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The Regulation of Financial Analysts

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The regulation of investment research: where do we go from here?

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I propose first to recall briefly the recent wave of worldwide regulatory reform in the area of investment research, then mention the current research-related issues that many regulators are dealing with now (in particular the new European Union Directives). In concluding I would like to raise a few significant questions that may warrant convergent answers going forward.

1. **The recent drive to restore and strengthen integrity in investment research**

Over the past few years we have all participated in an extraordinary focus of regulatory thinking and action on securities research. Unless research is protected from the conflicts of interest inherent and widespread in today's multi-service financial institutions, it will likely be biased, and both the fair treatment of investors and the integrity of markets will be in jeopardy. This risk materialised at the beginning of the new millennium, particularly in the United States, and the publicity generated did much to undermine confidence in all our markets.

Legislators and regulators did not fail to react; 2002 was a watershed for the regulation of investment research. In July of that year the Sarbanes-Oxley Act directed the SEC to adopt rules addressing the conflicts of interest of security analysts and their employers. It should also be recalled that in May of 2002 the NYSE and the NASD had issued detailed rules, approved by the SEC, requiring the separation of analysts and investment banking staff and extensive disclosure of conflicts. It may also be recalled that the French market authorities had issued rules in March of 2002 dealing *inter alia* with Chinese walls and disclosure of conflicts, and prohibiting both trading by analysts in the securities they cover and analyst remuneration based on specific investment banking transactions. The German financial regulator issued rules focusing on disclosure of conflicts at the end of 2002.

The following year was equally rich as the issue of analyst objectivity became truly international. In April of 2003 the so-called "Global Settlement" between a dozen major international investment banks and a coalition of US regulators imposed not only monetary penalties (part of which is to be used to fund independent research) but also standards of behaviour on these banks. A few months later the UK Financial Services Authority issued a series of amendments to its Handbook in the area of research. And in September of 2003 of course, IOSCO published its Statement of Principles for Addressing Sell-side Securities Analyst Conflicts of Interest that insisted particularly on analyst independence and integrity, and transparency of conflicts. A few days earlier the Forum Group set up by the European Commission had issued its report on "best practices" addressing not only analyst objectivity and disclosure of conflicts but also the relationship between issuers and analysts, and recommending for example a uniform quiet period in the European Union and the free circulation of third country research reports subject to rules deemed equivalent to EU standards.

In 2002 and 2003 research had became a major subject of regulatory attention throughout the world not only because of increased scrutiny of the quality of information provided to investors since the end of a particular exuberant bull market and evidence of unacceptable conduct by a few analysts during this period, but also because research is an obvious target for any attempt to adopt global standards: a large portion of it is produced by firms that have a worldwide reach, and it directly affects the efficiency and integrity of markets on a daily, cross-border basis.

2. Current developments in Europe

The current situation with respect to the regulation of research, in the eyes of a European, is dominated by the entry into force of two recent European Union framework Directives (i.e. Directives allowing for the adoption of implementing measures) . The Market Abuse Directive of April 2003 and its implementing Directive of December 2003, which should have been implemented into the national regulations of the Member States by the fall of last year, contain detailed provisions on the "fair presentation" of research and the disclosure of conflicts of interest.

The implementing directive, closely based on the advice provided to the European Commission by the Committee of European Securities Regulators (CESR), provides for example, regarding fair presentation, that the producer of the research must ensure that:

- "facts are clearly distinguished from interpretations, estimates, opinions and other types of non-factual information";
- "all projections, forecasts and price targets are clearly labelled as such and that the material assumptions made in producing them are indicated";
- "any basis of valuation or methodology used to evaluate a financial instrument or an issuer of a financial instrument is adequately summarised"; and
- "any recommendation can be substantiated as reasonable upon request by the competent authority".

Regarding disclosure of conflicts of interest, the implementing directive provides that research reports must disclose "all relationships and circumstances that may reasonably be expected to impair the objectivity of the recommendation". Financial institutions must, in addition, disclose on a quarterly basis the proportion of their recommendations that are 'buy' , 'hold' or 'sell' as well as the proportion of issuers corresponding to each of these categories to which the institution has provided "material investment banking services" over the previous year.

The second piece of European Union legislation that will have a major impact on investment research is the Markets in Financial Instruments Directive or MiFID, which, like the Market Abuse Directive, is also a framework Directive. The framework Directive of April 2004 provides that an investment firm must:

- "maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest from adversely affecting the interests of its clients;" and
- "clearly disclose the conflict to the client before undertaking business" with him where such arrangements "are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented."

The Committee of European Securities Regulators has recently advised the European Commission (January 2005) to include in the future implementing provisions of the MiFID a requirement for each investment firm to establish and implement "an effective written conflicts policy that sets out the details of its organisational and administrative arrangements for identifying conflicts of interest and for preventing and managing material conflicts of interest in order to prevent damage to the interest of its clients." Supervising the adequacy and implementation of such conflicts policies will likely be one of the most important challenges for securities regulators in Europe in the coming years.

