



Consultation Paper 171

**Conflicts of Interest:
Investment Research and Issues of Securities**

**Response by
the UK Society of Investment Professionals**

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About UKSIP

The UK Society of Investment Professionals (UKSIP) is a professional body whose main aim is to foster and maintain high standards of professional ability and practice in investment analysis, portfolio management and related disciplines. It currently has over 4,000 members, who work or have an interest in the UK financial services industry. UKSIP oversees the Investment Management Certificate (IMC), the benchmark qualification for those working in investment management in the UK and currently held by over 12,500 investment professionals. The designation ASIP can be used by UKSIP members who successfully completed UKSIP's former Associate examination.

Although independent, the Society is the second largest member society worldwide of the Association for Investment Management and Research (AIMR[®]), and the largest in Europe. AIMR is a global non-profit organisation of more than 54,000 investment professionals, spread throughout the world. AIMR is best known as the organisation that develops and administers the Chartered Financial Analyst (CFA[®]) Programme. Over 100,000 candidates from over 150 countries are expected to sit the CFA examination this year.

UK regulation in the global context

The Financial Services Authority (FSA) has taken pains to explain the need for newly introduced UK regulatory requirements not to be in conflict with both broader EU directives and with US developments. On behalf of its members, UKSIP strongly supports this need and would be concerned if any of the current proposals showed inconsistencies with EU and US measures but were, nonetheless, adopted by the FSA.

Sell side and buy side research

Investment research can take a number of forms but UKSIP believes that the primary regulatory interest should be with "sell side" research undertaken within an integrated investment bank. Indeed, this can be inferred from the Consultation Paper. However, UKSIP would like the FSA to draw a distinction between this particular form of research and others. It would be most unfortunate, for instance, if "buy side" research undertaken within an investment management house were inadvertently caught; such research is not used outside the organisation in question. UKSIP is aware of other bodies holding a similar view; APCIMS being a case in point.

Q1 *Do our proposals address the main sources of conflict, and set a sufficiently clear line on acceptable and unacceptable conduct?*

Yes, for “sell side” investment research undertaken within integrated investment banks.

In 3.19 UKSIP assumes that the FSA is referring to the Research Objectivity Standards, currently being developed by AIMR. An important point about these Standards is that they can be adopted by firms globally and are consistent with the Code of Ethics and Standards of Professional Conduct to which AIMR’s individual members are required to sign up annually.

UKSIP agrees with the points made in 4.8 concerning analysts’ compensation and reward structures. Firms could be in a better position to demonstrate that they are adhering to FSA expectations if their relevant policy statements, such as corporate codes of ethics, addressed these matters.

In relation to 4.11 – and – to avoid any misunderstandings, care would need to be taken in connection with any disclosure of a decision to cease coverage of a company. Guidance in this area might be helpful.

Q2 *Do you think that the proposed approach to quiet periods for primary and secondary issues of securities would remove a significant source of conflict?*

Yes. Companies appear to engage so many advisers that cynics might suggest this could be a tactic for muzzling some analysts. Furthermore, as the prospectus is the primary source of information, there should be little need for additional research, as this should not contain any information additional to that in the prospectus.

Q3 *Do you agree with the proposed length of the quiet period for primary issues?*

Yes. Again, the wording in 4.18 “... or by any member of an underwriting syndicate” suggests that many organisations could be prevented from preparing research during “quiet periods”. UK primary issues are, of course, extensively sub underwritten to ensure their success and it is important that “buy side” analysts are not inadvertently caught by the FSA’s proposal. To avoid this possibility, it is suggested that the FSA differentiate between research for clients (“sell side”) and “other research”.

Q4 *Do you think that prohibiting personal dealing by analysts in the stocks and sectors they cover is an appropriate standard for tackling their personal conflicts of interest?*

No. It could be argued that the FSA’s proposals in 4.21 are not designed to manage conflicts of interest but seeks to avoid them altogether by prohibition. UKSIP is doubtful that prohibition would deal with the underlying concerns provided that these are well founded, in reality. Furthermore, such a development could undermine a firm’s senior management and its ethical culture. A firm’s personal account dealing rules should govern practices.

