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After the Bubble Has Burst: New Rules for Research Analysts and Research Related Conflicts of Interest

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Recent revelations of serious misconduct by some high profile research analysts during the boom years of the 1990s has forced securities market regulators and market participants alike to examine how conflicts of interest, particularly those arising from the production and dissemination of research, can be better managed in today's integrated financial services firms. The resolution of this issue, along with improved corporate governance standards, is seen by many as key to restoring investor confidence in securities markets. This paper examines the process whereby new regulations concerning research related conflicts of interest have been proposed and implemented in different jurisdictions over the past several years.

As is clear from the information presented in this paper, there is a wide variation in the regulatory framework for research related conflicts of interest that has been adopted in different jurisdictions. Regulations proposed for the European Union and already adopted in Germany, for example, rest fundamentally on principles and enhanced disclosure requirements. Regulators in most other jurisdictions, however, have adopted a much more prescriptive approach, relying on enhanced disclosure and outright prohibitions in order to limit the potential for biased research to be produced and disseminated. In many cases, the prescriptive measures will strengthen "Chinese walls" and limit other types of conflicts of interest. A number of jurisdictions, however, have gone even further by proposing or adopting regulations that will segment research from business units, particularly investment banking. These regulations will, in effect, completely undermine the business model that had developed in many large integrated financial services firms in the 1990s, where research analysts often played an important role in landing and marketing lucrative underwriting assignments and other investment banking deals.

It is far too early to draw definitive conclusions about the impact of the new regulations for research analysts and research related conflicts of interest, since regulatory policy regarding this issue is still evolving in most jurisdictions. It is evident, however, that the new regulations will improve the integrity of the research process primarily because the incentive structure that may have encouraged the issuance of biased research in the past has been virtually eliminated in the largest markets. At the same time, the new regulations will impose significant adjustment costs on many financial services firms, resulting in a substantial reduction in research budgets and research coverage. The new regulations may also adversely affect the capital raising process since they substantially restrict analysts' ability to interact with business units. In short, the regulations will have both

a beneficial impact as well as some adverse effects. An complete evaluation of these effects, however, will not be possible until some point in the future.

1. Global Efforts and Recent Developments in the U.S.

The effort to address potential conflicts of interest affecting the production and dissemination of research by securities firms is truly a global one, with regulators in almost all developed market economies having proposed or implemented new rules for research related conflicts of interest since early 2001 (Table 1). In addition to the work of national regulators, the European Union has recently issued two new directives that deal in part with research related conflicts of interest and has also appointed a Forum Group on Research Analysts that is examining the need for new regulations and/or best practices for research analysts in the European context. Finally, at the international level an IOSCO Project Team on Securities Analysts was formed in early 2001 to examine how securities regulators could address conflicts of interest faced by sell-side research analysts. The project team is currently working on the development of high-level principles that could be used as the basis for new regulations regarding research analysts and research related conflicts of interest in all IOSCO jurisdictions.[1]

While concerns about research analysts' conflicts of interest have generated attention on a global basis, the debate over the topic has been the most vigorous in the U.S., with market participants, regulators, Congress and the New York State Attorney General all contributing to the regulatory framework that is emerging. The first serious effort on this issue began in late 2000, when the largest trade association for the securities industry in the U.S., the Securities Industry Association, convened an ad-hoc committee composed of the heads of research of the major investment banks located in the U.S. The committee was charged with the responsibility of developing a set of "best practices" for research analysts and investment banks. Issued in June 2001, after lengthy and often tortuous negotiations with market participants, SIA's best practices served as a template for similar efforts in a large number of other jurisdictions. In the U.S., however, the private sector's effort to establish and maintain "best practices" was soon overtaken by other events.

[1] The IOSCO Statement of Principles on Security Analyst Conflicts of Interest, which a selected chairs' committee has been asked to submit to the organization's Technical Committee by September 2003, is expected to deal with the standards of disclosure of conflicts of interests, limitation or management of such conflicts, reporting and compensation systems, elimination of outside influence and the integrity and competence of research analysts.

Table 1

Chronology of New Rules for Research and Related Conflicts of Interest

International/Regional

IOSCO	Report of Project Team on Securities Analysts	Late 2003
EU	Draft Market Abuse Directive issued	November 2002
	Revised Investment Services Directive proposed	December 2002
	Report of EU Forum Group on Financial Analysts	Mid-2003
CESR	Consultation with market participants on possible implementing measures for the Market Abuse Directive	July 2002
	CESR's Advice on Implementing Measures for the Proposed Market Abuse Directive	December 2002

National

Australia	Best Practice Guidelines for Research Integrity[1]	November 2001
	ASX publishes Draft Guidance Note	September 2002
	Treasury issues Proposals Paper on Corporate Disclosure	September 2002
Canada	SICAS publishes *Report on Analysts Standards*	November 2001
	IDA approves Policy No. 11, "Analysts Standards"	June 17, 2002
	IDA revises Policy No. 11, "Analysts Standards"	December 2002
France	Conseil des Marchés Financiers (CMF) Implements N°2002-01	March 27, 2002
	CMF amends Articles 2-4-1, 2-4-7 and 3-2-5	May 10, 2002
Germany	Section 34B of the Securities Trading Act implemented	July 1, 2002
	BAFin issues Interpretive Guidelines for Section 34B	March 2003

[1] The best practice guidelines for Australia were released jointly by the Securities Institute of Australia and the Securities and Derivatives Industry Association.

Italy	CONSOB amends Article 69 of Regulation No.11971/99	July 2002
	CONSOB issues Communication n. 3019271[2]	March 2003
Japan	JSDA issues "Rules for Handling of Analysts' Reports"	January 25, 2002
	JSDA issues Interpretative Guideline	February 15, 2002
	JSDA issues revised "Rules for Handling of Analysts' and Reports" and Interpretative Guidelines	January 15, 2003
Korea	FSC amends "Supervision of Securities Business Rule"	March 2002
	KSDA revises" Securities Company Business Conduct Rule"	May 2002
	FSC implements Consolidated Supervisory Plan for Analysts' Conflicts of Interest	August 2002
	KSDA issues Securities Company Business Conduct Rule, Second Edition	August 2002
Sweden	SSDA Implements "Complementary Rules of Conduct"[3]	March 1, 2002
	FSA Implements Regulation FFFS 2002:7-8	July 1, 2002
UK	FSA publishes Discussion Paper No. 15	July 2002
	FSA issues Consultation Paper No. 171	February 2003
US	SIA publishes "Best Practices for Research"	June 2001
	New York State Attorney General opens investigations	July 2001
	NASD/NYSE announce new rules relating to research	February 13, 2002
	SEC approves NASD/NYSE rule changes	May 8, 2002
	NYSAG reaches settlement with Merrill Lynch	May 21, 2002
	Sarbanes-Oxley Act signed	July 30, 2002
	SEC proposes Regulation AC	August 2, 2002
	NASD/NYSE issue additional rules for research	October 3, 2002
	NASD issues further rule changes	December 2002
	Preliminary settlement with major investment banks	December 19, 2002
	SEC approves Regulation AC	February 6, 2003
	Global settlement with major investment banks	April 28, 2003
	NASD/NYSE issue new regulations	May 22, 2003

[2] Communication No. 3019271 replaced Communication DME/1029755 that had been issued in 2001.

[3] The full title of the rule issued by the Swedish Securities Dealers Association is "Complementary Rules of Conduct for Analysts and Corporate Finance Personnel".

On the regulatory side, NASD began to examine the need for more extensive regulations regarding research related conflicts of interest in early 2001. That project took on more urgency later in the year as the U.S. Congress held a series of hearings investigating research analysts' conflicts of interest and the New York State Attorney General's office released, as part of its own ongoing investigation, a series of damaging e-mails written by several prominent stock analysts during the late 1990s.[2] Both events had the effect of making research analysts' conflicts of interest front page news in the U.S., further complicating the regulators' task.

NASD and NYSE issued two sets of new regulations for research related conflicts of interest during the course of 2002, the first in February and the second in October.[3] The regulations include enhanced disclosure requirements along with a large number of prescriptive rules. Among other measures, the new regulations prohibit investment banking from supervising research analysts, require a firm's legal and compliance departments to act as intermediaries for any communication between research and investment banking regarding unpublished research and prohibit firms from basing research analysts' compensation on specific investment banking transactions. In addition, the regulations will require financial services firms to form compensation committees that will approve compensation packages for each research analyst, with the committees expressly prohibited from considering the analyst's contribution to the firm's overall investment banking business. The regulations also prohibit research analysts from participating in solicitation or "pitch" meetings with clients.

