



**ASIC**

Australian Securities & Investments Commission

**REPORT 24**

# **Research analyst independence**

August 2003

# What this report is about

The aim of this report is to:

- Provide an overview of the regulatory and compliance issues affecting the research analyst and investment bank relationships in Australia;
- Assess the impact in Australia of overseas regulatory and compliance improvements;
- Report on ASIC's surveillance campaign involving certain selected entities; and
- Provide a factual basis for policy guidance, which will follow the release of the Government's draft CLERP 9 legislation later in 2003, and ASIC's intended policy proposal paper.

# Contents

<b>What this report is about.....</b>	<b>2</b>
<b>Contents.....</b>	<b>3</b>
<b>Section 1: Executive summary .....</b>	<b>4</b>
<b>Section 2: Background.....</b>	<b>7</b>
<b>The role of research analysts .....</b>	<b>7</b>
<b>Identifying problematic areas.....</b>	<b>7</b>
<b>Section 3: Legal and policy context .....</b>	<b>9</b>
<b>Current law .....</b>	<b>9</b>
<b>CLERP 9 .....</b>	<b>10</b>
<b>US regulatory changes.....</b>	<b>11</b>
<b>Significance of regulatory developments .....</b>	<b>15</b>
<b>IOSCO Working Committee .....</b>	<b>15</b>
<b>Section 4: Analyst independence campaign .....</b>	<b>17</b>
<b>Objectives.....</b>	<b>17</b>
<b>Methodology .....</b>	<b>17</b>
<b>Stage 1 .....</b>	<b>18</b>
<b>Stage 2.....</b>	<b>19</b>
<b>Section 5: Campaign findings .....</b>	<b>21</b>
<b>Grey and restricted lists .....</b>	<b>21</b>
<b>Analyst remuneration .....</b>	<b>23</b>
<b>Analyst trading.....</b>	<b>24</b>
<b>Research process.....</b>	<b>25</b>
<b>Supervisory Analyst Processes .....</b>	<b>27</b>
<b>Disclosure .....</b>	<b>27</b>
<b>Organisational structure .....</b>	<b>28</b>
<b>Complaints management.....</b>	<b>28</b>
<b>Chinese wall procedures.....</b>	<b>29</b>
<b>Conflicts of interest management .....</b>	<b>30</b>
<b>Compliance and operational testing .....</b>	<b>31</b>
<b>Changes in light of US regulatory requirements ....</b>	<b>32</b>
<b>Section 6: Conclusion .....</b>	<b>33</b>

# Section 1: Executive summary

1.1 During the past two years there has been much political, regulatory, industry and media attention focused on the issue of conflicts of interest within investment banks. Much of this attention has been driven by the high profile investigations in the United States of America (USA) but it is a matter all securities regulators have displayed interest in, notably through the International Organization of Securities Commissions (IOSCO).

1.2 Within an investment bank, a conflict of interest can occur between the independence and objectivity of analysts' research and the independence of the investment banking function. The source of the conflict of interest appears to be driven by the dual nature of the "sell-side" research analysts' role. The research analyst is required to:

- Generate and assist objective investment strategies for clients of the investment bank; and
- Secure revenue for the investment bank by suggesting or assisting in investment banking transactions.

1.3 Where conflicts of interest are not managed they have the potential to undermine confidence in the financial markets and pose a threat to investor protection, both of which are serious concerns for ASIC.

1.4 In response to this, we established a campaign to examine research analyst independence and the role analysts play in promoting securities in financial markets. The aim of the campaign was to specifically review:

- the practices and activities of research analysts in Australia;
- standards of conduct and supervision of research analysts; and
- the adequacy of current regulatory requirements.

1.5 Broadly, the research practices of eight investment banks were reviewed with four of these entities then selected for closer examination. Corporate entities, independent research houses and investment banks without research functions were also invited to comment and their feedback has been considered as part of the project.

1.6 In undertaking the review we have tried to understand not only the issues but also the underlying causes and have attempted, in our findings and recommendations, to strike a balance between investor protection and fair and efficient markets.

