their analyst remuneration policy, for example as part of the written policy document referred to in Section 5.5.

The Group **recommends** that:

- Integrated firms should not link analyst remuneration to individual investment banking or other banking transactions. Consideration should be given to the objective measurement of research-related performance. (*Recommendation 22*)
- Investment banking departments should have no involvement in determining analysts' remuneration. (*Recommendation 23*)

The Group would wish to make clear that its recommendations relate to the avoidance and mitigation of conflicts of interest: it seeks neither to express an opinion on the overall size of analyst compensation packages, nor to isolate remuneration of analysts from overall firm profitability. However, a minority within the Group considered that Recommendation 22 should go further and recommend that there should be no direct or indirect link between analyst remuneration or revenues from investment banking or other banking transactions.

5.9 Conflict management and best practice in fund management firms

Fund managers in Europe constitute the bulk of the buy-side and, for these purposes, include institutional investors such as pension funds, mutual funds, insurance companies and charities, as well as private banking and money management businesses, and units of integrated houses performing fund management and in some cases performing multiple roles.

Members of the Group interviewed practitioners in each of the above categories, as well as several relevant professional bodies and trade associations in order to:

- discuss with them any conflicts relating specifically to buy-side analysts; and
- obtain their views on perceived conflicts in other parts of the investment research business chain.

The Group noted that most of the business-related conflicts faced routinely by sell-side analysts in integrated houses were not relevant to buy-side analysts. Buy-side analysts' occupational interests and motivations are indeed closely aligned with those of their in-house portfolio manager colleagues who are, in turn, serving the interests of their firms' investment clients.

In some firms – especially but not only smaller firms – the Group noted that the size of teams dedicated to serving investment customers' interests was often small and that the distinction between an individual's portfolio management role and his/her other roles was less pronounced. In such cases, research analysts often perform the dual function of reviewing or running portfolios and writing and distributing reports on individual securities and collective investment vehicles, for the benefit of both customers and internal users.

Multi-tasked investment teams such as these – typically to be found in stock-broking firms and in the private banking and retail-facing units of large integrated firms – rely not only on their own research but, also, on selective use of sell-side and unaffiliated analysts' contributions with respect to companies, sectors and economic and technological trends.

The Group notes that the value that such professionals add often involves multiple roles as described above, but believes that this would not prevent them from appropriately respecting and observing the principles and recommendations of this report.

Indeed, the Group concludes that, in general, the Principles set out in this Report have a broad degree of relevance to buy-side as well as to sell-side analysts. Particular importance was attached to full and fair disclosure of any conflicts affecting buy-side analysts, availability of buy-side firms' written policies regarding compliance generally, analyst remuneration and analysts' investment and trading activities.

The Group noted that the costs of services provided to fund managers, including research, and the industry's practices for their negotiation and settlement are currently the subject of consultation and rigorous review by regulators, practitioners and professional bodies in certain European centres (see discussion below on Bundling and Softing)³⁴.

As noted elsewhere in this report, some members consider, in the light of their market enquiries and experience that sell-side written research is frequently directed to institutional investors in Europe on an unsolicited basis. Such research typically contains investment action recommendations (such as buy, sell or hold) that are often of little if any interest to institutional recipients.

The Group appreciates that unsolicited recommendations may be of little direct value to portfolio managers, but some members consider that passive acceptance, by the institutional buy-side, of potentially biased recommendations, provides no incentive for sell-side providers to produce objective recommendations. Industry bodies representing the buy-side may wish to encourage sell-side providers of research to observe meticulous accuracy and objectivity, with respect to written investment action recommendations, if any, accompanying written research.

During our discussions, we identified some specific areas of possible buy-side conflict or potential misconduct in areas such as the solicitation of new investor accounts, particularly, where there could be pressures on buy-side analysts supporting marketing activities of fund managers. For example:

- Analysts could be asked to share (for no value received) their own market-sensitive investment and trading strategies or ideas creating potential competition in execution to the detriment of the firm's existing customers;
- There may be occasions when buy-side firms, through their analysts' relationships with the sell-side or, with companies, could apply improper pressure on sell-side firms to provide and distribute research recommendations enhancing the distribution of the buy-side firm's products, such as open-ended investment companies (OEICS);
- Corporate investors (pension funds) might seek to put buy-side management firms under pressure to collude (with analyst support) in market manipulations involving their own securities or those of specific corporate targets; and
- Buy-side analysts could theoretically collude with, or improperly induce companies, sell-side firms and/or their own colleagues, to artificially manipulate the value of illiquid stocks.