The SROs issued a third set of proposed regulations on the topic in May 2003, largely in response to mandates imposed by the Sarbanes-Oxley Act.[4] The latest set of proposed regulations are in many respects more stringent that the regulations issued during 2002. Among other measures, the proposed regulations would: (1) extend some restrictions on the relationship between research

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[2] New York State Attorney General Elliot Spitzer began to investigate allegations that research analysts had committed securities fraud in their research reports in mid-2001, beginning with an investigation into the practices of Merrill Lynch's equity analysts. The initial investigation resulted in a landmark settlement in May 2002, in which Merrill Lynch agreed to pay a $100 million fine and promised to: (1) separate research analysts' pay from the firm's investment banking business; (2) create a new committee to oversee the "objectivity" of stock ratings; and (3) establish a new system to monitor e-mails between investment bankers and equity analysts. Shortly after the settlement with Merrill, Saloman Smith Barney agreed to change the structure of its equity research department in a similar fashion. The SEC, NASD, NYSE and others eventually merged their ongoing investigations with the investigation by the New York State Attorney General, resulting in the global settlement that was announced on April 28, 2003.

[3] The first set of proposed regulations was issued in March and the second set was issued in October. The SEC has approved the proposed regulations issued in March, while those that were issued in October have not yet been approved.

and investment banking to all non-research personnel; (2) require additional disclosure on the part of analysts and firms, including the disclosure of any non-investment banking relationship between the financial services firm and the subject company; (3) prohibit financial services firms from publishing research if the research analyst attempted in any way to obtain investment banking business from the subject company; and, (4) impose a quiet period on firms that underwrite an initial public offering, which is in addition to the quiet period that is already imposed on firms that manage or co-manage primary or secondary offerings (Table 2).

In addition to the regulations proposed and implemented by the self-regulatory organizations, the Securities and Exchange Commission issued a new rule for research analysts in August 2002. Formally known as Regulation AC, this regulation requires research analysts to certify: (1) that the views they expressed in written research accurately reflected their own personal views; and, (2) that their compensation was not directly or indirectly related to specific recommendations or views contained in their research reports or public appearances. The regulation also requires analyst to certify on a quarterly basis that the views they express in public appearances are their own personal views and that no part of their compensation was related to their specific recommendations. Formally approved by the SEC in February 2003, Regulation AC is broader in scope than the regulations issued by the NASD and NYSE since it applies to both equity and fixed income research and also applies to research analysts based in foreign jurisdictions who are producing research for investors in the U.S.[5]

Alongside the regulations issued for the industry as whole, specific regulations regarding research related conflicts of interest have been imposed on the financial services firms that were party to the "global settlement" reached between those banks and a coalition of regulators and law enforcement officials in April 2003.[6] Under the terms of the settlement the firms agreed to pay fines

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[4] Although the Sarbanes-Oxley Act dealt primarily with accounting fraud, it also included one section that mandated a number of new regulations for research analysts and research related conflicts of interest.

[5] Currently, the regulations proposed and implemented by NASD and NYSE apply only to equity analysts. However, this situation may change in the future since the SEC has indicated that the SROs are studying when and how to broaden their rules so as to include fixed income research.

[6] The parties to the settlement on the official side included the SEC, NASD, NYSE, the New York State Attorney General, several other state attorney generals and the North American Securities Administrators Association. The securities firms that were party to the settlement included Bear, Stearns, Credit Suisse First Boston, Goldman, Sachs, Lehman Brothers, J.P. Morgan Securities, Merrill Lynch, Morgan Stanley, Citigroup (Salomon Smith Barney),UBS Warburg and U.S. Bancorp Piper Jaffray

Table 2

Regulations for Research Analysts and Research Related Conflicts of Interest in the U.S.[1]

Disclosure Requirements

All disclosure must be prominently displayed on research reports
Firms must disclose holdings equal to 1% or more of any class of equity securities of subject company[2]
Firms must disclose if the subject company was a client of broker-dealer and types of services provided[3]
Firms must disclose if they make a market in the subject company's securities
Firms must disclose if they has managed or co-managed offering of subject company in past 12 months
Firms must disclose if they received investment banking fees from subject company in past 12 months
Firms must disclose if it or affiliates received other compensation from subject company in past 12 months[4]
Firms must disclose any other actual material conflict of interest relative to the subject company
Firms must disclose if research analyst is officer, director or board member of subject company
Firms must disclose if research analyst received compensation from subject company in past 12 months
Firms must disclose if research analyst received compensation from investment banking division
Firms must disclose any other material conflict of interest of the analyst relative to subject company
Analysts must disclose if firm has received compensation from subject company in past 12 months[4]
Analysts must disclose any personal financial interests in covered company and nature of those interests
Firms must disclose valuation methods used for research, the meaning of ratings and the risks involved
Firms must publish or otherwise disclose the overall distribution of ratings
Firms must disclose the percentage of rated securities that are rated "buy", "sell" or "hold"
Firms must disclose the percent of companies that are investment banking clients within each category
Reports must include a chart depicting the price of equity over time and points when ratings assigned
Research reports must contain information on price and ratings history of all rated securities
Firms must publish notice of their intention to suspend or discontinue coverage of rated issues
Firms must disclose if they managed the subject company's IPO
Firms must disclose if a member of the analyst team owns shares in a firm that is going public

Prescriptive Requirements: Strengthening "Chinese Walls" and Segmenting Research

Information barriers between research and business units must be maintained at all times
Reporting lines between research and investment banking must be clearly demarcated
Investment banking personnel cannot supervise research

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[1] Includes both proposed and approved regulations.
[2] Requirement covers holdings in the five days prior to publication of a research report or a public appearance by analyst that is covering the company.
[3] Types of services that must be disclosed is to be classified as investment banking services, non-investment banking securities-related services and non-securities services.
[4] Must be classified as compensation derived from investment banking services, non-investment banking securities-related services and non-securities services. Disclosure must be made in written research and public appearances by research analyst.

Table 2 (continued)

Firms must ensure that material non-public information obtained by research is retained within research department and not shared with other areas of the firm
Firms must have clear guidelines for managing potential conflicts of interests faced by analysts
Firms must have clear guidelines for analysts who make public appearances of all types
Firms must monitor compliance with guidelines for managing conflicts of interest[5]
Non-research personnel and subject companies cannot approve research reports prior to publication[6]
Investment banking personnel cannot retaliate or threaten to retaliate against research analysts
Firms and employees cannot trade using unpublished information from research
Firm cannot publish research if analyst tried to obtain investment banking business from subject company
Firms cannot promise favorable research or a specific price target or offer to change a rating
Firms cannot publish or otherwise distribute research for 40 days after a primary offering[7]
Firm cannot publish or otherwise distribute research for 10 days after a secondary public offering[7]
Firm cannot publish or otherwise distribute research for 25 days after an IPO if it participated in the underwriting syndicate for the IPO
Firms cannot issue research for 15 days prior to and after expiration of a "lock up" agreement[8]
Research can notify an issuer of a change in rating only at a specific time
Research sent to a subject company prior to publication cannot include the rating or price target
Once coverage is initiated, any proposed rating change in an unpublished research report must be approved by compliance and legal if the subject company has reviewed the report
Research analysts are prohibited from participating in solicitation or "pitch" meetings with clients
Communication between non-research personnel and research must be through legal/compliance[9]
Analysts cannot be compensated with revenues from specific investment banking deals
A compensation committee at each firm is to approve annual compensation for research analysts[10]
Compensation committee cannot consider analyst' contribution to investment banking business
Research analysts' compensation will be based primarily on the quality and accuracy of their research
Basis for analysts' compensation is to be documented and certified annually

[5] Firms must certify annually that they have implemented measures to comply with all relevant SRO rules.
[6] Non-research personnel and the subject firm can only check unpublished research for accuracy.
[7] Applies to firms that have managed or co-managed primarily or secondary public offering of the subject company. Also applies to public appearances by research analysts covering the subject company.
[8] Restriction applies to firms that act as manager or co-manage and also covers public appearances by analysts.
[9] This regulation refers to communication regarding unpublished research.
[10] Compensation committee cannot include members of investment banking department.

