REPORT ON ANALYST CONFLICTS OF INTEREST

OICV-IOSCO

A REPORT OF THE TECHNICAL COMMITTEE OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

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REPORT ON ANALYST CONFLICTS OF INTEREST

In order to examine the issues that must be considered by securities regulators in addressing conflicts faced by analysts, the IOSCO Technical Committee established and directed the Analyst Project Team to:

- assess in the constituent jurisdictions[1] (the "Jurisdictions") the actual and perceived conflicts of interest that confront sell-side analysts and the firms that employ them;

- survey the existing rules, industry practices, and professional standards that address issues related to analyst conflicts of interest in the Jurisdictions;

- assess the means available to regulatory authorities for addressing the conflicts confronting analysts; and

- determine whether, and in what form, IOSCO should make any statements addressing the conflicts of interest faced by analysts.

The Analyst Project Team conducted an extensive survey in the Jurisdictions the results of which are discussed in this Report. As well, this Report explores the conflicts of interest analysts employed by firms face and the measures in place or proposed in the Jurisdictions to address these conflicts as of December, 2002.

The Report of the Project Team to the Technical Committee addressed the Technical Committee's mandate and discussed future directions and proposed that a set of high-level principles be developed as a next stage. This proposal led to the Technical Committee's adoption of the IOSCO Statement of Principles for Addressing Sell-Side Securities Analyst Conflicts of Interest approved contemporaneously with this Report. Contemporaneously with the adoption of its Statement of Principles, the Technical Committee also endorsed the Project Team's report as a report of the Technical Committee. The report of the Project Team to the Technical Committee follows:

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[1] The Project Team was chaired by Mr. Tatsuya Kanai of the Financial Services Agency of Japan. Members of the Project Team included: Commission des valeurs mobilières du Québec, Québec, Canada; Ontario Securities Commission, Ontario, Canada; Commission des Operations de Bourse, France; Bundesanstalt für Finanzdienstleistungsaufsicht, Germany; Securities and Futures Commission, Hong Kong; Commissione Nazionale per le Societa e la Borsa, Italy; Financial Services Agency, Japan; Comissão do Mercado de Valores Mobiliários, Portugal; Comisión Nacional del Mercado de Valores, Spain; Swiss Federal Banking Commission, Switzerland; Commodity Futures Trading Commission, United States of America; Securities and Exchange Commission, United States of America; Financial Services Authority, United Kingdom and Australian Securities and Investment Commission.

I. INTRODUCTION

Information is the lifeblood of modern capital markets. The flow of timely and accurate information among market participants promotes investor confidence in the markets, which aids in the flow of capital to businesses. However, the volume and complexity of information and raw data which is available – including, issuer disclosure statements, economic and employment statistics from governments, and marketing and purchasing trend reports from private sources – can often be overwhelming and confusing for investors. As a result, research analysts play an important role in the relationship between companies and investors, both retail and institutional. Research analysts study companies and industries, analyze the disparate raw data, and often make forecasts and recommendations about whether to buy, sell or hold securities. Investors often view analysts as experts on and important sources of information about the securities they cover and rely on their advice.

However, analysts (also referred to in this Report as securities analysts or sell-side analysts) employed by full-service investment firms[2] often face conflicts of interest that can interfere with the objectivity of their analysis. Conflicts arise because these firms ("firms" means in this Report full-service investment firms unless otherwise stated) often undertake many, potentially conflicting, roles – for example, firms may act as retail brokerage houses for individuals wishing to purchase or sell securities, while at the same time offering underwriting services to issuers of those securities – and research analysts are often called upon to assist with these conflicting activities. If an analyst's firm's activities place the analyst in conflict situations – for example, if the analyst has powerful financial incentives to direct clients towards specific securities, or if the analyst's job security depends on dissuading clients from selling certain shares – the advice the analyst offers may no longer be objective. These conflicts risk eroding investor confidence in research and, potentially, the markets as a whole if not adequately addressed.

Two of IOSCO's three core objectives are "the protection of investors" and "ensuring that markets are fair, efficient and transparent."[3] The integrity and objectivity of research provided to investors is crucial to promoting these objectives. The integrity of an analyst's research can only be achieved if situations of potential conflicts of interest[4] are avoided as much as possible and, if not avoidable, properly managed and disclosed to investors.

This Report is structured as follows:

Section I – Introduction.

Section II – Discussion of the types of activities performed by analysts employed by firms in the Jurisdictions.