³⁴ For example, the current UK Financial Services Authority consultation on Bundled Brokerage and Soft Commission Arrangements: <http://www.fsa.gov.uk/pubs/cp/176/index.html>

However, conflicts such as these would appear to be covered not only by the Principles in this Report but also by the Market Abuse Directive (and its implementing measures), the Investment Services Directive and/or by existing regulation or accepted codes of conduct in European jurisdictions. The Group concluded that, in most cases, any such examples of potential misconduct would be relatively unlikely to involve buy-side analysts more than other classes of fund manager employees.

There were mixed views from buy-side contacts on 'softing'³⁵ and on the bundling, by sell-side houses, of research with transaction execution services, topics which are of relevance to this report since they impact on the funding of providers of research – especially some unaffiliated providers. In this respect, the Group believes that payment for solicited research other than with cash should continue to be permitted subject to the transparency proviso below, at least until the likely market consequences of change become clearer. All contracts for soft payment should be transparent and approved by interested third parties such as customers of fund managers including, in particular, mutual fund investors.

As indicated above, the marketplace consequences of large-scale unbundling of research from execution probably require further debate before any related regulatory or marketplace reforms are undertaken. However, some members considered that unbundling would in effect remove a subsidy from the investment research business chain and might thus increase, in the short term, the direct costs of research users and ultimately investors.

On the other hand, unbundling could also serve to increase transparency regarding the cost of research and could also serve to encourage buy-side users – analysts and portfolio managers – to outsource on a competitive basis precisely focussed, objective investment research that would be more relevant to their needs. Also, it seems probable that unbundling would create a more even trading environment for unaffiliated providers of research to compete with providers in large integrated houses, who typically benefit from funding contributions from their investment banking and/or other profit centres.

Some buy-side analysts (and portfolio managers) are permitted by their firms to publish their research on individual stocks and discuss it with the media. The Group considered that this practice could in some circumstances create a conflict of interest (requiring disclosure) and/or affect the firm's fiduciary responsibility to investment customers. In such cases, some members of the Group took the view that, to assist investors' comprehension, written summaries of interviews or broadcasts by analysts might appropriately be offered to listeners, viewers or readers.

The Group suggests that relevant professional bodies representing institutional investors and individual analysts should be invited to consider whether their codes of conduct might be reviewed with regard to the areas of potential conflict described in this section.

The Group recommends:

- Buy-side analysts and portfolio managers making recommendations to a public audience should be subject to the Group's recommendations drawn up for sell-side analysts. (*Recommendation 28*)

³⁵ The use of soft commission structures. See Glossary at Annex 2 to this Report.

5.10 Fixed income and other non-equity securities research

Fixed income research is principally conducted by sell-side analysts in integrated houses; by unaffiliated providers of research; by buy-side analysts in institutional investment or fund management firms; and to a limited extent in retail-facing units of intermediary firms.

It may be further segmented as follows:

- Research aiming at establishing the degree of credit risk associated with a security (rating or equivalent analysis);
- Research on relative value and market risk associated with individual securities' interest rate, risk premium and liquidity exposure etc;
- Macroeconomic and political environment analysis including economic, interest rate and foreign exchange forecasting.

With respect to buy-side and independent analysts' roles in the fixed income sector, the Group notes no conflicts that differ materially from those faced in the equity sector although, compared with equity markets, we note a lower risk of price manipulation as a consequence of unethical practice by individual analysts, as discussed below.

With respect to sell-side fixed income research, the Group finds, also as discussed below, that conflicts relating to dissemination and production are substantially less significant than in the equity sector, and that the risk of inappropriate research reaching retail investors is reduced. And from the issuer's point of view, the significance of meetings with analysts, as well as the market impact of any distributed research (rating agency announcements being an important exception), appears to be much less than for equity research.

But when sell-side analysts become instrumentally involved in investment banking relationships and in new issue transaction generation, potential conflicts are similar to those confronting sell-side equity analysts. Consequently, we believe that the ethical principles applied in equity markets should also be applied, with appropriate emphasis, in the fixed income market. Indeed, comments received by and from members suggest that analysis conducted for a debt security below investment grade is closer in nature to equity analysis than to analysis conducted for investment grade debt securities.