Table 2 (continued)

Prescriptive Requirements: Improving Quality of Research and Analysts' Ethics

Ratings must be clearly explained and appropriately categorized
Supervisory analysts must be responsible for approving all research reports
Analysts and supervisory analysts must be registered with and qualified by NASD and NYSE
Analyst cannot trade securities of covered companies for 30 days prior to publication and 5 days after[11]
Analysts and family members cannot trade against their own recommendation unless authorized to do so
No analyst or family member can buy pre-IPO shares if the issuer is engaged in the same type of business that the analyst covers
Management should periodically review all research and recommendations
Firms must keep research reports on file for a specified period of time
Continuing education to be required for analysts stressing rules, ethics and personal responsibilities[12]
Analysts must certify that they have not received compensation for specific recommendations
Analysts must certify that the views they have expressed reflect their personal views

Specific Prescriptive Measures for Financial Services Firms Party to the Global Settlement[13]

Firms must impose a physical separation between research and investment banking departments
Firms must have separate legal and compliance staffs for research and investment banking
Firms must have separate budgeting processes for research and investment banking
Firms must implement policies to ensure employees do not seek to influence research reports[14]
Investment bankers can have no role in determining which companies are covered by research
Investment bankers can have no role in evaluating research analysts' job performance
Research analysts are prohibited from participating in efforts to solicit investment banking business[15]
Research analysts' compensation cannot be based on input from investment banking personnel
Research analysts' compensation will be based primarily on the quality and accuracy of their research
All decisions concerning compensation of research analysts must be documented

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[11] Restrictions also apply to family members of the research analyst.
[12] Also applies to supervisory analysts.
[13] This list is not comprehensive but instead excludes those requirements that apply to all financial services firms. The firms that were party to the global settlement concluded in April 2003 include Bear, Stearns, Credit Suisse First Boston, Goldman, Sachs, Lehman Brothers, J.P. Morgan Securities, Merrill Lynch, Morgan Stanley, Citigroup (Salomon Smith Barney),UBS Warburg and U.S. Bancorp Piper Jaffray
[14] The policies must be designed to ensure that employees do not seek to influence the content of research reports specifically for the purpose of obtaining or retaining investment banking business.
[15] Research analysts are expressly prohibited from participating in "pitches" and roadshows.

and other fees amounting to nearly $1.4 billion while also agreeing: (1) to impose a physical separation between their research and investment banking departments; (2) to create completely separate reporting lines, legal and compliance staffs and budgeting processes between research and investment banking; (3) that investment bankers will have no role in determining which companies are covered by the analysts; (4) that research analysts' compensation may not be based on investment banking revenues or input from investment banking personnel and that investment bankers will have no role in evaluating analysts' job performance; (5) that an analyst's compensation will be based in significant part on the quality and accuracy of the analyst's research and all decisions concerning compensation of analysts will be documented; (6) that analysts will be prohibited from participating in efforts to solicit investment banking business, including pitches and roadshows; and, (7) to implement policies and procedures reasonably designed to ensure that their personnel do not seek to influence the contents of research reports for purposes of obtaining or retaining investment banking business.

The financial services firms that were party to the global settlement in the U.S. also agreed to pay $80 million over the course of the next five years to fund independent research, which they must distribute to their customers and put on their own websites. This requirement, which in effect forces the banks to subsidize the activities of independent research houses, is intended as a way to ensure that investors have different sources of research available. It remains a highly controversial proposal since, as numerous critics have pointed out, the requirement will raise costs to clients without any guarantee that the research produced will be an improvement over the firms' own research.[7] In part because of the uncertain benefits of this requirement, no other regulator has issued a similar proposal.

2. Recent Developments in Canada

Work on new regulations for research analysts and related conflicts of interest began at an early stage in Canada, with the formation of the Securities Industry Committee on Analyst Standards (SICAS) in September 1999. Including representatives from dealers, issuers and institutional

[7] As the UK's FSA noted in a recent paper, an arrangement of this type will not necessarily produce high quality research since, "… the value and independence of a product paid for by a sell-side institution rather than the consumer, and which would be in competition with the institution's own research products, may be questionable." See Financial Services Authority, "Conflicts of Interest: Investment Research and Issues of Securities", Consultation Paper No. 171 (February 2003), page 26.

investors along with the Investment Dealers Association of Canada (IDA), the Toronto Stock Exchange, the TSX Venture Exchange and an observer from the Canadian Securities Association, SICAS was formed with the objective of examining the issues raised by research analysts' perceived conflicts of interest. After lengthy deliberations and review, the committee's report was published in November of 2001 and contained a large number of suggestions for new regulations to safeguard the integrity of research analysts. The SICAS report led to the issuance of IDA's proposed Policy 11, "Analyst Standards", on July 5, 2002. The proposed regulations in Policy 11 include both standards (requirements) and guidelines (best practices) designed to ensure that procedures to minimize potential conflicts of interest were in place at IDA member firms.

Shortly after Policy 11 was released for comment, the Ontario Securities Commission (OSC) surveyed Canada's ten largest investment dealers to find out how they managed analysts' conflicts. The OSC determined, based on the responses it received, that these firms were already in compliance with most of the measures proposed in Policy 11. The regulator noted, however, that the new regulations should include some additional restrictions, such as the U.S. requirement prohibiting trades in securities prior to an issuer's IPO. The OSC also pointed out that there was little consistency among the firms in their disclosure of analysts' potential conflicts of interest and noted that boilerplate language was no longer sufficient for the enhanced disclosure now expected of securities firms and analysts. Finally, the OSC stressed the importance of ensuring that any new Canadian regulations regarding research and related conflicts of interest were sufficiently harmonized with regulations in the U.S. so that Canadian firms would be able to retain their privileged access to the U.S. capital market.[8]

After extensive public comments and consultations with the Canadian Securities Administrators, Policy 11 was revised in late 2002 and 2003 to ensure that there was greater convergence between regulations for research analysts and research related conflicts of interest in the U.S. and Canada (Table 3). Accordingly, although there are still some important differences of emphasis, there is a high degree of harmonization between the regulations in the two jurisdictions. In some respects, however, the proposed Canadian regulations are stronger than those in the U.S. For

[8] Under the Multi-Jurisdictional Disclosure System (MJDS), Canadian-based issuers are able to access U.S. capital markets simply by complying with Canadian listing and disclosure requirements. Canadian issuers are granted this ease of access because of the high degree of harmonization between the U.S. and Canadian regulatory frameworks.

Table 3

Proposed Regulations for Research Analysts and Related Conflicts of Interest in Canada

Disclosure Requirements

Research reports must disclose if firm holds a specific percent of subject company's assets[1]
Analysts must disclose any personal interest that they have in the securities they cover
Reports must disclose if the subject company has paid a fee to the firm[2]
Firms must disclose if they make a market in the subject company's securities
All disclosure must be prominently displayed on research reports
Analysts must disclose if they or family members hold ownership positions in the firms they cover
Analysts must disclose which information is obtain from other sources and which is own opinion
Firms must disclose the names of employees who are officers, directors or employees of the issuer
Firms must disclose if analyst has received compensation from investment banking
Research must show the percentage of rated securities that are ranked as "buy", "sell" or "hold"
Firms must publish notice of their intention to suspend or discontinue coverage of rated issues
Firms should publish or otherwise disclose the overall distribution of its ratings
Firms must disclose if officers and associates have received remuneration from the subject company

Prescriptive Measures: Strengthening "Chinese walls" and Segmenting Research

Information barriers between research and business units must be maintained at all times
Firms must have clear guidelines for managing potential conflicts of interests faced by analysts
Business units and subject companies cannot approve research reports prior to publication
Reporting lines between research and business must be clearly demarcated
Firms must properly control material information obtained by research
Firms and employees cannot trade using unpublished information from research
Firms must monitor compliance with guidelines for managing conflicts of interest
Firms must monitor analysts' ability to own and trade securities of firms that they cover
Analysts cannot trade on their own recommendation for a specified period of time
Analysts cannot trade against their own recommendation unless authorized to do so
Firms cannot issue research for 40 days after a primary offering[3]
Firms must publish notice of their intention to suspend or discontinue coverage of rated issues
Firms cannot issue research or make appearances for 10 days after a secondary public offering

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[1] Under existing regulations in Canada, dealers must disclose any special interest they may have in a specific security for which they have issued a recommendation. In addition, under the contemplated revision of Policy No. 11, firms will need to disclose their holdings of any class of the subject company's securities if those holdings exceed 1% of the total.

[2] Firms must disclose any fees paid by the subject company to the firm during the 12 months prior to the issuance of the research reports.

[3] This restriction also applies to public appearances by research analysts.

Table 3 (continued)

Prescriptive Measures: Strengthening "Chinese walls" and Segmenting Research (continued)

Analysts cannot report on an issuer if they serve as a director, officer or employee of that company
Analysts cannot be compensated with revenues from specific investment banking deals
Firms cannot promise favorable research or threaten to change or delay a change in a rating
Investment banking cannot supervise research

Prescriptive Measures: Improving the Quality of Research and Analysts' Ethics

Ratings must be clearly explained and appropriately categorized
All investment recommendations must be clear and consistent
Supervisory analysts must be responsible for approving all research reports
Supervisory analysts must meet proficiency requirements
Research reports should include explicit description of valuation methods and potential risks
Analysts must have a Certified Financial Analyst designation or other appropriate qualification
Analysts must disclose if their reports are based on visits to the issuer, if visits were material
Analysts must be certified annually to ensure they comply with the AIMR Code of Ethics
Analysts must review financial estimates and ratings following release of material information
Research must maintain and publish financial estimates and recommendations on all rated issues
Research analysts must disclose if they have relied on third party experts and name such experts

example, an analyst in Canada will be prohibited from reporting on a specific company if he or she serves as a director, officer or employee of that company. That relationship is allowed in the U.S. although it must be disclosed. In addition, the proposed regulations in Canada are broader in scope than those in the U.S., since they apply to fixed income as well as equity research.

