IOSCO STATEMENT OF PRINCIPLES FOR ADDRESSING SELL-SIDE SECURITIES ANALYST CONFLICTS OF INTEREST

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I. INTRODUCTION

1. The primary objectives of securities regulators, as described in IOSCO's Objectives and Principles of Securities Regulation, are protecting investors, ensuring that markets are fair, efficient and transparent, and reducing systemic risk.[1] The flow of timely and accurate information about issuers and securities is fundamental to achieving these objectives. However, the volume of this information can be daunting to many investors. Securities analysts can provide valuable insights to investors trying to make sense of a wide range of information. They study companies and industries, analyze raw data, and may make forecasts or recommendations about whether to buy, hold or sell securities.

2. The Technical Committee recognizes that "sell-side" analysts,[2] in particular — *i.e.*, securities analysts employed by the research departments of full-service investment firms such as broker-dealers and investment banks — can face conflicts of interest that may compromise their abilities to offer investors independent, unbiased opinions. Sell-side analysts are by no means alone in facing such conflicts of interest and concepts developed in this work could be used in other areas. But the multiple roles these analysts may play within their organizations can pose special problems with respect to investor protection. Indeed, they can result in biased research that harms investors and undermines the fairness, efficiency and transparency of markets.

3. Because of concerns that analyst conflicts of interest pose problems for investor protection, the Technical Committee has examined the conflicts of interest analysts face and the methods securities regulators rely on to address these conflicts. The Technical Committee's review is summarized in the attached report (the "Report On Analyst Conflicts Of Interest") that outlines the types of conflicts of interest analysts face, along with the legislative, regulatory and private-sector mechanisms in place or contemplated to eliminate or manage these conflicts.[3]

4. The Technical Committee found that, generally, the conduct and professionalism of securities analysts is monitored and supervised by (1) the firms that employ analysts, (2) self-regulatory organizations (SROs), (3) government regulators or other authorized securities regulatory authorities, and/or (4) professional associations. Not all of these four types of oversight are present in all jurisdictions, and the degree of oversight conducted by each of these types of bodies varies by jurisdiction and even within a given jurisdiction, depending on the positions and duties of a particular analyst.

5. The Technical Committee also found that a number of regulators, SROs, and professional associations have recently proposed new statutes, regulations, rules or codes designed to address these conflicts. Other jurisdictions are actively considering

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[1] See IOSCO, *Objectives and Principles of Securities Regulation* (September 1998).

[2] For the purposes of these Principles, the term "analyst" refers to sell-side securities research analysts.

[3] See IOSCO Technical Committee, *Report On Analyst Conflicts Of Interest* (September 2003).

whether to adopt new guidelines or requirements to eliminate, manage or disclose analyst conflicts of interest.

6. Given such activity, the Technical Committee has concluded that a set of IOSCO principles regarding analyst conflicts of interest would be a valuable tool for IOSCO jurisdictions wishing to improve their oversight of securities analysts and would assist in the convergence of regulatory approaches.

7. A primary objective for regulators, investors, firms and analysts alike is an environment where research produced by analysts for clients is objective, clear, fair and not misleading. To help achieve this objective, the principles developed by IOSCO's Technical Committee focus on:

    a. The identification and elimination, avoidance, management or disclosure of conflicts of interest faced by analysts;

    b. The integrity of analysts and their research; and

    c. The education of investors concerning the actual and potential conflicts of interest analysts face.

8. The principles are intended to address the key issues regarding analyst conflicts of interest. They are designed to apply to all jurisdictions where analysts operate. However, the Technical Committee is cognizant that legal and regulatory structures and market characteristics vary among IOSCO jurisdictions. Consequently, IOSCO jurisdictions should tailor implementation of these principles to their own markets.

9. These principles identify key objectives that a robust system of oversight will strive to achieve and particular areas on which such a system may focus. Specific regulations, codes of conduct and internal firm rules addressing analyst conflicts of interest should be designed to ensure that objectives contained within each principle are not circumvented in practice.

10. While the Technical Committee recognizes that there is no "one-size-fits-all" approach to addressing analyst conflicts of interest, the Technical Committee agrees that certain core measures are critical to give effect to these principles. These core measures are intended to apply in all jurisdictions, regardless of their legal systems or level of market development. However, as noted below, jurisdictions may vary in how the core measures are implemented, with each jurisdiction taking into consideration its particular legal framework, legislative powers, and market characteristics.