A number of structural distinctions between equity and debt markets typically serve to diminish conflicts faced by fixed income analysts as well mitigating the potentially adverse impact of any research-related conflicts on retail investors. For example:

- Bond trading globally is overwhelmingly over-the-counter (OTC)³⁶ in structure and therefore tends not to be commission driven. Wholesale-targeted fixed income sell-side research is rarely published or broadly disseminated to retail investors³⁷ and seldom reaches them, except within the context of distribution of new issues, which are subject to the safeguards embedded in the Prospectus and Market Abuse Directives.

³⁶ See Glossary at Annex 2 for a definition of this term.

³⁷ It should nevertheless be noted that throughout Europe many smaller intermediaries, as well as retail-facing units of integrated firms, do indeed disseminate suitably-tailored fixed income research to their private client and retail customer bases. Such research is often adapted from wholesale-targeted sell-side research received by such intermediaries.

- In many cases, research is used primarily to determine in-house trading strategies and, only secondarily, is disseminated to the firm's institutional investor client base. Indeed, the institutional nature of clients means that the latter tend to rely mainly on their own (buy-side) analysis for decisions in this area. The institutional buy-side appears in many cases to place greater value on the liquidity provided by the (sell-side) market maker, on the quality of their trading suggestions and on their execution capabilities, than on their written research.
- With regard to new issue business, the fixed income analyst may interface with the issuer and, also, provide input to a firm's internal credit assessment and capital commitment procedures. The nature of such analysis tends to be less open to subjectivity than equity research.
- Fixed income analysts, acting independently, would seldom have the power to undertake manipulation of the market in widely-traded fixed income securities and profit from it; at a minimum, connivance with the in-house trading desk or with a very large institutional partner, or a highly leveraged derivatives transaction, would be required.

The Group notes that sell-side fixed income research teams in integrated houses are typically called upon to serve three internal constituencies:

- Sales and trading desks covering professional institutional investors and intermediaries;
- New issue origination desks;
- Internal risk management desks.

The Group notes that some integrated houses choose to staff these three functions with segregated teams in order to avoid or diminish potential conflicts for analysts.

In the corporate bond market, especially for non-benchmark issues with relatively poor liquidity, analysts are often likely to be called upon to assist in due diligence work on public offerings (crossing the wall to the corporate finance department). In this case, clearly the same rules as those applying to equity offerings would apply, including the restrictions imposed on account of the Prospectus Directive.

Knowledge acquired by analysts of major strategic investment strategies employed by institutional investors (for example, hedge funds and central banks) should also be treated as privileged information. In such cases, firms and their employees (including analysts recommending such strategies) should be prohibited from trading for their own accounts on the basis of such information. This prohibition should also apply to buy-side and unaffiliated fixed-income analysts (and connected employees) working for the same institutions.

In the area of derivatives, and especially of OTC derivatives, rules relating to the 'suitability' of the product for the client seem to be particularly important. Furthermore, this is also an area in which a firm is very likely to be acting both in an advisory (research) and principal (counterpart) capacity. This potential conflict should be disclosed adequately.

In summary, provided that the code of conduct and/or internal rules of firms cover the areas mentioned above and that compliance officers monitor adequately their implementation, the Group considers that many of the risks associated with fixed income and other non-equity research are likely to be less pronounced than those associated with equity research.

The Group **recommends** that:

- The same ethical principles and internal rules applying to analysts and firms producing research concerning equity markets should be appropriately observed in fixed income and other non-equity securities markets, with adaptations reflecting market structure and internal organisational differences. (*Recommendation 29*)

5.11 Retail

The Group considers it highly important to distinguish between dissemination of research to retail customers and the wider public on the one hand, and to institutional or wholesale clients on the other. As explained in section 4.3 above, retail securities market practice in Europe differs from US practice in that it is more common in Europe for retail accounts to be advised and administered by advisers or professionals, bringing such management under the scope of financial market regulation.

Firms providing such investment services must apply judicious filtering (including 'know your customer' rules) to address the suitability of any recommended products or securities. And, where research is offered to retail investors for their consideration, it is typically reviewed and often rewritten in simplified form to cater for its intended audience (for example, in Germany by research units serving the retail arms of universal banks and in the UK by analysts working purely for the retail arms of large financial conglomerates or for smaller broker-dealers). Such editing may or may not involve retaining the original recommendation(s). In other cases made known to Group members, research departments take care to ensure that all research reports are suitable for retail; the analyst then e-mails or telephones institutional investors with any comments of a more sophisticated nature. We know at least one integrated firm that encourages analysts to leave out recommended investment actions from reports disseminated to institutional investors (see discussion below).