3. Recent Developments in Europe

Regulatory policy concerning research related conflicts of interest in many European countries has been developed in the context of the European Union's Market Abuse Directive, approved in December 2002, and the revised Investment Services Directive (ISD2), a draft version of which was issued by the European Commission in November 2002. The Market Abuse Directive contains high-level principles for dealing with conflicts of interest, specifically requiring that investment research be fairly presented and that all relevant conflicts of interest be fully disclosed. Under the proposed ISD2, investment research carried out by financial services firms would be classified as an ancillary service and therefore would be subject to the directive's requirement that all conflicts of interest be managed in such a way so as to ensure that the client is not adversely affected.[9]

The Level 1 principles contained in the Market Abuse Directive are to be fleshed out with Level 2 implementing measures that will be adopted by the European Commission and the European Securities Committee (ESC). The Committee of European Securities Regulators (CESR) provided the first official proposals for these measures at the end of 2002, when it issued its advice on implementing measures for the Market Abuse Directive to the European Commission. The measures proposed by CESR include a large number of disclosure requirements but not any prescriptive measures, such as those in the U.S., Canada and elsewhere.[10] In effect, CESR has

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[9] The proposed ISD2 requires that firms identify conflicts of interest that arise in their business activities and prevent those conflicts of interest from adversely affecting the interests of clients, either directly or through organizational and administrative arrangements.

[10] Specifically, CESR has proposed that an analyst or firm must disclose any material financial interest or other material conflicts of interest relative to the subject company. In addition, firms must disclose: (a) when their shareholdings in the subject company exceed 5% of that company's total share capital (against a 1% threshold in the U.S.); (b) when the firm is a market-maker for the subject company; (c) if the firm has led or co-led a public offering for the subject company in the 12 months prior to the issuance of the research report; and, (d) if the firm provided material investment banking services to the subject company in the 12 months prior to the issuance of the research report. CESR also proposed that firms must disclose: (a) the nature of their policies and procedures regarding reporting structures and management of conflicts of interest; (b) if the individual analyst has received any remuneration tied to investment banking; and, (c) the proportion of all recommendations rated "buy", "hold" or "sell" as well as the proportion of rated

proposed that the regulations regarding research related conflicts of interest in the EU should be principals-based, as opposed to the prescriptive regulatory framework found in many other jurisdictions.[11]

In addition to the recent Directives and regulatory advice dealing with research related conflicts of interest, the European Commission has also established a Forum Group on Financial Analysts that is examining how research analysts' conflicts of interest can best be managed. The Forum Group is looking specifically at the need for additional regulations and/or best practices for research analysts in the European context. The Forum Group, which is composed of market participants as well as regulators, is expected to issue its report in mid-2003. Depending upon the recommendations made by the Forum Group, the European Union may adopt additional regulations for research analysts and research related conflicts of interest.

Alongside the regulatory framework that is being developed for the European Union, regulators in a number of individual European jurisdictions have also proposed or implemented their own regulations for research related conflicts of interest. This is the case in Italy, for example, where regulators began work on research related conflicts of interest in 2001, well before the issue claimed international attention. Shortly after discovering that the share of rated securities with a sell recommendation rose from 6% of the total to only 9% of the total in 2001, despite the fact that the market fell by 25 percent that year, the Italian securities regulator (CONSOB) introduced new regulations requiring that all research reports contain a graphically highlighted warning stating the nature and extent of the business relationships between the analysts' firm and the subject company.

A new legal and regulatory framework for research related conflicts of interest is also being developed in Germany, which recently implemented principles for securities research along with enhanced disclosure requirements. Both were contained in the Fourth Financial Market Promotion Act, effective in July 2002, which significantly expanded the transparency regulations in Germany's Securities Trading Act (WpHG). Under the new Section 34B of the WpHG, financial services firms are required to conduct securities analysis with the requisite degree of expertise, care and conscien-

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issuers corresponding to each of these categories for which the firm has supplied material investment banking services over the previous 12 months.

[11] Several months after having received CESR's recommendations, the European Commission released a pre-draft Working Document containing its own proposed Level 2 implementing measures for the Market Abuse Directive, which differs in some important respects from the recommendations made by CESR. The ESC is expected to issue the directive containing the final Level 2 implementing measures for the Market Abuse Directive later this year.

tiousness and to disclose potential conflicts of interest.[12] The German Supervisory Financial Authority (BAFin) issued interpretive guidelines to complement the new legislation in March 2003, which specified certain other situations that would trigger a disclosure obligation for financial services firms.[13] BAFin also noted that other possible conflicts of interest would also have to be disclosed if the firm did not maintain strict barriers (e.g., "Chinese walls") on information flows between research and business units.[14] In effect, BAFin has encouraged financial services firms to strengthen their "Chinese walls" without imposing any specific requirements.

Regulators in several other jurisdictions in Europe have proposed or implemented new regulations regarding research related conflicts of interest that go significantly beyond the rules that have been proposed at the level of the European Union. This is the case in France, where the Conseil des Marchés Financiers (CMF) announced new regulations for research related conflicts of interest in early 2002. These regulations: (a) prohibit a specific link between an analyst's remuneration and investment banking transactions; (b) clarify the rules governing breaches of "Chinese walls"; (c) prohibit research analysts from dealing in the securities of covered companies; (d) prohibit an investment services provider's internal departments from taking priority over clients when research is disseminated; and, (e) require disclosure of any factors that, "may restrict the independence of analysts."[15] The new regulations, which apply to both equity and fixed income research, also

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[12] Specifically, firms are to disclose: (1) when their shareholdings in the subject company exceed 1% or more of the share capital of the subject company (against a 5% threshold proposed for the EU); (2) if they par-ticipated in the syndicate that underwrote the most recent issue of the subject company's securities during the five years preceding the issuance of the research report and whether the firm has assumed placement risk or comparable guarantees concerning the securities that are the subject matter of the research report; and, (3) if they act as an exchange sponsor for the securities analysed in the research report when that sponsorship is on the basis of a contract concluded with the issuer and not with a third party.

[13] Specifically, BaFin stated that a firm must also disclose if: (1) it has a net sales position amounting to 1% or more of the share capital of the subject comp any; and, (2) it holds shares of the subject company in its trading portfolio, although the amount of such shares does not have to be disclosed.

[14] Some aspects of the new regulations in Germany, which were prepared without extensive input from market participants, remain unclear. For example, although the recent BAFin directive clarified some of the confusion created by the new Section 34b of WpHG, it also states that research analysts must reveal potential conflicts of interest when they appear in the media. Since the directive did not specify how and to what extent such conflicts of interest must be disclosed, or if the analysts could be held personally liable if such conflicts of interest were not disclosed, a large number of Germany's research analysts have refused to speak publicly since the directive was issued for fear that they could run afoul of the regulators.

[15] In particular, research reports must disclose if: (1) the firm has been involved in a public offering for the subject company within the past 12 months; (2) the subject company received a copy of the draft research report; and, (3) the firm holds more than 5% of the shares of the subject company.

require the appointment of a research supervisor who is responsible for supervising the exchange of information between research and other departments.[16]

In Sweden, new regulations for research related conflicts of interest issued by the Swedish Securities Dealers Association also rely on disclosure requirements and a limited number of outright prohibitions, the most important of which restrict research analysts' ability to: (1) make short profits for their own account; (2) trade within a specific period of time after the publication of research reports; and, (3) trade against their own recommendations. Other new regulations that have been introduced in Sweden in response to concern over research related conflicts of interest include the requirement that information barriers between research and business units are maintained at all times, that firms have clear guidelines for managing conflicts of interest and that reporting lines between research and business units are clearly demarcated.

Regulators in the U.K. have recently proposed an extensive set of regulations for research related conflicts of interest that in some respects go beyond the regulations issued elsewhere. The Financial Services Authority first examined the issue in July 2002, when it indicated that the U.K.'s principles-based regulatory framework appeared to have been sufficient to prevent the types of abuses found in the U.S. After extensive consultation with market participants following the publication of its first paper, however, the FSA found that management at many firms in the U.K. did not appear to understand or employ the "standards of conduct" necessary in order to ensure that conflicts of interest related to investment research were properly managed. In response, the FSA proposed an extensive set of disclosure requirements as well as new rules and guidelines for research related conflicts of interest in February 2003. The FSA's proposals are both broader in scope and more extensive than those proposed elsewhere since they potentially cover fixed income as well as equity research and seek to place extensive prohibitions on interactions between research analysts and sales and trading as well as between research and investment banking.

