The UK Society of Investment Professionals

November 2002

Response on FSA Discussion Paper 15 Investment Research: Conflicts and other issues

UKSIP is a member society of AIMR®

FSA Discussion Paper 15

Investment Research: Conflicts and other issues

Response by UKSIP

About UKSIP

The UK Society of Investment Professionals (UKSIP) has over 4,000 investment professionals as its members. The majority of these members also belong to the Association for Investment Management and Research (AIMR) the global standards body of which UKSIP is the UK-based Society. Both AIMR and UKSIP provide support for the Chartered Financial Analyst (CFA) designation and over 100,000 candidates sat parts of the CFA exams in 2001. Currently there are over 1,500 CFA Charterholders in the UK and, during 2002, more than 5,000 candidates sat the three levels of the CFA examination here.

With professional excellence at the core of its objectives, UKSIP itself runs the Investment Management Certificate, the entry level qualification of choice for those wishing to become investment analysts or fund managers in the UK and for those seeking an introduction to investment management. Success at UKSIP's Associate Examination enables investment professionals to use the ASIP designation which, like the CFA, offers recognition of high achievement.

Research Objectivity and AIMR

As UKSIP is one of the largest member Societies of AIMR, it has recently offered its views to AIMR on its draft Research Objectivity Standards (AIMR-ROS); a copy of this response is incorporated with UKSIP's comments on Discussion Paper 15. The important point about AIMR-ROS is that they are intended to apply to firms globally rather than individual AIMR members who are already subject to that organisation's Code of Ethics and Standards of Professional Conduct.

Discussion Paper 15 – UKSIP overview

UKSIP is strongly supportive of the approach taken by the Financial services Authority (FSA) in Discussion Paper 15. It contains balanced and constructive comment, mindful of the needs of retail as well as institutional investors and of wider regulatory developments. It considers conflicts and other issues relevant to investment research in some detail; such issues are neither new nor unknown to professional investors and are, of course, covered by conduct of business rules and systems and controls operated within individual investment firms.

The discipline necessary to pass relevant and good quality examinations would help those responsible for investment analysis and recommendations. An examination such as the Investment Management Certificate and CFA Level I each includes tests of standards of practice and of codes of ethics. Furthermore, CFA Charterholders are required to sign up annually to a Statement of Professional Conduct. Such disciplines help to ensure that analysts' recommendations have a reasonable basis in fact and offer an audit trail, thus avoiding "off the wall" views. Enclosed is a copy of AIMR's Standards of Practice Handbook.

Investment research and information dissemination

UKSIP agrees with the contention in 3.5 that, as longer term investors, institutions – where they consider research reports – do so in order to check on facts about particular companies, rather than headline recommendations. It is also true that such reports can lose some of their value by the time they reach retail investors; clearly, retail investors who are relying on such reports to make investment decisions, are unlikely to be following advice given in the financial press, by their advisors or by the regulators.

UKSIP understands the contention in 3.9 that analysts could well damage their careers should they compromise their integrity by issuing recommendations contrary to their own views. FSA suggests, however, that there is evidence that this has happened in the UK. No evidence, however, is offered.

Q3.1: Do research analysts commonly undertake other work not described here?

This section adequately describes the work of a research analyst.

Conflicts of interest and other perceived problems

In 4.2, the potential for retail investors to misinterpret analysts' reports is mentioned. As research reports are produced primarily for use by institutional investors, it seems unreasonable to expect them also to fully meet the needs of retail investors, without some informed help.

As is acknowledged in 4.8, many of the conflicts that could arise involving research analysis can be avoided by using independent research companies. Access to such research comes at a cost which some investors are prepared to meet; many others are not.

In 4.9 it is suggested that a review of research by the corporate issuer may result in a lack of objectivity and independence by the analysts involved. UKSIP suggests that accuracy is of prime importance in investment research, and would be interested to see any evidence that objectivity and independence had been compromised in the quest for accuracy.