Consequently, the risk of occurrences affecting retail investors in Europe, along the lines of recent US cases, might be regarded as somewhat reduced. The Group is clear, however, as mentioned elsewhere, that Europe must not be complacent.

Potential conflicts of interest might, for example, result in the following cases:

- the editing of sell-side research by retail arms of integrated firms (such as the universal banks) may not eliminate any bias present in the original report or recommendation. Retail investors are likely to be less adept than institutional investors at 'interpreting' what is really meant by any jargon used in recommendations and, indeed, by comparison with their wholesale counterparts, are arguably more likely to act on the recommendation than on conclusions reached after studying the underlying analysis;
- 'leakage' of sell-side research aimed at the wholesale sector, to retail, in particular the often very succinct dissemination via news services, the Internet or the 'popular' press. It would appear that many retail investors consider such investment tips to be 'research'.

Whilst such dissemination has its advantages, the risks to retail investors are, first that eye-catching excerpts may induce retail investors to act differently from how they would act if they had access to full reports and, second, that they might act upon such information after its value has already been reflected in the market, given that research will normally be disseminated to (institutional) investment clients first. In other words, depending upon the medium, recommendations may have been disseminated, considered and/or acted upon by retail investors *after* the price has moved. The problem is most acute where investors act without taking advice first, through execution-only transactions (given, as noted above, the tendency of regulation to be addressed towards provision of investment advice). It should be pointed out, however, that in such cases investors also assume part of the responsibility.

The Group notes that all investments naturally carry varying amounts of market-related risk, which are, as a rule, balanced by the anticipated return on the original investment. Clearly, the Group does not consider it possible or desirable to eliminate such risks for any investors. Nor do we believe that potential conflicts of interest such as those described above can be totally prevented. However, we do consider that such conflicts can be mitigated through good practice and discipline.

In particular, the Group would advocate the following best practices:

- Sell-side research, re-written as described above, should aim at removing any ‘bias’ in either the report itself or the recommendation.
- Disclosure of issue date of first dissemination to other clients, and the market price of the security on that date.
- Making sure that, while retail investors should not be discriminated against in terms of the information they receive, the research made available to them is suited to their needs and expertise. Where research is targeted specifically at the institutional market and/or buyers who have paid for it, its dissemination might be restricted – for example through controlled access websites and closed-circuit television (as practised by some firms and in some marketplaces) – with the effect of preventing ‘leakage’ to retail. Clearly, restricted dissemination should not lead to selective disclosure of market-sensitive information, which would be in breach of the Market Abuse Directive³⁸.

Producers of research should therefore always take reasonable care in the distribution of research, adopting proper policies with respect to timing and channels of distribution, in order to safeguard market integrity and avoid any information asymmetry that might result from knowledge of investment recommendations but not the underlying research.

³⁸ Moreover, in Italy, there are rules preventing selective disclosure to different targets (wholesale or retail investors) where this might lead to rumours and so compromise market integrity. See Annex 3 for further details.

- Education and awareness campaigns sponsored by regulators, working with professional bodies and with market practitioner firms, and aimed at retail investors and fiduciaries responsible for retail-targeted collective investment vehicles, should be encouraged. These can be useful in educating retail investors and their fiduciaries as to the structure of the fund management industry including, in particular, the role of research and how it is paid for and/or commissioned, as well as how to interpret tips in journals or newspapers or how to interpret research reports. The aim should be to explain any inherent risks and conflicts of interest, and ways to mitigate and interpret them.

The Group notes the political sensitivity of press-related issues; but also notes that the press – through either statutory or self-regulatory provisions³⁹ – will be subject to the requirement of the Market Abuse Directive to present research fairly (Article 6(5), see section 7.2). Provided that the press is acting consistently with such provisions, which are designed to protect investors, the Group does not consider that investment research should be excluded or restricted as source material for press commentary.