11. The Statement also includes examples of additional measures IOSCO jurisdictions might adopt to give effect to the goals laid out in the principles. Unlike the core measures, these measures are not necessarily intended for all jurisdictions. Rather, these are additional measures that firms, SROs or regulators may wish to consider in giving effect to the principles, tailored according to each market and legal system.

12. The approaches described as core measures and other measures are broad descriptions of specific objectives government and non-government regulators, SROs and firms should seek to achieve in implementing each principle. Consequently, neither the

principles nor the core measures and other measures describing how the principles are given effect are designed themselves to serve as regulations, rules, specific codes of conduct or internal firm rules. Rather, the objectives and concepts underlying the principles and measures should be considered in adopting regulations, rules or codes of conduct in ways that take into account how a particular market or legal system functions.

13. The principles themselves and the measures described in this Statement are not intended to be all-inclusive. Rather, this Statement reflects the current understanding of the Technical Committee of the types of conflicts of interest analysts face and how these conflicts can be addressed. The Technical Committee intends to review these principles and measures on an ongoing basis and revise them if need be.

14. Although focusing on the activities of sell-side analysts, many of these principles and mechanisms for implementing the principles may be equally applicable to other types of securities analysts.

15. The IOSCO Technical Committee also intends to monitor implementation of these principles among its members.

II. PRINCIPLES

As noted in the Technical Committee's Report on Securities Analysts, the actual and potential conflicts of interest analysts face differ from jurisdiction to jurisdiction, and even from firm to firm. However, the Technical Committee agrees that, as a fundamental matter, addressing these conflicts requires mechanisms that eliminate or manage the conflicts of interest. Consequently, securities regulators, SROs or firms, as appropriate, should analyze the types of conflicts of interest that exist and adopt measures that eliminate, limit, manage or disclose these conflicts.

The form these measures take must be tailored according to local market circumstances and each jurisdiction's legal system. Depending on their own circumstances, regulators, SROs or firms may decide that some conflicts are better managed through limitations or prohibitions, while others are better addressed through disclosure. Likewise, they may decide that some conflicts of interest can only be managed through regulatory requirements. In other cases, the nature of a conflict may be best addressed through internal firm mechanisms, with the firm responsible for ensuring that a recognized conflict is addressed to the satisfaction of regulators or the market. As a result, mechanisms for addressing analyst conflicts of interest may take the form of:

– Government regulation;

– Regulations imposed by an independent, non-governmental statutory regulator;

– Binding rules imposed by an SRO; or

– Industry codes of conduct that are strictly applied and enforced.

Regardless of the specific mechanism employed to eliminate, avoid, manage or disclose analyst conflicts of interest, the following principles identify key areas that the overall oversight system should address.

1. Analyst Trading and Financial Interests

Principle 1: *Mechanisms should exist so that analysts' trading activities or financial interests do not prejudice their research and recommendations.*

Analysts provide investors with research and recommendations regarding the securities of public issuers. Analysts can face a conflict of interest insofar as these recommendations influence the decisions investors make. An analyst whose research and opinions are widely respected can affect the price of a security through his or her recommendations. If an analyst has a financial interest in an issuer that he or she reviews, this interest may conflict with the analyst's ability to provide clear and unbiased research accurately reflecting what the analyst believes is the issuer's true financial prospects. Consequently, jurisdictions should be aware of this conflict of interest and consider approaches to address it.

Core Measures

The IOSCO Technical Committee believes the following are core measures aimed at preventing analysts' research and recommendations from being prejudiced by their financial interests or trading activities:

– Prohibiting analysts from trading in securities or related derivatives of an issuer they review in a manner contrary to their outstanding recommendations, except in special circumstances subject to pre-approval by compliance or legal personnel;

– Prohibiting analysts from covering an issuer, where the analyst serves as an officer, director or member of the issuer's supervisory board and requiring disclosure of any such relationship involving individuals related to or associated with the analyst; in the alternative, requiring analysts covering an issuer to disclose if they, or individuals related to or associated with them, serve as officers, directors or members of the issuer's supervisory board;

– Prohibiting analysts from trading securities or related derivatives ahead of publishing research on the issuer of those securities; and,

– Requiring analysts or firms employing the analysts to publicly disclose if the analysts have investment positions or otherwise have financial interests in issuers that the analysts review.