The evidence in 4.10 is interesting but not unexpected. It would seem unreasonable to expect firms to make a substantial number of "sell" recommendations against their own clients and FSA has already contended that institutions do not pay much attention to such recommendations.

Conflicts arising from "multi-tasking" of analysts – as set out in 4.14 – may require a regulatory resolution, if they are felt to be of sufficient concern. Similar arguments apply to the question of payment for research as set out, for example, in 4.17.

4.20 and 4.21 touch on the integrity of analysts; if an analyst does hold shares in an institution that he/she covers, any trades by that individual should be consistent with recommendations made.

In 4.37 the question of disadvantaging private investors is again touched upon. In 4.38 it is suggested that investors may not understand or may simply ignore disclosure statements on research reports. UKSIP would not object to a strengthening of such statements, but remains unconvinced that some private investors can be protected against their own folly.

Q4.1: Have the most important conflicts and perceived problems been identified?

The Discussion Paper may not place sufficient emphasis on the need for analysts to have a reasonable basis for particular recommendations. This requirement should be included in standards of practice. It may also be worth reviewing UKSIP's response to AIMR-ROS which, in some respects, takes a broader view of various conflicts, extending to issuing companies, the media and so forth.

Q4.2: Are there any particular factors that make the main conflicts and perceived problems more or less relevant to the market in the UK?

UKSIP understands that, statistically, UK individuals represent a smaller proportion of direct investors than, say, in the US. Arguably, it is also the case that the UK's financial press provides levels of financial expertise unlikely to be reached in many other markets. Lastly, the UK's regulatory regime has been established in the full knowledge that such conflicts exist.

Q4.3: How well do you think conflicts of interest are identified and managed?

It is likely that they are managed as effectively in the UK as elsewhere, although the adequacy of potential conflicts of interest needs to be reviewed by the media in such areas as investors television channels and in the weekend papers.

Q4.4: Which of the issues identified, are most important to you and which do you think are most significant to the regulator?

Initial achievement and the subsequent maintenance of high professional standards are key issues for UKSIP. These can also help the regulator to ensure a healthy market environment.

Relevant regulatory provisions in the UK

UKSIP considers this section of the Discussion Paper to be a useful resume of the present regulatory impacts on financial analysts.

Q5.1: Do market participants believe that the current regulatory standards affecting analyst research are appropriate in today's markets?

Q5.2: Are there any areas where additional guidance and/or new, more detailed rules may be appropriate?

Whilst the UK has not suffered the same corruption of the role of an analyst as in the US, there is still potential for abuse since, as long as research is linked to investment banking, sales and trading, companies can still apply pressure for research reports to be favourable in order to direct business. Research needs to report separately from these areas.

Q5.3: Do you consider a more prescriptive regulatory approach to managing conflicts of interest to be necessary?

No, but FSA reviews of financial institutions should focus on the independence of the research function from investment banking and sales/trading.

Q5.4: Would investment firms continue to produce research if all such reports had to be labelled "financial promotions"?

Firms would be greatly discouraged because the "research" in question would be viewed as biased.

International context

UKSIP is particularly interested in the comparisons drawn – in paragraphs 6.19 to 6.29 – between the UK and US situations. Since the Discussion Paper was prepared, further significant US regulatory developments have since taken place. The comments in 6.21 are particularly reassuring.

With regard to the lack of a uniform industry standard for analyst qualifications, as mentioned in 6.26, UKSIP would remind FSA of the growing reputation of the Chartered Financial Analyst® qualification, which is gaining global acceptance.

Q6.1: Do you think the situation in the UK market has been accurately described?

Yes.

Q6.2: Are there any particular aspects of the CESR proposals or the new US Rules that we should take into account when assessing the UK regime?

The new US rules prescribing prohibition from bonuses of favourable research, disclosure of firm compensation and limitations on reviews of research reports by the issuer or the investment banker, are worth considering.

Q6.3: We understand that many of the largest investment firms have global policies covering research. Will the new US Rules be adopted on a global basis or will different regional practices continue to exist?