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[2] The term "full-service investment firm" as used in this Report is intended to refer to entities that provide a variety of financial and financial-related services to clients. In some Jurisdictions such entities may be referred to as broker-dealers, sell-side firms, banking groups or multi-service firms.

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

[4] In this report, the words "conflict" or "conflicts" refer to a conflict of interest or conflicts of interest.

Section III – Discussion of the types of conflicts of interest faced by analysts and their firms.

Section IV – Description of certain statutes, rules and regulations that the Jurisdictions have designed to address conflicts of interest faced by analysts and their firms.

Section V – Discussion of the key issues facing securities regulators in addressing analyst conflicts of interest.

II. SELL-SIDE ANALYSTS

A. Types of Analysts

Sell-side analysts historically have served an important role in the markets, promoting efficiency by compiling publicly available information and offering analysis and insights on companies and industries. The term analyst encompasses individuals with varying functions within the securities industry. Analysts are generally classified into one of three broad categories depending on the nature of their employment: sell-side, buy-side and independent.

Sell-side analysts are the focus of this Report.[5] They are typically employed in the research department of full-service investment firms. Analysts on the sell-side typically publish research reports on the securities of companies or industries that they cover. These research reports are distributed to customers of the firm and often include a specific recommendation – such as a recommendation to buy, hold, or sell the subject security – and often include the analyst's expectation of the future price performance of the security ("price target"). As will be discussed in this Report, sell-side analysts often perform functions other than producing research. Many analysts work for firms that also provide investment banking services for corporate clients – including clients whose securities the analysts cover.[6]

Unlike sell-side analysts, buy-side and independent analysts typically are not associated with firms that underwrite the securities they cover and generally have few, if any, other conflicts that could impair the objectivity of their research.

Buy-side analysts generally work for money managers – such as mutual funds, hedge funds, pension funds, or investment advisers – that purchase and sell securities

[5] The potential for conflicts of interest is not limited solely to sell-side analysts; buy-side and independent analysts may also encounter conflicts. The Project Specification, however, instructed the Project Team to focus on sell-side research in order to conclude the project within a reasonable period. Moreover, sell-side research has the biggest impact on retail and small institutional investors, and sell-side analysts face numerous conflicts of interest. Among other things, the second stage of this project can consider whether to review conflicts that pertain to other types of analysts.

[6] Some firms that have discontinued their investment banking operations now market themselves as more independent than full-service investment firms, emphasizing their relative lack of conflicts of interest.

for their own investment accounts or on behalf of others. Buy-side analysts counsel their employers about which securities they should buy, hold or sell and their research is usually not distributed to anyone but the employer. For buy-side analysts, success or failure is a function of the accuracy and value-added nature of their analysis; buy-side analysts are successful if their analysis results in good performance for their employers' accounts. Thus, their interests' generally are perceived to be more aligned with those of the money managers they work for and those of their clients.

Independent analysts work for research originators or boutiques that are legal entities separate from full-service investment firms and sell their research to others on a subscription or other basis. Because their research is sold, and because this constitutes their unique or main source of income, independent analysts have a strong incentive to produce objective analysis for the subscribers of their company's research.

There are other entities that provide research, such as, newspapers, consensus instruments and consolidators of information (such as Multex.com Inc.) but this Report does not address such research.

B. Activities Performed by Sell-Side Analysts

Sell-side analysts provide clients with analysis and investment recommendations. Their work is often disseminated in written research reports that include their analysis and recommendations on whether to buy, sell or hold a security and often include target prices for securities. Research is often provided by a firm as part of a package of services to clients in return for trading commissions directed to the firm. Research information is often provided to clients indirectly through the firm's salespeople who have direct contact with clients.

In recent years, analysts have become involved in other services provided by firms in addition to research. Some Jurisdictions report that the other services sell-side analysts provide to firms include:

- supporting the firm's investment banking department;
- assisting in securities marketing efforts;
- providing help to the firm's investment management department; and
- giving presentations to the firm's sales and trading staff.

1. Investment Banking Support. Most Jurisdictions report that sell-side analysts are often brought over the "Chinese Wall"[7] that separates their firms'

[7] A "Chinese Wall" is an internal structure aimed to ensure physical and/or informational separation among the departments of a full-service investment firm to prevent the circulation of "inside information." Crossing "over the wall" refers to a situation where an analyst in the research department is formally brought over the informational barrier that exists between the research and investment banking departments and is temporarily considered part of the investment banking unit. The head of the research department and/or head of the legal and compliance department must usually approve such instances of wall-crossing by analysts. In some Jurisdictions, while an analyst is over the

research department from other departments to add their expertise to corporate finance transactions. These duties may include evaluating prospective investment banking clients and performing “due diligence” examinations. Analysts may also attend marketing meetings with their investment bank colleagues that are intended to persuade a prospective client to use the firm’s banking services. Indeed, issuers may award investment banking business to firms based on the reputation and stature of the firm’s analysts. Several Jurisdictions have noted that analysts may also generate ideas for corporate transactions for the investment banking department.