Clearly, if an analyst does hold shares in an institution covered by that individual, any trades made should be consistent with relevant recommendations. UKSIP does not believe that an overwhelming case has been made to prohibit such personal dealings. This should remain a matter for individual firms as it could be argued that the freedom to deal on one's own account provides an incentive for good analysis. Lastly, why single out analysts when others – such as stockbroker traders – are likely to have a more active promotional role with clients?

Q5 *If not, what controls could be implemented that would constitute a viable alternative to prohibition?*

Above comment refers.

Q6 *Do you think that 1% is the appropriate threshold for disclosure of material shareholdings?*

A blanket 1% disclosure threshold irrespective of the size of the company in question, would not be an optimum outcome.

Q7 *Do you agree that a firm's positions in other company securities, and related derivatives, should be disclosed?*

There is, of course, some potential for conflicts of interest where a firm issues research on a company for which it is involved in raising capital or in whose securities it deals, whatever the type of security. However, UKSIP would not recommend disclosures other than equity holdings before the serious cost issues have been fully assessed.

Q8 *Would thresholds be useful for this purpose, and, if so, at what level(s) should they be set?*

Detailed disclosures could possibly give rise to issues of commercial confidentiality, not UKSIP imagines, an intended consequence of this proposal. Perhaps it would be sufficient for firms to disclose the existence of material positions. As to materiality, it should be for senior management to determine the point at which the potential for conflict arises, mindful that they would be able to call on advice from their auditors.

Q9 *Do you agree with our conclusion?*

Yes, and UKSIP believes it is addressed in the Code of Market Conduct.

Q10 *If not, what arguments are there in favour of self-certification by analysts?*

Whilst the FSA is not convinced that self-certification would be a useful additional disclosure, this need not necessarily be discouraged as it could be useful in appropriate circumstances. However, as research is normally signed off in the firm's name, self-certification would be unlikely to address the

question of bias, although it could cover deliberate misrepresentation by an individual analyst.

There may be some reason to suppose that the release of research material is being regarded by the FSA as akin to a company issuing information into the market. UKSIP would content that investor education is the key concern rather than consumer protection.

Similarly, it would seem that FSA concerns may not extend to rating agencies, notwithstanding that they can be hugely influential. They, of course, only rate organisations that pay them.

Q11 *Do you think that these proposed amendments address the scope for abuse of the existing dealing ahead rules?*

UKSIP agrees that the rules on dealing ahead should be tightened. It nevertheless believes that firms should still be permitted, in the interests of orderly markets, to deal ahead in anticipation of expected customer demand. To prevent abuse, such dealings should be subject to subsequent scrutiny by FSA.

Q12 *Do you think there are any other circumstances in which a firm could legitimately deal knowingly without prejudice to its clients' interests?*

None, other than the two exemptions that the Consultation Paper proposes to retain and dealing ahead in anticipation of expected customer demand.

Q13 *What arguments are there for requiring investment firms in the UK to fund the provision of independent investment research for the benefit of retail investors?*

None of any merit. Independent research is already available to those willing to pay for it. The consultation paper exaggerates the extent to which retail investors are likely to be misled. Private investors are not obliged to manage their own investments themselves and those who do tend to do so out of interest and frequently with considerable intelligence and knowledge. UKSIP also finds it hard to see the justification for a campaign by the FSA to tell private investors that, for example, they are not the exclusive recipients of the tips that they read in the press. The FSA should not forget that institutional investors, and through them millions of pensioners and pension scheme members, - rather than the investment banks – ultimately pay the cost of regulation. No doubt the FSA will continue to be careful to avoid confusing its investor education objectives with the issues of market integrity and consumer protection.

Q14 *Do the conflicts of interest, and the measures to combat them, also apply to the production of non-equity research?*

Yes. Similar conflicts apply and should be managed through the same sort of management arrangements and disclosures as for equity research (UKSIP recognises the problems of determining appropriate disclosure thresholds for non-equity research).

UKSIP is not responding to the matters raised in Section 5 of the Consultation Paper.

Please note that, in view of the public interest in these matters, UKSIP may brief the media on the basis of this paper.

J E Rogers
Chief Executive

12 May 2003