Global firms are likely to adopt consistent research policies throughout their organisations.

Review of options to address perceived problems

UKSIP would support the indication in 7.1 that FSA should place some reliance on the role of market forces and should recognise that it is difficult to regulate on the question of "personal ethics". As FSA will be aware, all members of the Association for Investment Management and Research (AIMR) are subject to its Codes of Ethics and Professional Standards. The introduction by AIMR of its Research Objectivity Standards (AIMR-ROS) are a logical extension of these codes to firms globally.

UKSIP would support the review visits by the regulator, provided they were constructive in nature and designed to help regulated firms rather than simply seek to identify regulatory shortcomings.

With regard to increasing investor awareness and understanding, it is likely that FSA will have contacted Proshare on the basis that its "Investment Clubs" nationally may provide helpful indicators.

Regarding the possibility of company pressure on analysts, your attention is drawn to UKSIP's response to AIMR-ROS.

UKSIP notes that in sections 7.19 and 7.20 the FSA has considered minimum education or mandatory authorisation requirements. UKSIP also believes that education, training and awareness should be part of setting high professional standards in the UK. The IMC examination offered by UKSIP meets minimum regulatory standards for the role of providing investment management services. This examination includes a module covering regulation and ethics that professionals operating in the UK must be aware of and comply with. Also, the equivalent global qualification for the IMC is the CFA Level I examination offered by the AIMR. UKSIP believes that analysts practising in the UK market should be required to have completed one of these or similar qualifications that could test their knowledge of regulatory and ethical standards.

UKSIP would also like to remind the FSA of its role in ensuring high standards for analysts and investment professionals. A high and increasing population of the members of UKSIP are also regular or affiliate members of AIMR. As such, they subscribe to the Code of Ethics and Standards of Professional Conduct, (copy is attached) and annually file a statement of Professional Conduct certifying their adherence to these standards. The Standards of Professional Conduct include relationships with and responsibilities to clients and prospects. Standard A.1 requires members to:-

a) Exercise diligence and thoroughness in making investment recommendations or in taking investment actions.
b) Have a reasonable and adequate basis, supported by appropriate research and investigations for such recommendations or actions.
c) Make reasonable and diligent efforts to avoid any material. misrepresentation in any research report or investment recommendation.
d) Maintain appropriate records to support the reasonableness of such recommendations or actions.

Standards A2 cover Research Reports and requires that members shall:-

a) Use reasonable judgement regarding the inclusion or exclusion of relevnt factors in research reports.
b) Distinguish between facts and opinions in research reports.

Additionally, these standards cover Fair Dealing, Priority of Transactions and Disclosure of Conflicts to Clients and Prospects.

These standards, if followed by individuals, would be helpful in protecting institutional and retail investors. The FSA should review whether these standards, especially A1 and A2 are adequately covered in the current regulation or Code of Conduct. One possibility is to incorporate similar standards in the Code of Ethics for analysts and investment professionals so that they are tested in the IMC. Another possibility is that analysts should be required to be members of the UKSIP.

Q7.1: Of the five broad regulatory options, would you favour:

- Maintaining the status quo;
- Review visits by the regulator;
- Measures to increase investor awareness and understanding;
- Additional regulatory rules/guidance;
- Steps to discourage subject company pressure on analysts

Additional regulatory rules should be introduced for the qualification and examination of those undertaking the analyst’s role, including a test of knowledge of standards of practice as well as annual certification of compliance.

Q7.2: Is there some combination of those options which you would favour?

A combination of review visits plus the regulatory rule proposal above should be considered. It is difficult to discourage an issuing company's direct or indirect pressure on an analyst as long as that individual does not enjoy independence from such influences.

Q7.3: Where you would propose new regulatory provisions, how should they be articulated – as requirements set down in rules or through guidance?

Begin with guidance.

In view of the public interest in the above issues, UKSIP may use this submission as a basis for briefing the media.

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