2. Securities Marketing. In some Jurisdictions, analysts may be involved in marketing, and even selling, securities that they cover to institutional investors. For example, they may assist investment bankers during “road shows” where they make marketing presentations to potential institutional investors.

3. Investment Management Assistance. In some Jurisdictions, analysts assist their firms’ investment management departments in evaluating transactions.

4. Presentations to Sales and Trading Staff. Analysts sometimes provide internal presentations and briefing sessions to their firms’ sales staff and trading staff concerning the securities they cover. These analyst presentations are meant to provide staff in the sales and trading departments with background and overview concerning current events and company announcements.

C. Analyst Qualifications and Registration Requirements

Most Jurisdictions report that, currently there is no particular set of minimum qualifications or particular registration required to work as a securities analyst conducting strictly research activities. In only one Jurisdiction was an analyst required to pass an examination testing the analyst’s general industry and regulatory knowledge. Regulators in another Jurisdiction recently proposed a new registration category and corresponding qualification examination for research analysts.

Despite the general lack of specific qualification or registration requirements, several Jurisdictions note that it is common for analysts to possess some combination of a post-graduate degree, certain professional qualifications (such as a CFA (certified financial analyst) or CPA (certified public accountant) certification), and to have some experience in the industry they cover.

Securities analysts may incur other qualification requirements if their position within the firm entails certain other obligations (in addition to their research activities), such as a managerial responsibility or client interaction. In certain Jurisdictions, analysts that meet with customers or publish their name and contact information in a research report are required by self-regulatory organization (“SRO”) rules to pass an examination for general securities representatives. Those Jurisdictions also report that analysts who act in a supervisory capacity and approve

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wall and for a certain period thereafter, an analyst is not permitted to write a research report on the subject issuer, since the analyst is considered part of the banking team and therefore possibly privy to inside information.

research reports for distribution must pass an examination for supervisory analysts and be deemed sufficiently experienced or "fit and proper."

Several Jurisdictions report that analysts may voluntarily opt to take examinations administered by industry groups or professional analyst associations as a condition of membership in these organizations. However, in many Jurisdictions, passing such an examination is not itself a qualification to work as an analyst, and membership in such associations is often voluntary.

Most Jurisdictions do not require that analysts' qualifications or backgrounds be specifically disclosed. However, some SROs and analyst associations make qualifications of analysts available on websites. Likewise, some firms publish their analysts' *curriculum vitae* along with their research reports.

D. Oversight of Sell-Side Analysts and Full-service Investment Firms

Oversight of analysts is complex, layered, and varies by Jurisdiction. Generally, the conduct and professionalism of sell-side analysts is monitored and supervised by one or more of: (1) the firms that employ the analysts; (2) self-regulatory organizations; (3) government regulators or other authorized securities regulatory authority; and (4) professional associations. Not all of these four types of oversight are present in all Jurisdictions.[8] The degree of oversight conducted by each of these entities varies among Jurisdictions, and may even vary within a given Jurisdiction depending on the position and duties of a particular analyst.

Complicating this picture, the depth of oversight by each of these entities and the coordination among the oversight entities is currently under extensive examination in several Jurisdictions. As discussed below, until recently most Jurisdictions reported that there was little, if any, direct regulation of analyst conflicts at the statutory or regulatory level; most oversight was performed at the firm or professional association level. However, several Jurisdictions have recently enacted – or are considering – legislation at the statutory and/or regulatory level to address conflicts faced by analysts.

1. Internal Firm Rules. According to the survey, internal firm rules currently appear to have the largest role in addressing the conflicts of interest faced by securities analysts. In some of the Jurisdictions, laws and government regulations require firms to be organized in such a way as to be able to address conflicts of interests faced by their employees (including analysts). For example, most firms have internal rules restricting analysts' investments in the securities of the companies (and sectors) they review, or in firm clients.