The Group **recommends** that:

- While respecting all legal requirements on selective disclosure of market sensitive information, disseminators of research should take reasonable care to ensure that research is not distributed to investors other than the intended audience and that market integrity is not compromised. (*Recommendation 10*)
- Producers of research who target both retail and institutional investors should disclose any earlier publication targeting institutional investors. (*Recommendation 11*)
- Education of retail investors – and particularly of fiduciaries responsible for retail collective investment vehicles – should be encouraged. (*Recommendation 30*)

5.12 Rating and recommendations systems

The inclusion of misleading investment action recommendations in published research was at the heart of the conflicts highlighted in the recent US cases. The relative prevalence of ‘buy’ recommendations during the bull market at the end of the 1990s is well documented, as is the response of investors. Effectively, many institutional investors were able to interpret any bias and disregarded the investment recommendation, whilst some retail investors were reportedly more inclined to follow such recommendations.

The Group considers that, in general, there appears to be a better distribution of recommendations since 2002, indicating that practice has responded to such criticism. Nevertheless, it considers that requiring a ‘balance’ of ‘buy’ and ‘sell’ recommendations would not necessarily be in investors’ interests, since the relevance of recommendations will depend upon specific, sector-related or even wider economic and asset allocation considerations, among which the overall orientation of the market will often be paramount. (See also Section 7.4 below on quantitative analysis in assessing recommendations.)

³⁹ The choice of statutory regulation or self-regulation rests with each Member State.

As noted in Section 5.11 above, the leakage to retail investors of institutional investment research containing potentially out-of-date recommendations can be unhelpful, particularly in cases where retail investors are conducting investment business on an execution-only basis. This may happen, for example, if a firm has a policy of disseminating its research first to its client base and then releasing it or its headline content to the media and the wider public, after a certain time-lag.

The Group does not wish to be prescriptive on this issue. However, rating or recommendation systems should provide investment clients with basic information on the methodology followed and the interpretation to be given to the terms used.

6 INDEPENDENT OR UNAFFILIATED PROVIDERS OF RESEARCH

6.1 Background

The Group agreed on some basic observations regarding unaffiliated or independent providers of securities research.

Independents represent a potentially valuable source of unbiased analysis and opinion. Members' findings have revealed that independent research firms are currently growing in terms of numbers and volume of coverage in Europe and the US. As noted elsewhere in this report, some unaffiliated providers believe that they face inappropriate competition from integrated houses, who subsidise their firms' research budgets and often provide free research to the buy-side for marketing purposes.

The Group notes that certain published performance statistics from specialist firms indicate frequently better-timed action recommendations from unaffiliated research providers during the recent bull market. Nevertheless, members agree that the fact that a provider is independent does not *per se* guarantee the quality or added value of its research. Some of the Group consider that, whereas independent research commissioned by the user of the research is likely to deliver high value added for the user, there is nevertheless a risk this would not be the case with mandatory funding of independent research, which is a feature of the US settlement.

Nevertheless, the current climate in the industry represents an opportunity for independents to offer value-added research, often of a customised nature, and possibly increasingly to offer coverage of SMEs, to intermediaries and to institutional investors.

6.2 An EU passport for independent providers

The Group considers that appropriately qualified research analysts – including those working for independent or unaffiliated providers – should be permitted to disseminate investment research throughout the EU.

In this context, the Group debated whether independent research should be treated as a core service under the Investment Services Directive (ISD)⁴⁰, with appropriate exemptions from capital requirements for provider firms or individuals if no relevant activities were being conducted, noting that in most European jurisdictions there is no regulatory framework for independent research businesses – as opposed to investment firms.

There were divided views on this topic. Some members considered that treating investment research as a core service under the ISD was necessary in order to create a level playing field for providers not affiliated with investment firms. (The Commission proposal for a revised ISD⁴¹ treats it as an ancillary service which would not, of itself, merit an EU passport).

⁴⁰ See also Section 7.2 below.

⁴¹ See http://europa.eu.int/eur-lex/en/com/pdf/2002/com2002_0625en01.pdf, published 19 November 2002.

It was thus argued by some members of the Group that continued exclusion of investment research from the list of core services under the ISD might require unaffiliated research firms undertaking cross-border activity to comply with a series of different national regulations, imposing increased costs and possibly implying a reduced supply (or even quality) of research by unaffiliated providers than would be the case, were an EU passport available. Under passporting arrangements, they argued, independent providers would be able to disseminate research throughout the EU on the basis of a home country authorisation, which might include a minimal and ongoing level of qualification for analysts and mandatory linkage to a code of conduct. Such a framework might also be helpful in securing mutual recognition of European standards by other jurisdictions.

In addition, some members of the Group took the view that SME coverage by smaller, localised unaffiliated providers of research would be particularly enhanced by the availability of an EU passport. See Annex 5 for an example of one way of providing an electronic 'platform' to assist in this endeavour.