Other Measures

The following additional measures may or may not be appropriate for all IOSCO jurisdictions, but nonetheless merit consideration:

– Prohibiting analysts from trading in the securities or related derivatives of issuers and/or industries they review; and,

– Mandating a “holding period” for analyst trading prior to and after issuance of an analyst report.

2. Firm Financial Interests and Business Relationships

Principle 2.1: Mechanisms should exist so that analysts’ research and recommendations are not prejudiced by the trading activities or financial interests of the firms that employ them.

The firms that employ analysts may have financial interests or business relationships that present conflicts of interest insofar as these firms influence the research or recommendations of their analysts. Firms that employ analysts may be involved in a variety of businesses, investments or practices that may benefit from favorable research or recommendations issued by the analysts they employ. They also frequently trade securities of the issuers their analysts cover. Depending on the circumstances, these analysts may feel pressure or have an incentive to issue research or recommendations biased in favor of their employers’ interests. Securities regulators should be aware of this possibility and consider approaches to addressing these conflicts of interest.

Core Measures

The IOSCO Technical Committee believes the following are core measures aimed at protecting analysts’ research and recommendations from being prejudiced by the financial interests or trading activities of the firms that employ the analysts:

– Requiring analysts, or firms employing analysts, to publicly disclose if an analyst’s firm makes a market for securities of an issuer that the analyst reviews or if the firm has a significant financial interest in the issuer;

– Requiring analysts or the firms employing analysts to publicly disclose if individuals employed by or associated with the firm serve as officers, directors, or members of the supervisory board of an issuer that the analysts review; and,

– Prohibiting firms that employ analysts from improperly trading securities or related derivatives ahead of the analyst publishing research on the issuer of those securities.

Other Measures

The following additional measures may or may not be appropriate for all IOSCO jurisdictions, but nonetheless merit consideration:

– Prohibiting analysts from covering an issuer in which members of the analyst’s firm serve as officers, directors or members of the supervisory board; and,

- Requiring analysts and/or the firms that employ them, to file with a regulator, SRO or independent authority or otherwise publicly disclose their research reports after a period of time has passed.

Principle 2.2: Mechanisms should exist so that analysts' research and recommendations are not prejudiced by the business relationships of the firms that employ them.

In many cases, the firms that employ analysts also provide investment banking or other services to the issuers that the analysts cover. As such, the promise of favorable reviews may encourage an issuer to engage the services of a particular firm — creating a conflict of interest for the analyst. The nature of such conflicts, however, can vary considerably, depending on the type of business relationship.

Core Measures

The IOSCO Technical Committee believes the following are core measures aimed at preventing analysts' research and recommendations from being prejudiced by the business relationships of the firms that employ them:

- Establishing robust information barriers between analysts and a firm's other divisions in order to limit the potential for conflicts of interest and prevent other individuals in the firm from attempting to influence analysts' research;

- Prohibiting firms that employ analysts from promising issuers favorable research coverage, specific ratings, or specific target prices in return for a future or continued business relationship, service or investment; and,

- Prohibiting analysts from participating in investment banking sales pitches and road shows.

Other Measures

The following additional measures may or may not be appropriate for all IOSCO jurisdictions, but nonetheless merit consideration:

- Requiring analysts or the firms that employ analysts to publicly disclose if an analyst's firm is seeking, has, or recently has had an investment banking relationship with an issuer that the employer reviews;

- Mandating "quiet periods" immediately before and after a securities offering underwritten or managed by an investment firm employing an analyst, during which time the analyst may not publish research reports about the issuer;

- Requiring analysts to disclose the selection criteria for the issuers they cover and to give notice promptly of cessation of coverage of an issuer; and,

- Requiring analysts to certify under oath that the opinions they express and recommendations they make in research reports and/or public appearances are, in fact, the opinions they themselves hold.