2. Self-Regulatory Organizations. In some Jurisdictions, analysts' activities are overseen by SROs in the analysts' capacity as employees of firms that are members of a SRO. These SROs have rules that their member firms must adhere to and that require the firms to adequately supervise securities analysts who work for them. In some Jurisdictions, these rules tend to relate to full-service investment

[8] In some Jurisdictions the securities regulatory authority is neither a SRO nor a government regulator but an independent body created by statute.

firms' employees generally and require firms to address all types of conflicts of interest that financial-sector employees may face. In others, these rules may specifically single out analysts and require member firms to address analyst conflicts of interest through specific internal supervisory procedures. These types of rules – and proposed rules currently being considered – are described in Section IV.

3. ***Government Regulators.*** Although few Jurisdictions impose specific regulations on analysts, in most Jurisdictions analysts are subject to regulations or policies that may affect their activities, such as business conduct rules, best practices, principles for business, organizational requirements and laws prohibiting insider dealing and the dissemination of false or misleading information. In many countries, the analyst needs to be approved or registered with a securities regulatory authority if the analyst trades with or advises clients. In most of the Jurisdictions, a securities regulatory authority is responsible for monitoring compliance with and enforcing adherence to the statutes, laws or regulations regarding analyst's conflict of interests as part of the conduct of firms.

Most of the Jurisdictions surveyed had no statutes or regulations specifically addressing analysts' conflicts of interests. However, one Jurisdiction recently issued a regulation directly concerning analysts and disclosure of conflicts of interest and, in another Jurisdiction, regulations specifically dealing with disclosure of conflicts of interests of analysts have been passed by the national legislature. A more detailed description of the legislative and regulatory oversight currently in place and recently proposed in the Jurisdictions is contained in Section IV.

4. Industry Groups and Professional Associations. Membership in certain industry groups and professional associations require analysts to adhere to codes of conduct and/or best practices, which are designed to enhance analyst integrity in the production of research. Some countries oblige the analyst to disclose in their reports if they are members of an industry association or group. Many of these associations stress the need to produce independent research and always act in the interests of the client, and often require the members to observe standards of conduct in addition to those required by statues, rules and regulations. Failure to abide by these codes may result in expulsion from the association. However, since membership in these organizations is voluntary and not a requirement to do business in most Jurisdictions, sanctions for violating these association codes are relatively limited.

Several Jurisdictions have national professional associations that issue codes of conduct for their securities analyst members. Securities analysts or their firms in other Jurisdictions may belong to a "multinational" professional organization with membership standards of conduct.

III. CONFLICTS OF INTEREST FACING SELL-SIDE ANALYSTS

Sell-side analysts work in an environment with many inherent conflicts of interest and competing pressures. On the one hand, full-service investment firms want their individual investor clients to be successful over time because satisfied long-term investors are a key to a firm's long-term reputation and success. An investment research team that is well respected for its objective analysis and recommendations is, therefore, an important asset to a firm. At the same time, several factors can create pressure on an analyst's objectivity. Non-research functions that sell-side analysts are often required or requested to perform may create incentives to issue recommendations that conflict with investors' interests.

A number of potential conflicts of interest faced by sell-side analysts in the Jurisdictions have been identified. These conflicts generally arise as a result of:

- the various commercial activities pursued by full-service investment firms;
- analyst compensation arrangements;
- financial interests in covered companies held by analysts and their firms; and
- the reporting relationships within full-service investment firms.

A. Conflicts Created by Services Provided by Full-Service Investment Firms and Proprietary Trading

Understanding the importance of sources of income for full-service investment firms helps to identify and understand potential conflicts within these firms. In particular, the commercial requirements of investment banking activity, proprietary trading by the firm and the provision of brokerage services may create conflicts of interest for analysts.

1. Investment Banking Relationships. Providing investment banking services, such as underwriting an initial public offering ("IPO") or advising clients on mergers or acquisitions, can be a lucrative source of revenue for full-service investment firms. Sell-side analysts at these firms may be inhibited from making statements or publishing research reports that could jeopardize existing or potential client relationships for their investment banking colleagues.

Indeed, an analyst may be substantially involved with the investment banking unit that takes a company public and thus be part of the "banking team." Underwriters assisting a company with a public offering have a strong interest in the success of the offering and the performance of the company's securities in the post-offering period. An analyst assisting the investment bankers with a company's public offering may be expected to issue research reports containing favorable recommendations about the company's securities.

These conflicts can manifest themselves in variety of ways. For example, an analyst may refrain from issuing a negative report against a company with whom his or her firm has a relationship or he or she may publish research that presents the issuer in a positive light, but in fact does not accurately represent that analyst's actual assessment of the issuer. An analyst may also cease to issue research altogether on a particular company in order to avoid issuing a negative report. As well, the pressure to refrain from presenting a company in an unfavourable light can result in misleading terminology being used in research reports.