1.7 It is important to say that generally the review has not identified the same corporate failings or misconduct as had occurred in the USA, nor did it indicate that any of the misleading selling practices being investigated in the USA are present domestically. It is also relevant to emphasise that our review was conducted as a surveillance campaign, because the grounds on which an investigation may be commenced were not present. As a consequence our information-gathering powers were less extensive and intrusive in this surveillance campaign than would otherwise be the case for an investigation.

1.8 Our approach to this project differed from the USA regulatory authorities' who specifically selected an earlier period for review and investigation prior to the enhanced compliance procedures implemented in 2002. As a consequence, our review focused on a different set of systems and procedures and a later time period during which many compliance-driven enhancements were implemented.

1.9 Our review did however identify a number of issues around the independence of research analysts operating within the investment banking environment. It also indicated potential risk areas that may benefit from additional regulatory or policy guidance.

1.10 Specifically our review suggested that the industry guidelines developed by the Securities and Derivatives Industry Association (SDIA) and the Securities Industry of Australia (SIA) have not been adopted as closely as intended and that there is still significant room for conflicts of interest to occur and to remain unmanaged.

1.11 The project was carried out in two stages: stage 1 was a high-level review of eight entities, and stage 2 was a closer examination of four of the entities selected from stage 1. Interestingly, most entities faced significant additional compliance enhancements between stages 1 and 2 of the project. Many concerns identified at stage 1 had been corrected before the stage 2 visits had commenced. This may be due in part to USA regulatory changes coming into play; however, ASIC's publicised campaign, Australian Stock Exchange (ASX) proposals and the government's Corporate Law Economic Reform Program (CLERP) 9 reform agenda have all had a positive compliance effect on the industry.

1.12 The most significant ongoing concern is a continuing reliance on investment banking staff to identify conflicts of interest and importantly on staff integrity to manage and disclose these conflicts. There is a risk that expectations of staff and management will be different and consequently without documented and tested guidelines and procedures, outcomes will be inconsistent and pose a threat to the analyst, the bank

and its investors. We regard this risk as unacceptable and undesirable from the perspective of sound practice.

1.13 A recurring theme among all firms was a need for regulatory consistency. There was reference to the role of international regulations being imposed and where possible any additional domestic regulations being consistent. This is also in reference to circumstances where there is regulatory responsibility domestically and then additional best practice guidelines required by industry bodies. Given that tension, and in recognition of the risk of regulatory overload, we have consulted with ASX, SDIA and SIA (as well as other relevant regulatory and industry bodies) in the course of this review. Where possible the project recommendations have endeavoured to embrace these concerns.

1.14 The next section of this report (Section 2) provides some background to our campaign and highlights some of the problematic areas for research analyst independence that we were expecting to examine as part of our review. Section 3 then looks at the legal and policy context of research analyst independence, including recent regulatory changes in the USA and CLERP 9 in Australia. Section 4 provides an overview of the analyst independence campaign, and Sections 5 and 6 describe our key findings and conclusions.

## Section 2: Background

### The role of research analysts

2.1 The role of research analysts in the securities industry is varied and they perform a number of different functions. At the most basic level analysts study companies and draw on a wealth of industry, economic and business trend information to make an assessment of a company's potential.

2.2 Analysts may sell their research on subscription and consider themselves "independent" such as those analysts employed by research houses. Analysts may be employed to provide research to institutional investors and these analysts are known as "buy-side" analysts. Analysts working for a full service investment dealer are typically referred to as "sell-side" analysts.

2.3 This project was mainly concerned with sell-side analysts. Sell-side analysts carry out two main roles:

- They generate investment ideas, using all sources of information and interpreting it to generate performance and valuation estimates about a company and ultimately a recommendation to a client about investment in the company.
- They assist in securing investment-banking transactions by suggesting transactions for the investment banking arms of their firm to consider. They may also be involved in "road shows" and other marketing strategies for initial public offerings (IPOs) as well as mergers and acquisitions, venture capital financing and other corporate finance projects.

2.4 Trends in capital markets over the years have resulted in the increased importance of investment banking. Consequently this has impacted on the importance of the role of sell-side analysts in the investment banking business and the subsequent potential for conflicts of interest between analysts providing objective and independent research and investment banking revenue.