3. Analysts' Reporting Lines and Compensation

Principle 3: *Reporting lines for analysts and their compensation arrangements should be structured to eliminate or severely limit actual and potential conflicts of interest.*

In many jurisdictions, actual and potential conflicts of interest arise for analysts because of the manner of compensation and reporting structure within their firms. The investing public has a right to expect objectivity in analysts' recommendations. Where an analyst's likelihood for promotion or financial bonus depends on his or her ability to promote the firm's investment banking business or promote shares that the analyst's employer has underwritten, objectivity may be compromised because the analyst's interests and those of the investing public diverge. The degree to which reporting and compensation structures present conflicts of interest for analysts varies considerably; in some jurisdictions, analysts are largely salaried employees and do not report to anyone outside the firm's research department. However, given the direct conflict of interest that reporting lines and compensation arrangements may pose, regulators should be particularly aware of the source of conflict, and, where it exists, establish mechanisms to manage, limit or disclose it.

Core Measures

The IOSCO Technical Committee believes the following are core measures necessary to structure analyst compensation and reporting arrangements to eliminate or severely limit actual and potential conflicts of interest:

- Prohibiting analysts from reporting to the investment banking function;
- Prohibiting analyst compensation from being directly linked to specific investment banking transactions;
- Adopting mechanisms within firms to safeguard reporting line and compensation structures to protect analysts' independence; and,
- Prohibiting the investment banking function from pre-approving analyst reports or recommendations, except in circumstances subject to oversight by compliance or legal personnel where investment banking personnel review a research report for factual accuracy prior to publication.

Other Measures

The following additional measures may or may not be appropriate for all IOSCO jurisdictions, but nonetheless merit consideration:

- Requiring analysts or the firms employing analysts to disclose how the analysts they employ are compensated and to whom the analysts report;
- Requiring analysts or the firms employing analysts to disclose if an analyst receives compensation that is based, in whole or in part, on the firm's investment banking revenues; and,
- Prohibiting analysts from participating in investment banking activities.

4. Firms' Compliance Systems and Senior Management Responsibility

Principle 4: *Firms that employ analysts should establish written internal procedures or controls to identify and eliminate, manage or disclose actual and potential analyst conflicts of interest.*

Requirements imposed by regulators, SROs and industry associations do not discharge firms from their own responsibilities to actively identify and address, through their own internal mechanisms, the conflicts of interest that may influence the research and recommendations made by the analysts they employ. As with all procedures and controls within a firm, senior management bears ultimate responsibility for the adequacy and enforcement of written internal procedures and controls designed to identify and eliminate, manage or disclose analyst conflicts of interest.

The mechanisms firms can employ to address these potential conflicts will vary according to the size and activities of the firm. Some of these mechanisms may be voluntarily adopted, while others may be required by regulators, SROs or industry associations.

Core Measures

The IOSCO Technical Committee believes the following is a core measure necessary to establish written internal procedures or controls to identify and eliminate, manage or disclose actual and potential analyst conflicts of interest:

- Requiring firms that employ analysts to have written internal procedures for addressing actual and potential analyst conflicts of interest.

5. Outside Influence

Principle 5: *The undue influence of issuers, institutional investors and other outside parties upon analysts should be eliminated or managed.*

Issuers and large shareholders often have a deep interest in the reviews provided by securities analysts because these reviews can encourage or dissuade investors from purchasing or selling shares of a company. These outside parties may try to pressure an analyst into making a favorable recommendation through a variety of means, ranging from monetary bribes to refusing to provide the analyst with key information provided to the analyst's competitors. In some cases, such pressure may be viewed as a form of fraud and/or market manipulation.

Core Measures

The IOSCO Technical Committee believes the following are core measures to eliminate or manage the undue influence of outside parties:

- Requiring that analysts, or the firms that employ analysts, publicly disclose whether the issuer or other third party provided any compensation or other benefit in connection with a research report; and,

– Prohibiting issuers from selectively disclosing material information to one analyst and not other analysts, except as specifically permitted by law or regulations.

Other Measures

The following additional measures may or may not be appropriate for all IOSCO jurisdictions, but nonetheless merit consideration:

– Requiring analysts or the firms that employ analysts to broadly and/or simultaneously disseminate their research reports according to standard internal procedures;

– Requiring analysts or the firms that employ analysts to disclose their policies and procedures for disseminating research reports; and,

– Prohibiting analysts from accepting, or requiring analysts to publicly disclose, any separate compensation they receive from issuers they review or from institutional investors or other outside parties.