Analysts often use a variety of terms – buy, strong buy, near-term or long-term accumulate, near-term or long-term over-perform or under-perform, neutral, hold – to describe their recommendations. The meanings of these terms can differ from firm to firm. In some cases, the use of these terms may involve a "code" for more sophisticated investors. For example, when an analyst issues a "hold" recommendation, retail investors understandably may believe this to mean a recommendation to maintain ownership of the security, whereas institutional investors recognize that the analyst is really recommending the sale of the securities. The coded terminology may be used to avoid making a negative statement about a present or prospective investment banking client.

In addition to confusing terminology, the research distribution channel at full-service firms also may raise concerns. Some clients of a firm may enjoy a type of "preferred status" and receive notice of important information – including research reports and intentions to issue an upgrade/downgrade – before the other clients of the firm are informed of such information. One Jurisdiction expressed concerns regarding analysts distributing reports to banks or other companies with which the firm does business, allowing these companies to buy and sell shares in anticipation of the report's publication.

2. Proprietary Trading and Discretionary Trading for Clients. Conflicts of interest may arise where a firm trades, for its own account or for clients, securities of companies covered by the firm's analysts. Firms may trade securities in companies covered by their analysts for several reasons, such as market making (or other liquidity provision), private equity investments, or portfolio management services for clients. Because research recommendations often have the ability to impact the price of a company's securities, analysts may be inclined to produce favorable reports and recommendations in an attempt to maintain or boost the value of the securities held by the firm, or its clients. Similarly, a firm may take advantage of pending research and position themselves ahead of its publication, effectively "front-running" their own recommendations.

3. Brokerage Services. An analyst's report can help his firm make money indirectly by generating the buying and selling of covered securities – which result in commission revenue for the firm.

B. Financial Interests in Covered Companies

A firm, its analysts and other employees may own significant positions in the companies the firm's analysts cover. Analysts also may participate in employee stock-purchase pools that invest in companies they cover. In a recent trend called "venture investing," a firm, analyst, or colleagues may obtain discounted, pre-IPO shares and thus acquire a significant stake in start-up companies. These practices allow firms and their analysts to profit, directly or indirectly, from owning securities in companies the analyst covers, which creates an incentive to issue favorable research.

Commercial relationships between a firm and a company may create conflicts for analysts. For example, where a firm, or its affiliates, has granted a significant loan to a company resulting in a large credit exposure, the analyst may be encouraged by the firm to issue a favourable report on the company in order to decrease the risk that the company may default on the loan.

C. Conflicts Stemming From Analyst Compensation and Reporting Arrangements

Compensation and reporting arrangements for sell-side analysts can result in substantial conflicts of interest that may impinge on their objectivity and credibility.

Compensation arrangements can be complex and vary by Jurisdiction and by firm. Several Jurisdictions report that firms consider multiple factors in determining an analyst's remuneration, which may include the analyst's ranking, the performance of the analyst's recommendations, investment banking revenue and trading revenue attributable to the analyst, and overall firm profitability. Some Jurisdictions report that firms significantly link the compensation of their research analysts to investment banking revenue generated by the analyst. One Jurisdiction indicated that some senior analysts at one firm have contracts that provide for bonuses based on the amount of investment banking revenue generated in the business sectors the analyst covers. In a few Jurisdictions, analyst compensation is explicitly tied to the ability of an analyst to "collaborate" with other groups within the firm, including the investment banking division. In other Jurisdictions, the link between analyst compensation and investment banking deals is not always explicit, yet is still perceived to be considerable.

While analysts in some Jurisdictions are compensated almost entirely through fixed salaries, analysts in most Jurisdictions receive some combination of salary and bonus. How and by whom bonuses are set also varies widely from firm to firm. Bonuses may be linked to firm or individual analyst performance (often both), with the individual analyst's performance bonus frequently linked to investment banking transactions they generate or facilitate. One Jurisdiction noted that as much as 90 percent of an analyst's bonus could be based on such a consideration. In some Jurisdictions, the bonuses received as part of an analyst's role in an investment banking arrangement can be much larger than the analyst's fixed salary or bonuses related to research duties.

Some Jurisdictions report that sources external to the firm also may have an effect on an analyst's compensation. These sources include institutional clients' opinions of analyst performance and third party rankings of analysts.