### Identifying problematic areas

2.5 We have been maintaining a "watching brief" of domestic and international issues on analyst conduct, in particular conflicts of interest and research integrity. We have identified a number of concerns, including:

- whether conflicts of interest are being adequately managed; and
- whether current disclosure levels are adequate.

2.6 Initial interviews conducted early in 2001 with a number of investment banks indicated that conflicts of interest existed but there was a degree of uncertainty about the extent that these conflicts were impacting on retail consumers or market fairness. Some problematic areas included:

- pressure from companies and institutional clients;
- inadequate separation of investment banking from equities and research functions;
- analysts' remuneration;
- analyst trading;
- disclosure of conflicts of interest; and
- research dissemination.

2.7 These early discussions seemed to indicate that most investment banks did not feel there was significant risk to retail investors; however, it appears that in fact retail investors are the primary consumers of sell-side research.

2.8 Institutions employ their own "buy-side" analysts to carry out investment research and offered the opinion that sell-side research contains a certain level of marketing focus that is a function of the investment banking business but does not necessarily meet the institutions' need for independent research.

2.9 Importantly, the existing regulatory framework is currently being reviewed within CLERP 9 and the recently released proposals consider possible approaches for improving it. A key objective of this project was to provide feedback for the CLERP 9 process by assisting both our submissions to the government on CLERP 9 and our own policy development process.



## Section 3: Legal and policy context

3.1 The *Corporations Act 2001* (as amended by the *Financial Services Reform Act 2001* (FSRA)) includes provisions specifically aimed at protecting retail investors. Ensuring that investors receive good investment advice is imperative to the efficient functioning of the marketplace. Research analysts play a pivotal role in translating market information for investors by providing analysis of stocks through research reports and recommendations.

### Current law

3.2 There are a number of sections within the existing legislation that address various areas relating to recommendations in research reports and the conduct of research analysts. There are also adequate legal remedies (administrative, civil and criminal) available for action against conduct that contravenes the requirements under the law.

3.3 The law addresses disclosure, advice, false and misleading statements, continuous disclosure and insider trading. However, the amendments arising from the FSRA impose some additional obligations on licence holders.

3.4 Our recently released Policy Statement 175 *Licensing: Financial product advisers — Conduct and disclosure* [PS 175] provides guidance for entities holding an Australian financial services (AFS) licence who provide financial product advice.

3.5 Where personal advice is provided to a retail client, the key obligations are:

- to prepare and provide a Financial Services Guide (FSG);
- to comply with the suitability rule (s945A);
- if the personal advice is based on incomplete or inaccurate information, to warn the client accordingly; and
- to prepare and provide a Statement of Advice (SOA).

3.6 Whenever general advice is provided to a retail client, the providing entity must generally give the client an FSG, and provide a warning to the client that the advice has been prepared without taking into account the client's objectives, financial situation or needs.

3.7 [PS 175] sets out our policy on these obligations. In particular, it considers:

- the difference between personal and general advice;
- when and how an FSG must be provided;
- when an FSG can be combined with a Product Disclosure Statement (PDS);
- the FSG content requirements, including the requirement to disclose fees, commissions and other benefits;
- the suitability rule (s945A), including the extent of the obligation to make “client inquiries” and the meaning of “appropriate” advice; and
- the SOA content requirements, including the obligation to disclose the “basis” of the advice and to disclose fees, commissions and other benefits.

3.8 [PS 175] also refers to standard licence conditions which we will impose requiring certain records to be kept by licensees.

## **CLERP 9**

3.9 The government published its CLERP 9 Discussion Paper “Corporate Disclosure: Strengthening the Financial Reporting Framework” (CLERP 9) in September 2002.

3.10 The paper contained a chapter covering “Analyst independence and the regulation of general advice” and proposed that “ASIC ... be asked to provide guidance by policy statement on the level and manner of disclosure required” under the general licensee duty to operate efficiently honestly and fairly, which (the paper stated) includes an obligation to “ensure that conflicts of interest are disclosed adequately and managed effectively”.