Other members of the Group considered that introducing investment research as a core service under the ISD could have negative unintended consequences, bringing unaffiliated firms within a regulatory regime that might impose disproportionate compliance costs and thus impact negatively on both the supply of research from such firms and on their numbers. It was thought that national regulation could perhaps be adapted to accommodate the dissemination of cross-border independent research.

6.3 Funding of independent providers – effects of softing and bundling

The Group noted that current regulatory investigations of softing practices might lead to loss of business in the short term for some independent providers who relied predominantly on softing. The Group believes that any national or EU-level reforms or regulations should be introduced on a staged or deferred basis to allow time for unaffiliated providers to renegotiate any softened contracts.

Apart from their concerns over the potential business consequences of reform, unaffiliated houses consulted were generally of the opinion that reforms, especially of bundling, by integrated house providers of research would ultimately lead to a fairer and more transparent marketplace for investment research in which the quality and relevance of the product and service offered would be the determining success factors (see also section 5.9 above on Conflict management and best practice in fund management firms). Integrated houses were more cautious, favouring retention of bundling.

The Group **recommends** that:

- Analysts in independent houses should be required to respect the Principles of this report. (*Recommendation 31*)

7 A REGULATORY AND BEST PRACTICE FRAMEWORK

7.1 The balance of regulation and self-regulation

Section 3 sets out the principles-based approach adopted by the Group in developing the recommendations contained in this report. In creating an optimal framework of regulatory, self-regulatory and best practice provisions, the Group thinks it important to bear in mind the principle of proportionality. Compliance costs relating to regulatory provisions should be proportionate to the contribution made by analysts to the investment business, in order to ensure that investment research activity is not stifled.

In this regard, the Group believes that it is important to consider the role of analysts' professional bodies in the overall framework for supervising analysts.

In addition to offering training and setting out professional qualifications (see section 7.3 below), these organisations issue codes of conduct for their members, covering ethics and best practice. In some cases, such codes⁴² are legally enforceable.

Where regulation is deemed necessary, it should mainly be aimed at ensuring that analysts and firms comply, and have in place systems to ensure compliance, with the Principles set out in this report, including clear enforcement procedures in case of rule breaches.

Section 7.2 below and Annex 3 to this report illustrate the extent of the current and prospective legislative framework of, respectively, European and national rules that affect analysts or are likely to in the future. Annex 4 provides an overview of the various codes in place in Europe.

7.2 Community legislation

Once fully agreed and implemented in the Member States, measures already in the pipeline at European level are designed to set out a broad framework for the management and disclosure of conflicts covered by this report.

For example, the Group has already noted that financial analysis and research is included, as an ancillary investment service, in the Commission's proposal⁴³ for an upgraded **Investment Services Directive**. This means that firms combining research and analysis with other investment business would be subject to the new Directive. Specialised and independent research firms/analysts would remain, as presently envisaged, outside its scope but subject to national supervisory regimes (see also comments in favour of a passport for unaffiliated providers in Section 6.2 above).

The Group notes in particular that the proposal for a revised Investment Services Directive contains a provision that seeks to ensure that investment firms are organised so that client interests are not adversely affected by conflicts of interest between the brokerage and dealing business of the firm. Broker-dealers would be required to identify, prevent or otherwise manage conflicts of interest so that they do not adversely affect investment clients' interests (including those of retail customers).

⁴² Such as that of the DVFA in Germany.

⁴³ See http://europa.eu.int/eur-lex/en/com/pdf/2002/com2002_0625en01.pdf, published 19 November 2002.

Under the Commission's proposal, legally-binding implementing measures specifying the types of administrative and organisational arrangements that broker-dealers would need to introduce would be developed at level 2 of the so-called Lamfalussy process⁴⁴. The Commission's intention is that such measures would permit regulators to react, in a concerted and targeted manner, to occurrences of those types of conflict of interest which warrant particular attention, including those arising from the combination of financial analysis/research and brokerage or underwriting/placing activities.

The provision of general investment recommendations/financial analysis is also subject to obligations imposed by the **Market Abuse Directive**. This Directive, which was adopted on 3 December 2002⁴⁵, establishes transparency standards requiring that persons who produce or disseminate information recommending or suggesting investment strategies to the public, or to distribution channels, *disclose* their interests or conflicts of interest and fairly present such information. In practice, this provision (Article 6(5)) will apply in particular to research analysts, and to those financial journalists recommending investments to the public.