Several Jurisdictions report that reporting structures of full-service investment firms may also be a source of conflict for sell-side analysts. For instance, requiring the research department, or the individual analyst, to report to other business units within the firm may compromise the integrity of research. Likewise, requiring analysts to submit pending research reports to the investment banking department or other divisions prior to publication can result in pressure being exerted on analysts to slant research to meet the objectives of the other divisions of the firm.

D. Other Sources of Conflicts

The management of companies that the analyst covers may exert pressure, subtle and overt, on analysts to issue positive research coverage. Companies may contact the analyst or complain to firm management about an analyst after a negative report or recommendation. In some Jurisdictions, companies have acknowledged that they would deny an analyst access to management – a vital source of information for analysts – should an analyst issue a negative report about the company. Significant firm clients also may pressure analysts to issue favorable research or refrain from issuing negative research about securities in which they hold large positions.

IV. REGULATION OF RESEARCH ANALYST CONFLICTS OF INTEREST

A. Legislative Requirements

Traditionally, few Jurisdictions have directly regulated securities analyst conflicts of interest through legislation, although in the last few years some Jurisdictions have started to review, or have proposed legislation to address these issues. Many Jurisdictions currently apply anti-fraud, market manipulation and insider trading laws to analysts as they do to other market participants. Analysts who promote shares they own in order to increase the market price for the security, for example, can be charged with fraud or market manipulation by securities regulators and criminal authorities. In some Jurisdictions, investors can also sue securities analysts to recover damages caused by analyst fraud.

Analysts pursuing their own (or their employers') interests at the expense of their clients often violate criminal and civil laws in addition to securities laws that prohibit such conduct. Moreover, investors and regulators have charged such conflicted securities analysts with (among other things) negligence, breach of contract, fraudulent misrepresentation and breach of fiduciary duty.

Depending on their specific duties, analysts in some Jurisdictions may be regulated under securities legislation governing "investment advisers," "securities traders" or other regulated activities. Such laws frequently require that those individuals and firms offering investment advice to act fairly and in the best interests of their clients. Furthermore, securities statutes in some Jurisdictions prohibit analysts and the firms that employ analysts from recommending securities whose issuers have some form of relationship with the analyst or firm unless a full and complete description of the relationship is prominently disclosed in the research report or recommendation.

B. Regulation by Securities Regulators and SROs

Some countries manage and oversee analyst conflict issues through a combination of government securities agencies and/or self-regulatory organizations. Government agencies typically possess broad regulatory authority over market participants, which is often supplemented by oversight by SROs. Government regulators usually oversee SRO rule-making and enforcement. SROs impose rules on their members and penalties (including expulsion) for non-compliance. Unlike voluntary professional associations, the law often mandates SRO membership. Consequently, adherence to SRO rules is compulsory for members and violations of SRO rules may entail significant sanctions (particularly if the violator is expelled from the organization and prohibited by law from doing business within the Jurisdiction).

The measures that countries utilize to address analyst conflicts differ widely, vary according to the size and structure of the securities market, and the nature of the conflicts analysts face. In addition to current rules and regulations, several Jurisdictions are now considering new initiatives to further address analyst conflicts issues. Among the current rules and regulations already in place and the new initiatives under consideration are the following:

1. Current Rules and Regulations in Project Team Jurisdictions

- ***Conflicts Disclosure***. Several Jurisdictions require the disclosure in research reports of actual and potential conflicts of interest faced by the individual analyst issuing the report and/or the firm employing the analyst. The level of detail required in such disclosures varies by Jurisdiction, but may include mandatory disclosures:

    - if the analyst receives compensation that is based on giving a specific recommendation;
    - if any part of analyst compensation is related to other investment activity performance;
    - if the analyst or analyst's employer has a relevant financial interest in the company being reviewed;
    - if the analyst's firm has an investment banking relationship with the issuer;
    - if the firm employing the analyst is a market-maker or liquidity provider for securities in the company being reviewed;
    - of the percentage of recommendations in the buy, hold and sell categories; and
    - where the research is paid for by the subject company

- ***Prohibitions on Boilerplate Disclosures.*** Some Jurisdictions require that all conflicts disclosures, whether written or oral, be unambiguous (i.e., prohibit the use of boilerplate language such as "may have a position") and that written disclosures be clear and prominent.

- ***Public Appearances.*** Several Jurisdictions require appropriate conflict disclosures not only in research reports, but also in public appearances by analysts, such as television and radio interviews. In recognition of the characteristics of these media, the conflict disclosures required may be different depending on the characteristics of the media.