6. Clarity, Specificity and Prominence of Disclosure

Principle 6: *Disclosures of actual and potential conflicts of interest should be complete, timely, clear, concise, specific and prominent.*

Insofar as analysts face conflicts of interest, the complete nature of these conflicts should be disclosed, in a timely fashion, to investors who might rely on the recommendations or research these analysts provide. What, how and in what form these disclosures are made will vary according to the nature of the market and the laws and regulations of a particular jurisdiction, as well as the media by which the analyst makes a recommendation (e.g., research report provided to clients, the Internet, public appearances, etc.)

In some cases, however, even disclosures of actual and potential conflicts of interest may be inadequate if the disclosures are difficult to understand or provided in areas of a report or document likely to be overlooked by readers. Similarly, disclosures may use generic language that merely lists a variety of possible conflicts that may or may not apply to the particular analyst, report or circumstance. The Technical Committee believes that certain types of "disclosures" actually defeat the purpose of transparency requirements and limit investors' abilities to make informed choices. Consequently, the Technical Committee believes disclosures mandated of analysts and firms employing analysts should be complete, timely, clear, concise, specific and made in a prominent manner so that investors obtain the full benefit of the information provided.

7. Integrity and Ethical Behavior

Principle 7: *Analysts should be held to high integrity standards.*

Investors expect analysts to be both competent and honest. Requirements for honesty lessen the potential that analysts will be swayed by the conflicts of interest they may face.

Fundamental to the analyst function is that analysts should have a reasonable basis for the analyses and recommendations they disseminate.

Core Measures

The IOSCO Technical Committee believes the following are core measures designed to hold analysts to high standards of integrity:

– Imposing general legal obligations on analysts and/or the firms that employ analysts to act honestly and fairly with clients; and,

– Prohibiting analysts and/or the firms that employ analysts from acting in ways that are misleading or deceptive.

Other Measures

The following additional measures may or may not be appropriate for all IOSCO jurisdictions, but nonetheless merit consideration:

– Imposing "fit and proper" requirements or otherwise prohibiting individuals with criminal records or demonstrably compromised integrity from being employed, indefinitely or for a period of time, as analysts;

– Requiring analysts to take periodic examinations designed to test analysts' knowledge of their legal and ethical duties;

– Making public analysts' disciplinary records;

– Requiring analysts to disclose their professional credentials in research reports distributed to investors;

– Requiring analysts to disclose their real names and license status when making comments on issuers or recommending securities via the media;

– Requiring analysts to define the terms they use when making recommendations;

– Requiring analysts to disclose a breakdown comparison (in percentage or proportion terms) of the number of the different types of recommendations (e.g., "buy", "hold", or "sell") they make over a given time period;

– Requiring analysts to disclose a comparison of the target price forecasted in the past versus the actual price of a covered security over a period of time from the date of the forecast; and,

– Requiring analysts to include in their reports a discussion of the assumptions underlying their recommendations and a sensitivity analysis to help investors understand how changes to these assumptions may affect the analysts' conclusions.

8. Investor Education

Principle 8: *Investor education should play an important role in managing analyst conflicts of interest.*

An essential element of any regulatory approach towards managing analysts' conflicts is making investors aware of such conflicts. In particular, investors should be encouraged not to rely solely on an analyst's recommendations to confirm that a particular investment is appropriate for their own financial circumstances. Investor education can also focus on making investors aware of the disclosure rules in their own jurisdiction so that they can better conduct their research and evaluate potential biases and conflicts of interest.

Effective investor education programs can be instituted by regulators and governments, industry associations, and nonprofit consumer and investor groups. Securities regulators can promote investor education about actual and potential analyst conflicts of interest through a variety of methods, including websites and public outreach programs. Non-profit consumer and investor education groups and the popular media frequently can reach a broad audience of potential investors. Such programs may be independent projects or joint projects coordinated with other groups. Depending on the nature of these groups, regulators can often enlist their support in informing investors about the conflicts of interest analysts may face.