The FSA continues to retain a principals-based approach for regulating research related conflicts of interest at a general level. It notes, for example, that senior management at financial services firms must ensure that appropriate systems and controls are in place so that, "… analysts are as free as possible from conflicts of interest that could improperly influence the content of their

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[16] The legislative framework for regulation research related conflicts of interest is likely to change in France relatively soon, as the government is now considering a new law to regulate research analysts. Details of the new legislation are not yet available.

work."[17] However, the FSA has also proposed very explicit guidance for those systems and controls, which in effect will function as prescriptive restrictions. In particular, the FSA notes that: (1) analysts should not be used in a marketing capacity, including in pitches for new investment banking mandates or the marketing of new issues; (2) an analyst's compensation cannot be based on specific investment banking deals and cannot be determined by managers in investment banking or equity sales and trading; (3) a firm or its employees cannot offer or accept any inducement to produce favorable research; and (4) any research report sent to the subject company prior to publication cannot include the proposed recommendation or price target. The FSA also suggests that analysts should be prohibited from dealing in the securities of the companies that they cover and those of other companies in the same sector. In addition to the new guidelines, the FSA has proposed a number of rule changes as well as extensive disclosure requirements (Table 4). The FSA also intends to abolish some of the exemptions that currently allow a firm to trade for its own account ahead of the issuance of a research report.[18]

4. Recent Developments in Asia and Australia

Regulators in a number of Asian markets have also looked closely at the issue of analysts' independence and in many jurisdictions have issued new regulations in order to minimize the potential for conflicts of interest between research and investment banking. In Japan, the issue first surfaced in mid-2001 when a securities firm was sanctioned due to a misleading research report. The Japanese Securities Dealers Association (JSDA) established a working group to examine analysts' activities and other relevant issues soon after that incident and, based on the results of that working group, issued new rules concerning the handling of research reports in January of 2002. JSDA published interpretive guidelines to help clarify those rules the following month. Japan's Financial Services Agency also noted the importance of research related conflicts of interest in its "Program for Promoting Securities Market Reform", published in August 2002. Among other

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[17] "Conflicts of Interest: Investment Research and Issues of Securities", FSA Consultation Paper No. 171 (February 2003), pg. 16.

[18] Specifically, the FSA is proposing to delete the exception that currently allows a firm to trade the securities of a subject company prior to the issuance of a research report if: (1) it believes the report would not materially move the price of the security concerned; (2) if it is merely anticipating expected customer demand; or (3) if it has disclosed in the report that it has traded the securities of the subject company.

Table 4

Proposed New Regulations for Research Analysts and Related Conflicts of Interest in the U.K.

Disclosure Requirements

Firms must disclose holdings equal to 1% of more of the subject company's equity shares
Firms must disclose any other holdings or exposure to the subject company[1]
Firms must disclose if they had investment banking mandates for subject company in past 12 months[2]
Firms must disclose if they managed any issues for the subject company in past 12 months[2]
Firms must disclose if they make a market in the subject company's securities
Firms must disclose if they act as a corporate broker for the subject company
Firms must disclose when coverage of a rated security is discontinued and give the reasons why
Firms must publish or otherwise disclose the overall distribution of their ratings
Firms must disclose the distribution of ratings for issues from corporate customers
Analysts must disclose if they or associates hold ownership positions in the firms they cover

Prescriptive Measures: Strengthening "Chinese walls" and Segmenting Research

Reporting lines between research and business must be clearly demarcated
Investment banking cannot supervise research
Equity sales and trading cannot supervise research
Investment banking cannot determine research analysts' compensation
Equity sales and trading cannot determine research analysts' compensation
Investment banking cannot make decisions regarding coverage, timing or content of research reports
Equity sales and trading cannot make decisions regarding coverage, timing or content of research
Firms and employees cannot trade on their own account using unpublished information from research
Firms must supervise operations so that analysts are able to express independent opinions
Firms cannot issue research for 30 days after an IPO if acted as manager, co-manager or underwriter
Business units and subject companies cannot approve research reports prior to publication[3]
Research sent to a subject company prior to publication cannot include the rating or price target
Firms cannot promise favorable research or threaten to change or delay a change in a rating
Analysts are prohibited from owning and trading securities of firms that they cover[4]
Analysts cannot be compensated with revenues from specific investment banking deals
Analysts are prohibited from participating in solicitation or "pitch" meetings with client
Analysts cannot be used for the marketing of new issues
Subject company cannot make access to company information contingent upon favorable research
Firms and employees cannot offer or accept any inducement to provide favorable research

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[1] If said holdings could create the potential for a conflict of interest.

[2] Firms must also disclose if it expects to have any such business with the subject company during the six months after the issuance of the research report.

[3] Specifically investment banking and sales and trading cannot approve research reports.

[4] The FSA has also suggested that research analysts should also be prevented from owning and trading securities of firms in the same sector as those that they cover.

Table 4 (continued)

Prescriptive Measures: Improving the Quality of Research and Analysts' Ethics

Ratings must be clearly explained and appropriately categorized
Research must include three-year historical charts to show analyst's track record
Research must indicate for which clients the reports are intended
Research must reference sources of data and give date of first release
Research must contain information on price and ratings history of all rated securities
Research must distinguish fact from opinion
Research must contain information on the spread of the firm's ratings on a global and sector basis
Analysts must explain which information is obtain from other sources and which is own opinion
Firm must keep records of changes made to recommendations and timing of research publications

measures, the FSA requested that JSDA review its rules concerning securities analysts and sales representatives as a means to strengthen investor confidence in Japan's securities markets. Responding to that request, JSDA issued a revised set of rules and guidelines for research related conflicts of interest in January 2003, adding additional restrictions to the ones earlier implemented. As a result, the regulatory framework for research analysts and research related conflicts of interest in Japan is now extremely comprehensive and similar in many respects to the framework that has been emerging in the U.S.

The new regulations in Japan are specifically intended to protect "the independence of analysts' views." To that end, financial services firms are required to establish an internal system that will allow them to manage, among other issues, reviews of analysts' research reports and securities transactions conducted by the analysts while also maintaining strict controls over the flow of information between research and other parts of the firm. In addition, the new regulations: (1) prohibit analysts from being employed by investment banking units; (2) prohibit firms from promising favorable research; (3) require firms to disclose any conflicts of interest that the firm or analysts may have with the subject company; (4) require firms to disclose their relationship with a subject company when a research report is published; and, (5) prohibit investment banking from having any influence on analysts' compensation (Table 5).

Regulators in South Korea have also issued new regulations in response to concerns about research related conflicts of interest. The Financial Supervisory Commission issued a consolidated supervisory plan for analysts' conflicts of interest in March of 2002, which was further revised in August 2002. The details of the new regulations were implemented by the Korea Securities Dealers Association through a revision of its Securities Company Business Conduct Rule, first in May of 2002 and again in August of 2002. Among other measures, the new rules prohibit securities companies and analysts from receiving benefits or compensation tied to their recommendation of specific stocks. In terms of disclosure, the rules require that: (1) securities firms and analysts that recommend shares in a specific company must disclose their financial relationship with that company in a written form; (2) firms must disclose if they own 1% or more of a company whose shares they are recommending; (3) research reports must disclose if the subject company received a copy of the draft research report; and, (4) research reports must also disclose the meaning of the ratings that are used in the reports and changes to those ratings the previous 12 months.

Table 5

New Regulations for Research Analysts and Related Conflicts of Interest in Japan

Disclosure Requirements

Firms must disclose the names of employees who are officers, directors or employees of the issuer
Firms must disclose if they managed the subject company's IPO
Firms must disclose if they are an affiliate of the subject company
Firms must disclose their relationship with the subject company when research is published
Firms must disclose any conflicts of interest they might have with the subject company
Firms must disclose any conflicts of interest that analysts might have with the subject company
Analysts must disclose any personal interest that they have in the securities they cover
Analysts must disclose if they or family members hold ownership positions in the firms they cover
Analysts must disclose which information is obtain from other sources and which is own opinion
All disclosure must be prominently displayed on research reports

Prescriptive Regulations: Strengthening "Chinese walls" and Segmenting Research

Reporting lines between research and business must be clearly demarcated
Information barriers between research and business units must be maintained at all times
Firms must have clear guidelines for managing potential conflicts of interests faced by analysts
Firms must monitor compliance with guidelines for managing conflicts of interest
Investment banking cannot supervise research
Firms must establish in-house rules for transfer of information
Firms must supervise operations so that analysts are able to express independent opinions
Firms must properly control material information obtained by research
Investment banking and the subject company cannot approve research reports prior to publication
Firms and employees cannot trade on the basis of unpublished information from research
Investment banking cannot determine or influence research analysts' compensation
Analysts cannot be compensated with revenues from specific investment banking deals
Analysts must be able to express independent opinions relative to specific clients
Analysts are prohibited from owning and trading securities of firms that they cover
Research sent to a subject company prior to publication cannot include the rating or price target
Research can notify an issuer of a change in rating only at a specific time
Firms cannot indicate a target price or rating for a period of time after having participated in an IPO
Firms cannot promise favorable research or threaten to change or delay a change in a rating
Firms cannot promise that a research report on a specific issuer will be written
Communication between research and investment banking must be through compliance and legal[1]

[1] This regulation refers to communication regarding unpublished research.