- ***Analyst Trading Restrictions.*** Some Jurisdictions bar analysts from investing in a company's securities prior to its IPO if the company is in the business sector that the analyst covers. In addition, "blackout periods" prohibit analysts from trading securities of covered companies for a certain period of time before and after they issue a research report about the company. Some Jurisdictions also prohibit analysts from holding shares in companies that they cover. In one Jurisdiction, analysts are expressly prohibited from trading contrary to his/her recommendation.

- ***Analyst Compensation Arrangements.*** There are few restrictions on analyst compensation arrangements, as most Jurisdictions do not directly regulate this activity. Other Jurisdictions require that the nature of an analyst's compensation arrangement be disclosed to firm clients, and other Jurisdictions have banned -- or are considering banning -- links between analyst compensation and specific investment banking deals.

- ***SRO Membership Requirements.*** Several Jurisdictions report requirements that analysts or firms employing analysts be members of SROs or professional associations that have rules of conduct.

- ***Filing of Research Reports.*** One Jurisdiction requires that research reports be filed with the securities regulator and made public after a certain length of time has passed.

- ***Immediate Disclosure and Filing Obligation.*** One Jurisdiction requires an immediate disclosure obligation of the contents of a research report if rumors of the contents of reports reach the market prior to the release of the report.

- ***Internal Firm Procedures.*** Many Jurisdictions require that firms establish internal procedures and mechanisms to minimize and/or manage securities analyst conflicts of interest. Though the details of such internal procedures and mechanisms may not be specified in the regulations, in practice these procedures may take the form of information barriers between a multi-service firm's research and investment banking divisions and internal restrictions on analysts owning shares in companies they review.

2. Recent Initiatives in Project Team Jurisdictions

As previously noted, securities regulators and SROs in several Jurisdictions are currently considering a variety of regulations to address analyst conflicts issues. These proposals are detailed in the survey and include:

- ***Legal separation of research from investment banking.*** Some Jurisdictions are considering whether it is feasible to force a legal separation of research departments from other investment banking activities.

- ***Compensation Committee.*** Establishing a compensation committee to review and approve research analyst compensation. The committee may not have representation from the firm's investment banking department and may not consider a research analyst's contribution to the firm's banking business. The committee would consider the associated person's individual performance (e.g., quality of research product), correlation between a research analyst's recommendations and stock prices, and overall ratings from various internal or external parties exclusive of the firm's investment banking personnel.

- ***Pitch Meetings.*** Prohibiting research analysts from participating in solicitation or "pitch" meetings with prospective investment-banking clients.

- ***Analyst Certification***. Requiring research analysts and/or head of research to certify the truthfulness of their views in research reports and public appearances, and disclose whether they have received any compensation related to the specific recommendation provided in those reports and appearances.

- ***Termination of Coverage.*** Requiring notification to customers when a firm terminates research coverage of a subject company. This addresses situations where an analyst may have discontinued coverage of a company rather than lower a rating or change a recommendation.

V. KEY ISSUES TO BE RESOLVED IN ADDRESSING ANALYST CONFLICTS OF INTEREST AND OTHER ISSUES

This Report and its appendices have addressed the conflicts of interest faced by sell-side analysts in the production of equity research and by the firms that employ them. This Report and its appendices have also provided a comprehensive survey of existing rules, industry practices and professional standards that address issues related to analyst conflicts of interest in the constituent Jurisdictions.

The Technical Committee agreed at its meeting in October, 2002 that a brief discussion on future directions from the Project Team would be helpful. The following comments are in response to that request from the Technical Committee.

The Project Team recommends that its work should continue in order to formulate a set of high-level principles that IOSCO members could look to for guidance when drafting measures to address conflicts of interest faced by sell-side analysts in the production of equity research. Since many IOSCO members are currently in the process of considering what action to take to address analyst conflicts of interest, the Project Team recommends that the Technical Committee consider giving high priority to developing these high-level principles.

The key areas that the Project Team suggests be considered when developing the high-level principles for addressing analyst conflicts of interest in order to ensure investor protection include:

1. **Integrity** – how do regulators ensure that analysts and the firms they work for act with integrity when producing research reports?

2. **Conflicts of Interest** – what conflicts need to be avoided, what conflicts need to be managed and when and in what form is disclosure of conflicts required?

3. **Proficiency** – should there be specific entry criteria or proficiency requirements to work as an analyst?

4. **Investor education** – what role should investor education initiatives play in addressing analyst conflicts of interest?