CESR is now finalising the last piece of its advice to the European Commission which will include measures to deal specifically with investment research. CESR will recommend the incorporation of the principal "core measures" contained in the IOSCO Principles (other than the core measures implemented by the EU market abuse legislation) in additional implementing measures of the MiFID. Such implementing measures would state that the core measures must be included in the conflicts policy of investment firms.

3. Issues and questions for tomorrow

A great deal of work has been accomplished already in the area of investment research. It would be misleading however to suggest that all the important issues have been addressed satisfactorily. A number of significant and difficult issues remain that will require more thought, debate and action on the part of regulators.

a. How should one define investment research?

Definitions vary considerably from one country to another, and usually leave considerable latitude for interpretation. An approach that CESR is now considering in its work on implementing measures of the MiFID is to allow investment firms to label documents that might appear to be research reports as "marketing communications" not subject to the specific rules applying to research provided that the label is clear and prominent and the document carries a suitable "health warning" that the specific requirements for research have not been complied with. This self-labelling approach would be without prejudice to the general provisions on conflicts of interest and to the general requirement that all marketing communications must be clear, fair and not misleading.

Another element of the definition of research is the extent of dissemination of the report. The EU market abuse legislation for example only applies to research "to which a large number of people have access" because the objective of that legislation is market integrity. It may however be appropriate to adopt a less restrictive definition for research under the MiFID because the objective of this second piece of legislation is to protect all the clients of the investment firm.

Another element of the definition of research is the status of the entity disseminating the report, which may or may not be a regulated financial institution, and the status of its author, who may or may not have the title of securities analyst. Additional uncertainties arise when regulation covers—as is the case in the United States and the European Union— not only written material but also recommendations expressed on radio or television for example. Last but not least, some regulations distinguish equity analysis from other types of research such as credit and bond research.

b. How does the receipt of research affect assessment of best execution?

In today's markets most trade execution services, in particular for portfolio managers, are bundled together with research, which is either produced in-house by the brokerage firm itself or provided by a third party (who may or may not be an independent research house). Since such research will generally neither be available separately nor priced separately, and may be dependent on the volume of the trading business done, it is difficult for the portfolio manager to assess whether he is obtaining value for his client's money and the client may well think that the inducement supplied "free of charge" by the broker in the form of research is in fact causing his portfolio manager to choose a broker who is not offering the most cost-efficient services. Last year the UK FSA confirmed plans to prohibit fund managers from buying anything other than execution and research with their clients' money and to require them to provide their clients with information about the respective costs of execution and research, so enabling institutional clients to put pressure on fund mangers to control costs. This issue arises for all the Member States of the EU with the upcoming implementation of the MiFID that contains a strict best execution standard.

c. Should minimum qualifications be required of analysts?

Some jurisdictions require analysts to take examinations and follow training programs (at least analysts working for regulated entities), others do not.

d. *How can equal access to issuer information be ensured for analysts, and how can undue issuer influence and retaliation against analysts for unfavourable coverage be prevented?*

Should regulators address these issues directly? Or encourage the development of self-regulatory codes of conduct?

e. *How can equal access to issuer information be ensured for the investing public in a world where many analysts (like some major investors) may have special access to senior management?*

It has long been the stance of the French authorities that any non-public, price-sensitive information given to an analyst should be immediately disclosed to the public, and the SEC's Fair Disclosure Regulation takes the same approach. How do other jurisdictions handle this issue?

f. *How should independent research be regulated?*

The EU market abuse legislation requires independent research houses to disclose their conflicts, although many of the detailed rules that apply to investment firms do not apply to independent analysts. Yet investment firms are disseminating more and more research produced by the independents, sometimes under their own name. What is the best way of addressing this type of situation? How can regulation at the same time encourage—or at least not discourage—independent research and ensure that it is high quality and truly independent? How can the production of high-quality and objective research become a viable business in today's markets?

The AMF has recently set up a working party chaired by a member of its board to look at these issues.

g. *What is the nature and size of a position, held by the financial institution or the individual analyst, that should trigger a disclosure requirement?*

For shares held by an investment firm, for example, the threshold varies from 1% to 5% between jurisdictions, and the rules on disclosure of positions above such thresholds vary considerably (additional thresholds or nothing).

h. *In a cross-border situation which regulator should have jurisdiction for research reports, and how can regulators ensure both a level playing field and the free circulation of research that meets commonly agreed standards?*

Under the MiFID it is clear that the home country of the investment firm will have jurisdiction for the organisational arrangements of the firm, but the EU market abuse legislation does not designate a single competent authority for ensuring that the content of research reports complies with the disclosure rules. Can a common approach to standards and to jurisdictional issues be achieved?

i. *Would a uniform approach to quiet periods around primary market transactions be possible and desirable internationally?*

Again, rules and practices vary considerably. Do current discrepancies disrupt markets, confuse investors and worry investment banks and their lawyers?