3.11 Our submission on CLERP 9 suggested that it was inadequate to simply rely on the “efficiency, honestly and fairly” obligation, and that the legislation should specifically provide for an integrated approach consisting of:

- Restrictions or prohibitions on certain conduct which cannot otherwise be effectively regulated by an obligation to manage or disclose conflicts of interest;
- A general obligation on licensees to manage other conflicts of interest when providing research reports; and

- A specific obligation on licensees to disclose conflicts of interest when providing research reports.

3.12 In June 2003 the Parliamentary Secretary indicated that as part of CLERP 9 the Government would propose a new conflicts management obligation for all Australian financial service licensees.

3.13 The Parliamentary Secretary also pointed out that he asked ASIC whether it could produce a Policy Proposal Paper on the proposed new conflicts management obligation to be issued shortly after the Government has released its draft CLERP 9 legislation for public comment. ASIC is currently drafting a PPP on the likely conflicts management obligation – including some draft guidance for issuers of research reports. ASIC plans for this to be issued soon after the release of the Government's Exposure Draft 'CLERP 9 Bill'.

### **Policy proposal paper: Managing conflicts of interest**

3.14 It is intended that this policy proposal paper will set out high-level principles and guidance for AFS licensees generally, with more detailed guidance for providers of research reports, about managing conflicts of interest.

3.15 It will give some guidance about what we would expect of licensees in complying with their obligations for managing conflicts of interest. The policy proposal paper will outline:

- our approach to conflicts of interest;
- guidance for licensees generally on avoiding, controlling and disclosing conflicts of interest; and
- specific guidance for providers of research reports.

3.16 This report will provide a factual and pragmatic context in which ASIC will prepare its policy formulation and guidance for the industry. The key findings will assist to inform the parameters of our policy proposal paper.

## **US regulatory changes**

3.17 The issue of research analyst independence has also been of interest and been the subject of regulatory changes in the USA. The National Association of Securities Dealers (NASD) Rule 2711 proposes various measures for addressing conflicts of interest that arise due to the dual nature of research analysts within an investment banking environment. NASD members were required to implement many of the provisions by July 2002, although some provisions have had a later transition date.

3.18 The provisions most likely to influence the manner in which investment banks manage their internal conflicts of interest relate to certain restrictions and prohibitions and also requirements for disclosure.

### **Provisions relating to restrictions and prohibitions**

#### *Restrictions on relationship with research department*

3.19 The USA restrictions provide that research analysts must not be subject to the supervision or control of any employee of the member's investment banking department. Furthermore except as provided below employees of the investment banking area must not review or approve a research report of the member before its publication.

3.20 Investment banking personnel may review a research report before its publication only to verify the factual accuracy of information in the research report or to review the research report for any potential conflict of interest, provided that:

- any written communication between the investment banking and research areas regarding the research report are made through the legal and compliance areas or copied to the legal and compliance areas; and
- any oral communication between the investment banking and research areas regarding research reports must be documented and made either through the legal and compliance areas acting as intermediary or in their presence.

#### *Restrictions on review of report by subject company*

3.21 Members must not submit a research report to the subject company before its publication unless:

- the member only submits sections of a report to verify factual accuracy of information and the draft submitted does not contain a research summary, research rating or price target, a copy is sent to the legal and compliance area and, if changes are made, the legal and compliance area supervises this; or
- the member is notifying a subject company that it intends to change its rating of the company, provided that the notification occurs on the business day before the member announces the rating change, after the close of trading in the principal market of the subject company's securities.

*Prohibition of certain forms of research analyst compensation*

3.21 Members cannot pay any bonus, salary or other form of compensation to a research analyst based upon a specific investment banking services transaction.

*Prohibition of promise of favourable research*

3.22 Members cannot directly or indirectly offer favourable research, a specific rating or a specific price target, or threaten to change research, a rating or a price target, to a company as consideration or inducement for the receipt of business or compensation.

*Imposition of quiet periods*

3.23 Members cannot publish a research report on a subject company for which the member acted as manager or co-manager of:

- an IPO, for 40 calendar days following the date of the offering; or
- a secondary offering, for 10 calendar days following the date of the offering.

3.24 This imposition is not intended to prevent a member from publishing a research report concerning the effects of significant news or a significant event on the subject company within such 40- and 10-day periods, and provided further that the legal and compliance area authorises publication of that research report before it is issued.