A Jurisdiction's assessment of how to address analyst conflicts of interest may also include consideration of:

- the cross-border dimension of the dissemination of research;
- cross-border considerations in regulating analyst conflicts of interest; and
- the balance between government regulation, SRO rules and internal firm rules.

The following is a brief discussion of the key areas.

Integrity

As with all areas of financial service, it is important for investor confidence that analysts and firms act with integrity when producing research.

Integrity of research can be impacted by the integrity of the analyst producing the research, the integrity of the firm disseminating the report and the integrity of the research itself.

Some points that could be considered when addressing the issue of integrity include:

- responsibility within the firm for the integrity of research reports;
- firm reporting structures;
- standards for producing research reports and the infrastructure necessary for implementing and monitoring these standards at a firm, SRO and regulator level;
- the way in which regulators carry out monitoring and enforcement of rules and regulations concerning conflicts of interest faced by analysts and their firms;
- ethical guidelines and education for firms and analysts to emphasize the importance of integrity and the responsibilities of analysts and managers; and
- the use of market forces, such as analyst surveys, to improve integrity by highlighting a firm's objectivity in the research it produces.

Conflicts of Interest

Integrity is closely allied to the topic of conflicts of interest. As we have already discussed in this Report, there may be many conflicts of interest inherent within a multi-service firm that could compromise the objectivity of the research it produces. Regulators have tried to address some of these conflicts by prohibiting certain practices that lead to these conflicts, or by adopting regulations designed to help manage these conflicts fairly so that they do not disadvantage the investor. In other cases, regulators have required conflicts to be disclosed to investors so investors can judge whether the conflicts may have biased the research produced.

Some points that could be considered in determining whether to adopt a policy of prohibition, management and/or disclosure of conflicts are;

- the effectiveness of the disclosure – is the disclosure meaningful, pertinent and easy to read and understand? – related to this issue are the following considerations:

  – what information do investors need to make informed decisions?;
  – whether the disclosure relates to an "actual conflict" or "potential conflict"; and
  – where is the disclosure being made (e.g., written report, web-site, television, radio);

- does the disclosure about "potential conflicts" affect other aspects of the market (by, for example, "tipping off" a potential deal)?;

- what role can and/or should Chinese Walls play in addressing analyst conflicts of interest?;

- how should the structural arrangements (e.g., reporting relationships) within a firm that give rise to conflicts of interest for analysts be addressed?;

- what role, if any, should an analyst play in the investment banking process?;

- how do regulators address the possibility that compensation structures can compromise an analyst's objectivity if the analyst is being rewarded more for his or her contributions to other divisions rather than the quality and objectivity of his or her research?;

- what trading by a firm and its analysts is appropriate? and

- the impact a particular policy may have on all the firms a regulator regulates – for example, prohibition of some practices might force smaller firms out of business and reduce competition within the industry.

With respect to the financial interests an analyst or a firm may have in a particular company or industry sector that could give rise to a conflict of interest, future work on regulating potential analyst conflicts of interest might consider issues such as:

- what financial instruments represent a financial interest? – is it only cash equity instruments that are considered or should derivatives or related instruments also be considered?;

- what level of financial interest is a meaningful indicator of a conflict of interest?; and

- should the financial interests of associates and affiliates of a firm and its analysts and household members and other relations of an analyst also be considered?

Because analyst conflicts of interest can take different forms, future work might also consider potential conflicts that are not directly tied to an analyst's financial interest, compensation or the reporting structure within a firm. For example, future work might consider addressing issues such as "retaliation" by issuers against analysts who issue unfavourable reports (i.e., situations where issuers refuse to provide disfavoured analysts with key information which is given to other analysts) and situations where firms may use their ability to produce or withhold the production of research as an inducement to obtain or retain clients. As well, future work might consider how research reports are disseminated to investors including, questions of whether research is disseminated fairly to investors or selectively to certain investors.

Analyst Proficiency

Future work on the regulation of analyst conflicts of interest might also consider whether investors benefit from mechanisms designed to ensure that analysts are suitably skilled and knowledgeable to offer research recommendations, as is the case with other professions and is required of some analysts in some Jurisdictions. Likewise, future work may consider whether or not investors are better served through standardizing certain aspects of research reports, such as a standard meaning for recommendations (i.e., buy, hold and sell) and through the use of "plain language".

Investor Education

Future work on analyst conflicts of interest might also consider the role investor education plays in managing these conflicts. Such work might analyze the degree to which investor education successfully addresses concerns about analyst conflicts and which groups are best positioned to educate investors about potential conflicts that may influence their investment decisions.