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BRIEFING

FSA consultation paper 171

Conflicts of Interest: Investment Research and Issues of Securities

Executive summary

FSA consultation paper 171 *Conflicts of Interest: Investment Research and Issues of Securities* sets out the FSA's proposed guidelines to strengthen the regulatory regime for investment research and securities issues in order to promote higher standards. The proposals rely on the existing framework of the Principles for Business and the Conduct of Business Sourcebook rules, in respect of which specific guidance is added. However, in their current form they have significant implications for the way in which investment research is used both in sales and trading activities and in connection with new issues of securities.

In response to recent UK and international regulatory concerns on investment firms' practices in relation to conflicts of interest and IPO allocations, the Financial Services Authority (FSA) has published consultation paper 171 *Conflicts of Interest: Investment Research and Issues of Securities* (CP171). CP171 sets out the FSA's proposed guidelines to strengthen the regulatory regime for investment research and securities issues in order to promote higher standards. These guidelines have been developed as a result of responses to the FSA discussion paper released last year (DP15) and in view of recent developments in the US and EU.

The FSA's general conclusion from its work to date is that although the UK has not seen corporate failings on the same scale as the US, the same potential for conflicts exists in UK investment banking. The FSA proposals seek to address concerns that:

- there is insufficient industry understanding of the standards of conduct necessary to ensure that conflicts of interest are, and are seen to be, properly managed; and
- firms' existing systems and controls are not robust or consistent enough to manage conflicts effectively.

In addition, and as a result of recent US investigations, the FSA also considered the regulatory position of certain practices in relation to IPO allocations known as 'laddering' and 'spinning'.

To address issues in relation to conflicts, the FSA is proposing to provide clarification of the measures firms need to take to manage conflicts of interest through

further guidance on the existing Principles for Businesses (Principles). The FSA wishes to retain the current principles-based regime, as it considers that rules-based approaches do not sufficiently recognise the exercise of judgement necessary for controlling conflicts. However, it proposes the introduction of a number of detailed disclosure requirements. CP171 also proposes further restrictions on personal dealings by analysts and on dealing ahead of published investment research.

The FSA does not propose to follow the US in requiring funding of independent analysts or self-certification by analysts. It is proposing to issue new rules imposing a 'quiet period' around a securities offering during which the publication of research reports would be prohibited. The FSA also proposes to introduce guidance on how the existing regulatory regime applies to pricing and allocation practices when arranging issues of securities.

Existing rules

Investment research is currently subject to general legal principles including contractual duties of care, principles of negligence and fiduciary duties. The insider dealing provisions of the Criminal Justice Act 1993 and the provisions of the Financial Services and Markets Act 2000 relating to market abuse and the criminal prohibition on making false or misleading statements are also relevant. In addition, a framework of principles and rules is contained in the FSA Handbook, including the Principles, the Conduct of Business Sourcebook (COBS) and the Listing Rules of the UK Listing Authority.

Proposed changes: conflicts of interest in investment research

CP171 contains proposals to establish clearer guidance to firms on the management and control of conflicts of interest within investment banks. This will comprise specific COBS rules, examples of acceptable and unacceptable conduct and more general guidance.

The key elements of the approach in respect of analysts involve:

- limiting supervision and management of analysts by the investment banking and sales and trading divisions of a firm;
- limiting analysts' involvement in investment banking and sales and trading;
- restrictions on basing analysts' compensation and reward structures on their contributions to profits on specific banking deals; and
- systems and controls to manage analysts' exposure to subject company pressure.

A concern with the proposals is the degree of separation they appear to require between the research function and the sales and trading division and, in particular, the limitations they impose on contacts between analysts and the sales force.

Enhanced disclosure requirements also form a part of the proposal, although the FSA considers that disclosure is a necessary but not sufficient means of managing conflicts. Specifically, disclosure will now be required regarding the significance of the ratings used in research reports, the relationship between the firm and the subject company, the firm's track record and the spread of recommendations. In addition, and in line with the advice of the Committee of European Securities Regulators (CESR) on implementing the Market Abuse Directive, mandatory disclosure of shareholdings above 1 per cent, and possibly other positions, is proposed, although the proposals are more stringent than the CESR proposals, which require disclosure of holdings of 5 per cent or more.

The paper proposes imposing stricter controls on personal dealings by analysts. Although it is seeking views on the issue, the FSA declares its preferred approach to be a prohibition on individual analysts

dealing both in securities of covered companies and in securities of other companies in the same sector.

The FSA also proposes to remove some of the COB exemptions permitting a firm to deal ahead of published research, including if it believes that the research report will not materially move the price of the security concerned, if the firm is merely anticipating customer demand or if it has disclosed in the research report that it has or may have dealt.

One of the biggest changes is the proposed introduction of a 'quiet period' around a securities offering. In the case of a primary offering the publication of research by managers, co-managers and underwriters will be banned from the time the prospectus is published until 30 days after the securities are admitted to trading. Although the quiet period does not apply to secondary offerings, the FSA suggests that it would be for a firm issuing research during this period to show that the research could be justified and was not designed to condition the market.

It is not clear whether the FSA intends to go further than this and to prohibit pre-deal research by syndicate members. For example it states that it would be unacceptable for analysts to be involved in the active marketing of new issues whether by issuing research recommendations or by involvement in advice or sales to clients. The prohibition on involvement in active marketing would seem to preclude the attendance of analysts at roadshows.

Notably, the FSA has not adopted some of the recent US changes, including self-certification by analysts or arrangements by which investment banks are required to fund the provision of sell-side equity research by independent firms.

Proposed changes: securities issues

Although DP15 did not specifically seek to deal with conflicts arising in relation to securities issues, recent concerns in the US regarding practices where firms seek to participate in the profits made by investment clients (laddering) or use IPO allocations as inducements to obtain investment banking business (spinning) have led the FSA to broaden the scope of its review to specifically address these issues.

Following this, the FSA conducted a review of UK practices that revealed marked differences in the internal procedures, systems and controls used to manage conflicts during IPO allocations among firms. To address these issues the FSA proposes to issue guidance that aims to help firms to develop enhanced:

- supervision and management procedures;
- allocation policies; and
- pricing review procedures.

In particular, the guidance envisages greater transparency in the allocation process and more involvement by the issuer. However, the guidance does not distinguish between situations where a firm is acting as agent for an issuer and a 'bought deal' where the firm takes on principal risk. The guidance also makes clear that 'laddering' and 'spinning' are contrary to the rules.

Consistency with US and EU developments?

Although the FSA has acknowledged the desirability of maintaining international standards and the competitive position of UK investment firms, CP171 has been formulated on the basis that not all of the recent US proposals should be adopted for reasons of consistency alone as they do not fit neatly with the current principles-based regime. Having said this, the proposed disclosure requirements closely follow those in force in the US, although there remain differences of detail which could cause difficulties for firms wishing to prepare research for global distribution.

In addition, the proposal notes that any changes will need to be able to take account of the effect of likely EU developments, including CESR's advice to the Commission on the implementing measures to support the Market Abuse Directive and the Commission's proposed revision of the Investment Services Directive.

Conclusions

The FSA's proposals rely on the existing framework of the Principles and the COBS, in respect of which specific guidance is added. However, in their current form they have significant implications for the way in which investment research is used both in sales and trading activities and in connection with new issues of securities.

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