*Restrictions on personal trading by research analysts*

3.25 Research analysts cannot buy or receive securities before the issuer's IPO if the issuer is principally in the same sector as companies that the research analyst follows.

3.26 Research analysts cannot buy or sell securities issued by a company that the analyst follows, or any option on or derivative of such security, for 30 days before and five days after the publication of a research report about the company or a change in a rating or price target of the company's securities.

**Provisions relating to disclosure**

3.27 Members must disclose in research reports and analysts must disclose in public appearances:

- if the analyst or a member of the analyst's household has a financial interest in the securities of the company, and the nature of the financial interest;
- if, at the end of the month preceding the publication of the research report or a public appearance, the member or its affiliates beneficially own 1% or more of securities of the subject company; and
- any other actual, material conflict of interest.

#### *Receipt of compensation*

3.28 Members must disclose in research reports if the analyst responsible for preparation of the report received compensation that is based upon investment banking revenues and the member or its affiliates:

- managed or co-managed a public offering of securities for the subject company in the past 12 months;
- received compensation for investment banking services from the subject company in the past 12 months; or
- expect to receive or intend to seek compensation for investment banking services from the subject company in the next three months.

3.29 Analysts must also disclose in public appearances if they know that the subject company is a client of the member or its affiliates.

#### *Position as officer or director*

3.30 Members must disclose in research reports and analysts must disclose in public appearances if they or a member of their household serves as an officer, director or advisory board member of the company.

#### *Meaning of ratings*

3.31 Members must define in research reports the meaning of each rating used in its rating system. The definition of each rating must be consistent with its plain meaning.

#### *Distribution of ratings*

3.32 Regardless of the rating system that a member uses, they must disclose in each research report the percentage of all securities rated by the member to which the member would assign a "buy", "hold/neutral" or "sell" rating.

3.33 In each research report, the member must disclose the percentage of companies within each of these three categories for whom they have provided investment banking services within the previous 12 months.

#### *Price chart*

3.34 Members must present in a securities research report, a line graph of the security's daily closing prices for the period that the member has covered it or for a three-year period, whichever is shorter. The line graph must indicate the dates on which the member assigned or changed each rating or price target, depict each rating and price target assigned or changed on those dates, and be current as of the end of the most recent calendar quarter.

#### *Price targets*

3.35 Members must disclose in research reports the valuation methods used to determine a price target. Price targets must have a reasonable basis and be accompanied by a disclosure concerning the risks that may impede achievement of the price target.

#### *Market making*

3.36 A member must disclose in research reports if it was making a market in the subject company's securities at the time that the research report was published.

## **Significance of regulatory developments**

3.37 Importantly many US-based investment banks have indicated that they will adopt most of the provisions described above on a global basis. Clearly the domestic and international developments have generated the question about the necessity for more detailed guidance for research report providers. However any guidance we provide will necessarily be broadly based and each licensee will need to tailor their management of conflicts of interest to their own circumstances.

## **IOSCO Working Committee**

3.38 Through its Chair of the Technical Committee of the International Organisation of Securities Commissions (IOSCO) ASIC has a particularly keen interest in a harmonised and consistent regulatory approach to the management of conflicts of interest. The Committee is, at the date of this report, proposing to publish a statement of principles for addressing sell-side securities analyst conflicts of interest.

3.39 A set of IOSCO principles regarding such conflicts of interest will be a valuable tool for IOSCO jurisdictions seeking to improve their oversight of analysts and will assist in converging international regulatory approaches.

3.40 It is likely that the Committee will publish a statement of principles, which will address the following key issues:

- Analyst trading and financial interests
- Firm financial interests and business relationships
- Sell – side analysts' reporting lines and compensation
- Outside influence
- Clarity, specificity and prominence of disclosure
- Integrity and ethical behaviour
- Investor education

3.41 As a member of IOSCO and a keen contributor to that proposed statement, we will seek to harmonize both our policy proposal paper and regulatory approach with international principles.