Table 5 (continued)

Prescriptive Regulations: Improving the Quality of Research and Analysts' Ethics

Ratings must be clearly explained and appropriately categorized
All investment recommendations must be clear and consistent
Supervisory analysts must be responsible for approving all research reports
Research reports should include explicit description of valuation methods and potential risks

The situation in Australia regarding regulations for research analysts and related conflicts of interest is still evolving. Currently, Australia has no specific legal or regulatory requirements for research analysts. Instead, under the nation's Corporations Law, financial services firms and their employees are required to act "efficiently, honestly and fairly" at all times. However, in response to international developments regarding research analysts and research related conflicts of interest, the Securities Institute of Australia (SIA) and the Securities and Derivatives Industry Association (SDIA) issued best practice guidelines for research analysts in November 2001. Although these are currently the only published guidelines for research analysts and research related conflicts of interest in Australia, the situation may change in the near future as both the Australian Stock Exchange and the Australian Securities and Investments Commission (ASIC) have been examining the need for specific rules regarding research related conflicts of interest.

Work on a new regulatory framework for research related conflicts of interest began in September 2002, when the Australian Stock Exchange (ASX) released a Draft Guidance Note that called for some restrictions on research reports issued by financial services firms. Following extensive comments from market participants, the ASX issued a revised Draft Guidance Note in February 2003. Meanwhile, the government issued a policy paper in September 2002, which suggested that certain changes to the Corporations Law would be forthcoming in areas related to corporate disclosure and the management of conflicts of interest. At the same time the government instructed ASIC to prepare a Policy Statement regarding research related conflicts of interest that would complement the anticipated revisions to the Corporations Law. It is expected that the government's detailed proposal to change the Corporations Law and the ASIC's accompanying Policy Statement will be released in mid-2003.

5. Different Approaches to the Same Issue

The regulations that have been proposed or implemented regarding research analysts in different jurisdictions share a number of similarities as well as differences. The similarities are not surprising, since regulators are closely monitoring the regulations that are proposed elsewhere to assess the viability of those regulations for their own jurisdictions. At the same time, regulators in different jurisdictions are faced with significantly different domestic market conditions, which in turn affect the form that the new regulations will take. Such market conditions include, among other factors, the extent to which retail investors are important in the domestic securities market, the size

and structure of domestic financial services firms and, finally, the perceived importance of implementing new regulations for research related conflicts of interest as a means to restore investor confidence. In some jurisdictions, such as the U.S., political pressure to regulate research analysts has also played a role in shaping the regulatory regime that has emerged.

The one common element found in all jurisdictions that have proposed or implemented new regulations for research related conflicts of interest is an emphasis on enhanced disclosure requirements. Disclosure requirements are attractive for regulators and firms alike because they do not impose any significant adjustment cost on the financial services firms that are producing research while at the same time providing retail investors with information that may help them to understand the factors that could constrain research analysts' objectivity. The advantages of disclosure requirements may be particularly important for smaller financial services firms, for which the cost of implementing more detailed restrictions could be prohibitive.

Given these advantages it is not surprising that enhanced disclosure requirements play an important role in all of the new regulations that have been proposed or implemented for research analysts and research related conflicts (Table 6). In particular, almost all jurisdictions now require that: (1) research analysts disclose any personal interest that they or family members have in the securities and companies that they cover; (2) firms disclose when they hold a certain percent of a subject company's assets (with the threshold for disclosure ranging from 1% to 5% of the subject company's total share capital); (3) firms disclose if a fee has been paid by the subject company to the firm within a given period of time (generally twelve months prior to the issuance of the research report and, in some cases, for several months after the issuance of the research report); (4) firms disclose if they make a market in the subject company's securities; and, (5) all disclosure is prominently displayed on research reports and, in many jurisdictions, stated during public appearances by research analysts.

Beyond these "basic" disclosure requirements, firms in a number of jurisdictions are also required to disclose: (1) additional detail on the relationship between the firm and the subject company, such as the names of employees who are officers, directors or employees of the subject company, if officers and associates of the firm have received remuneration from the subject company and if the firm has managed the subject company's IPO; (2) whether the research analyst received compensation from the firm's investment banking unit; (3) detailed information on the

Table 6[1]

New Regulations for Research Analysts and Related Conflicts of Interest	Countries
Disclosure Requirements	
1. Research reports must disclose if firm holds a specific percent of subject company's assets[2]	**C**,**EU**,F,G,I,K,**UK**,US
2. Analysts must disclose any personal interest that they have in the securities they cover[3]	A,**C**,I,J,K,S,**UK**,**US**
3. Reports must disclose if a fee has been paid by the subject company to the firm[4]	A,**C**,**EU**,I,**UK**,**US**
4. Firms must disclose if they make a market in the subject company's securities	**C**,**EU**,F,G,**UK**,US

[1] Regulations that have been proposed but not approved in various jurisdictions are in bold. In the case of Australia, indicated measures refer to best practices.

[2] Under existing regulations in Canada, dealers must disclose any special interest they may have in a specific security for which they have issued a recommendation. In addition, under the contemplated revision of Policy No. 11, firms will need to disclose their holdings of any class of the subject company's securities if those holdings exceed 1% of the total. In the EU, CESR has proposed that firms must disclose when their shareholding in the subject company exceeds 5% of that company's total share capital. In France, firms must disclose when they hold 5% of the shares of the subject company. In the UK, the FSA has proposed that firms must disclose when they hold 1% or more of a subject company's equity shares and any other holdings or exposure to the subject company that could create the potential for a conflict of interest. In the U.S., firms must disclose holdings if it or an affiliate hold 1% or more of any class of common equity securities of the subject company during the five days preceding the issuances of a research report or a public appearance by a research analyst that is covering that company. In addition, the firm must disclose any other actual, material conflict of interest that it has with respect to the subject company, and the research analysts must disclose such conflicts of interest in any public appearance.

[3] In the case of Canada, Japan, Korea, Sweden, the U.K. and the U.S., the requirement also applies to the analyst' family members.

[4] In Australia and Canada firms must disclose any fees paid by the subject company to the firm during the 12 months prior to the issuance of the research reports. In the EU, firms are to disclose if they have provided material investment banking services to the subject company in the 12 months prior to the issuance of the research report. In Italy, research reports must disclose the existence of contracts that could give rise to fees. In the UK, firms must disclose if it had an investment banking mandates or managed any issues for the subject company during the 12 months prior to the issuance of the research report or expects to have any such business with the company during the six months after the issuance of the research report. In the U.S., firms must disclose any fee paid to it by the subject company during the 12 months preceding the issuance of the research report. They must also disclose if the fees or other compensation came from: (1) investment banking services; (2) non-investment banking securities-related services; or, (3) non-securities services.

5. All disclosure must be prominently displayed on research reports	**C**,I,G,J,K,S,US
6. Research analysts must disclose which information is obtain from other sources and which is own opinion	**C**,J,K,**UK**
7. Firms must disclose the names of employees who are officers, directors or employees of the issuer	**C**,J,US
8. Firms must disclose if analyst has received compensation from investment banking	**C**,**EU**,US
9. Research must show the percentage of rated securities that are ranked as "buy", "sell" or "hold"	**C**,**EU**,US
10. Firms must publish notice of their intention to suspend or discontinue coverage of rated issues	**C**,**UK**,**US**
11. Firm must disclose for a specified period of time if it managed the subject company's IPO	**EU**,G,J,US
12. Firms should publish or otherwise disclose the overall distribution of its ratings	**C**,**UK**,US
13. Research reports must contain information on price and ratings history of all rated securities	K,**UK**,US
14. Analysts must disclose if subject company is a client of the firm[5]	K,**US**
15. Firms must disclose if a member of the analyst team owns shares in firm that is going public	S,US
16. Firms must disclose if officers and associates have received remuneration from subject company	**C**
17. Firms must disclose their policies regarding reporting lines and management of conflicts of interest	**EU**
18. A firm must disclose if it is an affiliate of the subject company	J
19. Firm must disclose if it acts as a corporate broker for subject company	**UK**

[5] In the U.S., research analysts must also disclose the source of the compensation that the firm received from the subject company for the previous 12 months, classified as: (1) investment banking services; (2) non-investment banking securities-related services; and (3) non-securities services.