The technical measure drafted by the Commission⁴⁶ to implement this provision takes account of the specific situation of journalists by leaving the choice of appropriate regulation, including self-regulation, to Member States. Pure news reporting on recommendations produced by third parties does not fall under the scope of Article 8 of the draft implementing measure (working document ESC 23/2003), which relates to the general standard for dissemination of recommendations. Moreover, the rules relating to the disclosure of the identity of third parties producing investment recommendations address the specific professional situation of journalists and allow for their sources to be protected.

7.3 Qualifications

This Report has focused mainly on ethics and marketplace practice, which the Group considers at least as important as an analyst's technical or academic qualifications. Nevertheless, the Group notes with approval that practising analysts in many jurisdictions have a richly diverse range of technical qualifications.

Competent research analysts are an essential element in preserving market integrity and investor confidence. While the Group was unanimous on the need for analysts to be fully trained with respect to ethical standards and market practice, and relevant local laws and regulation, it was divided on whether specific analyst qualifications were a necessary pre-condition and should thus be made mandatory.

⁴⁴ See Annex 8.

⁴⁵ OJ L96, p16.
See http://europa.eu.int/eur-lex/pri/en/oj/dat/2003/l_096/l_09620030412en00160025.pdf

⁴⁶ Working document ESC 23/2003. See http://europa.eu.int/comm/internal_market/en/finances/mobil/marketabuse/insider_dealing/ind ex_en.htm.

Some members supported compulsory registration with the local regulator of analysts whose work is disseminated, subject to the possession of a relevant analyst's qualification, which the regulator might wish to specify; and that regulators should require firms employing analysts to publish any such memberships and/or qualifications held by their research writers. Such registration might also serve to meet minimum standards that could form the basis of any EU-wide passporting arrangements (see Section 6.2 above. Other members of the Group (some of whom emphasised the difference between sell-side and buy-side analysts) considered that the necessary basic skills and knowledge of ethics and local regulation/market practice might be achieved through training and qualifications; and that market forces will generally ensure that firms employ analysts of good repute.

The Group encourages both the activities of, and the qualifications offered by, relevant professional analyst bodies operating within Member States, insofar as they relate to the principles and recommendations set out in this report. Qualifications offered include the Certified International Investment Analyst (CIIA) and Certified EFFAS Financial Analyst (CEFA) diplomas offered by EFFAS and its affiliated local societies, and the Chartered Financial Analyst (CFA) programme offered by AIMR.

The Group recognises the importance of allowing candidates choice over languages and qualifications, and of requiring familiarity with local practices and rules (for example on accounting, takeovers and mergers), so as to enable them to operate in different countries and specific jurisdictions. The aim should be to allow all candidates an equal opportunity in the investment research marketplace and avoid discrimination between candidates, (subject to compliance with any applicable Community law and in line with the Principles and overall Recommendations contained in this report).

The Group **recommends** that:

- Research analysts should adhere to the highest ethical standards. (*Recommendation 7*)
- Analysts should receive on-going training in market practice and in relevant regional laws and regulation. (*Recommendation 8*)

7.4 Quantitative measurement of analyst performance

The Group has considered the extent to which it might be useful to measure the track records of individual analysts. This seems particularly relevant, given the emergence of the cult of “star” analysts, in particular in the US, whose reputations are typically not based on quantitative measurement.

There are a number of commercial firms in the market conducting qualitative surveys and quantitative measurement of analyst performance.

The Group was interested in particular in a number of quantitative performance measurement systems available or currently being developed, which will allow the comparison of the quality and accuracy of analyst recommendations over time, on a consistent basis, through making appropriate adjustments for the relative performance of different sectors and markets⁴⁷. Typically, such systems are based on specialist software which is sold to firms on a commercial basis.

⁴⁷ Some members favoured the development of a common standard, with a fully transparent methodology, for analyst quantitative performance.