20. Research must disclose distribution of ratings for issues from corporate customers	**UK**
21. Firms must disclose the share of issuers for which it has done investment banking in last 12 months	US
22. Firm must disclose if analyst received compensation from the subject company in past 12 months	**US**
23. Analysts must disclose the nature of any personal financial interest they have in the subject company[6]	US
24. Firm must disclose any other material conflict of interest of the analyst relative to the subject company	**US**

[6] This requirement also covers analysts' family members.

firm's investment ratings, including the percentage of securities rated "buy", "sell" or "hold", the price and ratings history of all rated securities and the overall distribution of ratings; and, (4) the nature and source of the information presented in the research report.

Enhanced disclosure requirements are a particularly important component of the new regulations proposed in the EU and adopted in Germany, where the regulatory framework for research related conflicts on interests is principles-based rather than prescriptive. Most other jurisdictions surveyed here, however, have taken a much more prescriptive approach to the problems posed by research related conflicts of interest. New regulations in these jurisdictions include both enhanced disclosure and prescriptive measures that strengthen existing "Chinese walls" between research and business units, limit or prohibit analysts' ability to have an ownership stake in the firms that they cover and limit inter-actions between research analysts and subject companies. Almost all jurisdictions, for example, now require that "Chinese walls" between research and investment banking divisions in integrated financial services firms are maintained at all times, that investment services firms have clear guidelines for managing potential conflicts of interest and monitor compliance with those guidelines, that reporting lines between research and business units are clearly demarcated and that firms' either restrict or monitor analysts' ability to own and trade the securities of the firms that they cover (Table 7).

Regulators in some jurisdictions, most notably Japan, the U.K. and the U.S., have proposed or implemented additional measures that go even further toward segmenting research from business units, particularly investment banking. The aim of these measures is to eliminate the incentive structure at integrated financial services firms that may encourage research analysts to produce biased research. As numerous critics have pointed out, because research is typically not able to finance itself but instead relies upon revenues from other areas of the firm, research analysts will benefit from a general increase in the firm's revenues. Since research analysts may be able to impact those revenues, and in particular the revenues of investment banking departments, through the issuance of research reports that have a specific slant or bias, they would have an incentive to produce biased research.

One way to eliminate this incentive structure would be to force integrated financial services firms to divest themselves of their research departments, although no jurisdiction has as yet followed that route. Instead, regulators in a number of jurisdictions have proposed or implemented

Table 7[1]

New Regulations for Research Analysts and Related Conflicts of Interest	Countries
Strengthening "Chinese walls"	
1. Information barriers between research and business units must be maintained at all times	A,**C**,F,G,J,K,S,US
2. Firms must have clear guidelines for managing potential conflicts of interests faced by analysts[2]	A,**C**,F,G,J,K,S,US
3. Business units and subject companies cannot approve research reports prior to publication	A,**C**,G,J,K,S,**UK**,US
4. Reporting lines between research and business must be clearly demarcated	A,**C**,F,G,J,K,**UK**,US
5. Firms must properly control material information obtained by research	A,**C**,F,J,K,S,US
6. Firms and employees cannot trade on their own account using unpublished information from research	**C**,F,J,K,S,**UK**,US
7. Firms must monitor compliance with guidelines for managing conflicts of interest	A,**C**,G,J,K,S,US
8. Firms must monitor analysts' ability to own and trade securities of firms which they cover	A,**C**,F,K,S,US
9. Analysts cannot trade on their own recommendation for a specified period of time or without approval	A,**C**,K,S,US
10. Analysts cannot trade against their own recommendation unless authorized to do so	A,**C**,K,S,US

[1] Regulatory changes that have been proposed in various jurisdictions but not yet approved are in bold. Measures agreed to in the U.S. as part of the global settlement, and which apply only to those banks that were party to the settlement, are underlined. In the case of Australia, indicated measures refer to best practices.

[2] The U.S. has also proposed that firms must have clear guidelines for analysts who make public appearances of all types.

11. Firms must establish in-house rules for transfer of information	A,F,J,S,US
12. Firms must supervise operations so that analysts are able to express independent opinions[2]	A,J,K,**UK**
13. Firms cannot issue research for some period of time after a primary offering[3]	**C**,K,**UK**,**US**
14. Firms must publish notice of their intention to suspend or discontinue coverage of rated issues	**C**,**UK**,**US**
15. Analysts are prohibited from owning and trading securities of firms that they cover[4]	F,J,**UK**
16. Research sent to a subject company prior to publication cannot include the rating or price target	J,**UK**,US
17. Firms cannot issue research or make public appearances for 10 days after a secondary public offering	**C**,**US**
18. Research can notify an issuer of a change in rating only at a specific time	J,US
19. An analyst cannot report on an issuer if she/he serves as a director, officer or employee of that company[5]	C
20. Firms cannot indicate a target price or a rating for a period of time after having participated in an IPO	J
21. No analyst or family member of the analysts can buy pre-IPO shares	US
22. All trading restrictions for research analysts also apply to senior research management[6]	**US**
23. Firms cannot publish or distribute research for 25 days after an IPO if acted as an underwriter	**US**

[2] In Japan firms are also required to ensure that analysts are able to express independent opinions relative to specific clients.

[3] In Canada, Korea and the U.S, the quiet period is for 40 days while in the FSA has proposed a 30 day quite period for the UK. Regulations in Canada, Korea and the U.S. prohibit public appearances by research analysts as well as written research during the quiet period. In the U.S., firms can also not distribute research during the quiet period.

[4] The FSA has also suggested that research analysts should be prevented from owning and trading securities of firms in the same sector as those that they cover.

[5] In Japan and the U.S., firms must disclose if the research analyst is an officer, director or employee of the subject company. In the U.S., firms must also disclose if members of the research analyst's household are officers, directors or employees of the subject company.

[6] Defined to include research directors, supervisory analysts, members of committees or other individuals who oversee analysts' recommendations.

Segmenting Research from Business Units

1. Analysts cannot be compensated with revenues from specific investment banking deals	A,**C**,F,J,**UK**,US
2. Firms cannot promise favorable research or threaten to change or delay a change in a rating	**C**,J,**UK**,US
3. Investment banking cannot supervise research	**C**,J,US
4. Communication with investment banking regarding unpublished research must be through compliance and legal	J,K
5. Investment banking cannot determine or influence research analysts' compensation	J,US
6. Firms cannot promise that a research report on a specific issuer will be written	J,US
7. Research analysts are prohibited from participating in solicitation or "pitch" meetings with clients	**UK**,**US**
8. Research analysts cannot be used for the marketing of new issues	**UK**
9. Neither investment banking nor sales and trading can supervise research	**UK**
10. Business units cannot make decisions regarding coverage, timing or content of research reports[7]	**UK**
11. Neither investment banking nor sales and trading can determine research analysts' compensation	**UK**
12. Once coverage is initiated, any proposed rating change must be approved by compliance and legal	US
13. Research management will make all company-specific decisions regarding coverage	US
14. Senior management is to determine research budgets without input from investment banking[8]	US

[7] Specifically, investment banking and sales and trading cannot decide on what stocks are covered, what is written and when it is published.
[8] Research budgets are also to be determined without regard to specific revenues that might be derived from investment banking.

15.	Research departments must be physically separated from investment banking	US
16.	Analysts' compensation cannot be based directly or indirectly on investment banking revenues	US
17.	Investment bankers will have no role in evaluating analysts' job performance	US
18.	Firms must have separate legal and compliance staff for research and investment banking	US
19.	A compensation committee at each firm is to review and approve compensation for research analysts[9]	**US**
20.	The basis for analysts' compensation is to be documented and certified annually	**US**
21.	Non-research personnel cannot approve research reports prior to publication	**US**
22.	Investment banking personnel cannot retaliate or threaten to retaliate against research analysts	**US**
23.	Firms cannot publish research if the analyst tried to obtain investment banking business from that company	**US**
24.	Analysts' compensation must be based on the quality and accuracy of his or her research	**US**
25.	Communication between research and non-research personnel must be through legal and compliance[10]	**US**

[9] The compensation committee must consider the individual analyst's performance, the correlation between the analyst's recommendations and the stock price performance, and the overall ratings received from clients and others regarding the analyst as factors in determining his or her compensation. The compensation committee will be expressively prohibited from considering the analyst's contribution to the firm's overall investment banking business when reviewing and approving compensation packages.

[10] This restriction refers to communication regarding non-published research.

measures intended to eliminate analysts' ability to realize financial gains from the issuance of biased research. They have done this primarily by implementing measures that separate research as much as possible from the firms' business units (see Table 7). Not surprisingly, regulators in these jurisdictions have focused on measures intended to ensure that analysts' compensation cannot be directly linked to or influenced by investment banking. Along these lines, Canada, France, Japan, the U.K. and the U.S. have all proposed or required that research analysts cannot be compensated with revenues from specific investment banking deals while Japan, the U.K. and the U.S. also prohibit investment banking from having any direct or indirect influence on research analysts' compensation. The U.K. has also proposed that sales and trading not be able to influence analysts' compensation while the U.S. has proposed that research analysts' compensation must be based on the individual analyst's performance, the correlation between the analyst's recommendations and the stock price performance and the overall ratings received from clients and others regarding the analyst.

The new regulations in this category also deal with other aspects of the relationship between research analysts and the banks' business units. Canada, Japan, the U.K. and the U.S. all require that investment banking cannot supervise research, with the U.K. also proposing that sales and trading be prohibited from supervising research. Further restricting the relationship between research and investment banking, the U.K. and the U.S. have both proposed that analysts be prohibited from participating in solicitation or "pitch" meetings with prospective clients while the U.K. has also proposed that analysts be prohibited from participating in the marketing of new issues. Japan, Korea and the U.S. all require that any communication between research personnel and investment banking regarding unpublished research must be through or in the presence of legal and compliance personnel, with the U.S. has recently expanding that restriction to include all non-research personnel. Finally, financial services firms that were party to the recent global settlement in the U.S. must now physically separate their research departments from their investment banking operations, create completely separate legal and compliance staffs and budgeting processes between research and investment banking, and implement policies and procedures designed to assure that their personnel do not seek to influence the contents of research reports for purposes of obtaining or retaining investment banking business.

Along with disclosure requirements and regulations intended to prevent research related conflicts of interest, regulators have also introduced a number of measures that deal directly with the quality of the research that is produced and the integrity of research analysts. Almost all

jurisdictions now require, for example, that ratings are clearly explained and appropriately categorized. Many jurisdictions also require that supervisory analysts approve all research reports. In order to improve the qualifications of research analysts, regulators in the U.S. have proposed the establishment of a new examination and registration category for analysts while Canada, France and Sweden now require that research analysts have a Certified Financial Analyst designation or other appropriate qualification. In addition, Canada has proposed that research analysts must be certified annually to ensure they comply with the AIMR Code of Ethics. Finally, Japan and the U.S. have proposed or require that research analysts take continuing education classes addressing rules, regulations, ethics and professional responsibilities (Table 8).

Investor education has become an additional element of the regulatory response to research analysts' conflicts of interest as regulators in several jurisdictions have begun or expanded their investor education programs as a way to help ensure that retail investors are better able to understand the biases that may be inherent in any research produced by integrated financial services firms. Both the SEC and NASD began to expand their investor education efforts in 2002, in response to revelations about research analysts' conflicts of interest. Investor education in the U.S. is likely to expand even further in the coming years since, as part of the global settlement with regulators, the ten largest investment banks in the U.S. will channel $80 million into investor education. The FSA in the U.K. recently announced that it would also mount a consumer awareness campaign intended to highlight the limitations of investment recommendations while also encouraging consumers to seek more factual information before making investment decisions. Since retail investors played an important role in sustaining the stock market bubble that developed in the late 1990s, investor education may prove to be one of the most important measures that regulators can implement in order to prevent (or at least influence the extent of) future market bubbles.

Conclusions

New regulations for research analysts and research related conflicts of interest have been proposed or implemented in almost all developed market economies. While the regulations differ significantly between jurisdictions, the underlying motivation for the regulations is quite similar: to prevent the production and dissemination of biased research and, thereby, to help restore investor confidence in securities markets. Although the regulatory framework regarding

Table 8[1]

New Regulations for Research Analysts and Related Conflicts of Interest	Countries
Improving the Quality of Research and Analysts' Ethics	
1. Ratings must be clearly explained and appropriately categorized[2]	A,**C**,J,K,**UK**,US
2. Supervisory analysts must be responsible for approving all research reports[3]	**C**,F,J,K,US
3. Research reports should include explicit description of valuation methods and potential risks	A,**C**,J
4. Research analysts must have a Certified Financial Analyst designation or other appropriate qualification	**C**,F,S
5. Firms must keep research reports on file for a specified period of time	J,US
6. Continuing education to be required for research analysts[4]	J,**US**
7. Research analysts must disclose if their reports are based on visits to the issuer, if visits were material	**C**
8. Analysts must be certified annually to ensure they comply with the AIMR Code of Ethics	**C**
9. Research analysts must review financial estimates and ratings following release of material information	**C**
10. Research must maintain and publish financial estimates and recommendations on all rated issues	**C**
11. Research analysts must disclose if they have relied on third party experts and name such experts	**C**

[1] Regulatory changes that have been proposed in various jurisdictions but not yet approved are in bold.
[2] In addition, Canada, Japan, Korea and the U.S. require that all investment recommendations are clear and consistent.
[3] In Canada, Japan, Sweden and the U.S., supervisory analysts must meet proficiency requirements.
[4] The continuing education is to emphasize rules, regulations, ethics and professional responsibility.

12. Research reports must include three-year historical charts to show analyst's track record	**UK**
13. Research reports must indicate for whom the reports are intended	**UK**
14. Research must reference sources of data and give date of first release	**UK**
15. Management should periodically review all research and recommendations	US
16. Analysts must certify that they have not received compensation for specific views or recommendations	US
17. Research analysts must certify that the views they have expressed accurately reflect their personal views	US
18. A new registration category and qualification exam will be established for research analysts	**US**
19. Supervisory analysts must be registered with and qualified by NASD and NYSE	**US**

research related conflicts of interest is already clear in most jurisdictions, it is far too early at this stage to draw definitive conclusions about the costs and benefits of the new regulations. That is particularly the case in those jurisdictions, including Australia, France, the EU and the U.S., which are expected to issue new or additional regulations in the near future.

At the same time, however, it is apparent that the new regulations for research analysts and research related conflicts of interest will have a number of important consequences. First and foremost, the new regulations will improve the integrity of the research process since conflicts of interest between research analysts' objectivity and their opportunities for material gain from the issuance of biased research are now much less likely to emerge than in the past. In addition, since all jurisdictions have included enhanced disclosure requirements as an important component of their new regulations for research related conflicts of interest, the new rules will help to ensure that retail investors are more aware of the bias that may affect research produced by integrated financial services firms.

Second, the new regulations will result in a significant change in the way that integrated financial services firms conduct their business, particularly regarding the relationship between research and investment banking. Research became increasingly integrated with business units in many of these firms during the 1990s, as analysts began to play a more important role in landing and marketing lucrative underwriting assignments and other investment banking deals than they had in the past. Because of the new regulations, however, that business model is no longer viable in many of the jurisdictions surveyed here. One result, which is already happening in some investment services firms, is a reduction in the number of research analysts and in the research coverage that is provided. The reduction in research coverage, in turn, may have a significant effect on certain companies and some market sectors, potentially adversely affecting the flow of capital to those companies and sectors. In addition, because the new regulations impose significant restrictions on research analysts' ability to "go over the wall" in order to work with business units, where they have traditionally provided advice on proposals for new issues and other related matters, the regulations may adversely effect the capital raising process. Neither of these adverse effects are likely to have a substantial impact in the near term, given the depressed state of global capital markets, but they may become more important over the longer term.

There are a number of other questions that cannot be answered at the present time. For example, in theory a principals-based regulatory approach to research related conflicts of interest

combined with enhanced disclosure and compliance measures should be adequate to ensure that biased research is not produced. This is the approach suggested by CESR for the EU and already adopted in Germany. It is apparent, however, that regulators in the largest financial markets – including Japan, the U.K. and the U.S. – have all adopted a much more proactive and prescriptive approach. At this point in time, however, it is simply not possible to evaluate the effectiveness of one approach relative to another.

It is also not clear how retail investors will respond to the new regulations for research related conflicts of interest, including ancillary efforts such as the investor education programs that some regulators have recently launched. The main question here is whether greater integrity in the research process will translate into improved confidence in equities markets on the part of retail investors. This is perhaps the most important question of all and one that clearly cannot be answered at the present time. If, however, the regulatory effort to eliminate biased research and other unsavory practices does contribute to a restoration of retail investor confidence in equity markets, then financial services firms may regard any adverse effects of the new regulations as simply additional business costs.