The Group would emphasise that such systems can only be used as one input to the formulation of any views on analyst performance. It notes that the production of consistently successful recommendations does not necessarily guarantee the quality of the underlying analysis – and vice-versa. This matters in a world where institutional investors may pay more attention to the latter than to the former (see section 5.12 above). Nevertheless, it considers that such quantitative measurement of analysts' performance will frequently be more meaningful for investors, regulators and their employers than existing, purely subjective, qualitative surveys. For example, quantitative analysis might:

- aid employers in securing a better view of how their analysts are performing relative to their peers;
- assist investors when reaching a view on how much weight to place on the views of competing research reports,
- mitigate the views noted among many research professionals contacted by group members, that *purely qualitative* surveys add very little value to the investment research market in that they are often no more than popularity contests; create a distraction factor in the management of analysts; and could be misleading to the whole investment research business chain;
- assist regulators, along with other diagnostic tools, drawing their attention to potential problems regarding investor protection and/or relating to firms' monitoring of analyst objectivity.

However, the Group's views are subject to the following caveats:

- disclosure of analyst track records by firms should not be made compulsory (in fact, those quantitative systems available on the market or in the pipeline typically rely on published data);
- where quantitative performance measurement is published, it should be accompanied with publication of the underlying methodology. Methodologies of both qualitative and quantitative surveys should be rigorously disclosed – especially if results are released for general publication.

7.5 Cross-border redress issues

Where an investor is able to take advantage of investment research or advice provided on a cross-border basis, that is to say provided by a firm not subject to regulation in the Member State of the investment client, the Group considers that there is a need for an EU-level arbitration or mediation process, facilitating simplified dispute resolution and avoiding court procedures.

In this context, the Group notes the establishment in 2001 of **FIN-NET**⁴⁸, the cross-border out-of-court complaints network for financial services, set up at the initiative of the European Commission. FIN-NET is based on co-operation between existing national dispute settlement bodies and is the first fully-functioning cross-border alternative dispute resolution network in the EU.

⁴⁸ For further information on FIN-NET, see the European Commission's website at http://europa.eu.int/comm/internal_market/en/finances/consumer/adr.htm

The network, which aims to make cross-border dispute resolution more user-friendly by overcoming some of the practical problems in handling cross-border complaints, has three main objectives:

- to provide consumers with **easy and informed access** to out-of-court redress in cross-border disputes. The network helps consumers to identify the right scheme for their specific complaint, and gives them all necessary information about relevant schemes in their own language;
- to ensure effective **exchange of information** between the different schemes, so that cross-border complaints can be handled as quickly, efficiently and professionally as possible;
- to ensure that out-of-court dispute settlement schemes from different European countries **comply with a common set of minimum standards**, which guarantee, notably, an impartial, fair and efficient dispute settlement procedure. The participating schemes all agreed in a Memorandum of Understanding to comply with these and other principles in accordance with Commission Recommendation 98/257/EC (on the principles applicable to the bodies responsible for out-of-court settlement of consumer disputes)⁴⁹.

The Group endorses FIN-NET insofar as it covers investment advice or research disputes and suggests it should be extended geographically to the whole of the Internal Market.

⁴⁹ See http://europa.eu.int/eur-lex/pri/en/oj/dat/1998/l_115/l_11519980417en00310034.pdf

8 CONCLUSION

This Group has drawn up a set of five overarching principles for the European investment research industry, together with a comprehensive list of 31 recommendations relating to the various issues it has analysed. These are listed where appropriate in the text and in the Executive Summary. As outlined in the chapters above, the Group firmly believes that its principles-based approach, which seeks to combine a high level of self-governance, sound ethical codes of practice, and compliance with a set of clear principles of conduct covering conflicts of interest and other issues relevant to the analyst's role, is the approach most likely to assist in meeting objectives related to investor protection and market integrity; and to deliver improvements in investor confidence.

The findings and recommendations of the Group contained in this report to the European Commission services meet the mandate set for the Group. They constitute a first step in a forward-looking process, which we trust will be developed over time by means of continued and thorough consultation involving national regulators, professional bodies and market practitioners.

Consistent with the principles-based approach adopted by the Group, the recommendations deliberately concentrate on actions, behaviours and outcomes, rather than the legal means of delivery. They have been framed so that they could be implemented on a pan-European basis – either through Community legislation or by cooperation among regulators and supervisors in the Member States, assisted by professional bodies and market practitioners. Another option would be for the principles to be implemented by means of locally-adopted rules; or through recognition of industry codes of conduct. It is for the Commission to reflect on whether legislative or other action is required at Community level.

Whatever legal means of delivery is chosen, the Group nevertheless believes strongly that investment research is a key component of the single market in financial services, and that it should be conducted subject to Community-wide standards of ethics and reliability, as evidenced by these principles and delivered through the adoption of the related recommendations.