## Section 4: Analyst independence campaign

### Objectives

4.1 At its most basic level the project was initiated to assess the impact of concerns about analyst independence in Australia. Beyond media and market speculation there have been no clear or identified complaints or cases.

4.2 The broad project objectives included:

- Identifying breaches of the Corporations Act (employing appropriate enforcement protocols where necessary);
- Correcting inadequate disclosure to consumers and other users of research;
- Providing policy guidance for industry;
- Providing law reform recommendations within the CLERP 9 framework;
- Identifying regional variations between institutions and international securities regulators;
- Contributing to IOSCO working party guidelines;
- Increasing investor awareness and education;
- Increasing our profile in this sector of industry; and
- Identifying unrelated compliance deficiencies.

### Methodology

4.3 The project was carried out in two stages:

- Stage 1 was a high-level review of eight entities; and
- Stage 2 was a closer examination of four entities selected from stage 1.

4.4 The initial targets were selected after reviewing a list of all full-service brokers operating within Australia. The final target selection included three US-based investment banks, three European investment banks and two Australian investment banks.

4.5 The eight initial targets for the stage 1 review were all contacted and advised of the surveillance campaign and given a short summary of the proposed methodology and project objectives before formal surveillance protocols were engaged.

4.6 Relevant industry bodies were also contacted and while we did not disclose target entities we did indicate the project scope and objectives as well as outputs. The following industry bodies were contacted:

- the Securities Institute of Australia (SIA);
- the Securities and Derivatives Industry Association (SDIA);
- the Australian Banking Association (ABA);
- the Investment and Financial Services Association (IFSA); and
- the International Banks & Securities Association (IBSA).

4.7 Additionally we advised our co-regulators, the Australian Stock Exchange and the Sydney Futures Exchange, of the project and provided a brief summary of the project scope and objectives.

## **Stage 1**

4.8 The objective of stage 1 of the campaign was to test whether concerns about analyst independence within the domestic market provided a basis for further review.

4.9 To ensure a comprehensive approach was undertaken, a selection of European, American and Australian investment banks were selected for stage 1 which would enable a global view to be formed as well as providing a basis for assessment and comparison with international standards.

4.10 This high-level review commenced with serving identical notices on all eight targets requiring production of books and records relating to the investment banking and research functions.

4.11 Notices under s30 of the *Australian Securities & Investments Commission Act* along with Corporations Act s788 directions were issued to all targets with supplementary notices issued to subsidiary companies of the targets where key functions were not carried out by the bank.

4.12 The notices requested documents on the banks' policies and processes for various functions as well as requesting more practical examples of research and management of the research function. The entities were all given identical time frames for satisfying the notices.

4.13 The books and records provided were then analysed within specific areas including:

- grey and restricted lists;
- analyst remuneration and reporting;
- analyst trading;
- research process;
- supervisory analyst processes;
- disclosure;
- complaints management;
- “Chinese wall” procedures;
- conflicts of interest management;
- compliance and operational testing; and
- changes in light of US regulatory requirements.

4.14 These areas were chosen after early discussions with industry identified concerns and the various US investigations and inquiries also identified them as being particularly problematic.

4.15 FSR Regulatory Operations senior staff also met with the US Securities and Exchange Commission (SEC) in March 2003 to share information and to confirm the relevant areas for enquiry based on the SEC’s experience.

## **Stage 2**

4.16 The objectives of stage 2 were to:

- Further analyse issues identified in stage 1
- Better understand how the policies and procedures operate in practice;
- Test personnel understanding of the policies and procedures in the firm to ensure consistency;
- Generally to discuss the views of the entity in relation to the issue of research analysts independence in the Australian market; and
- Identify and report on analyst conduct in the Australian market given issues about analysts' objectivity and conflicts of interest in the US market.

4.17 Additional notices were sent to the stage 2 targets to account for the elapsed time since commencing the project and to take account of US regulatory and compliance changes.

4.18 Interviews were conducted with senior staff in compliance, research and investment banking and these visits took place over a series of days. Whilst different issues had been identified within all targets, to ensure consistency, the surveillance plan used at each entity was identical, but augmented as issues arose.

## Section 5: Campaign findings

5.1 Many of the entities provided materials to us demonstrating comprehensive procedures clearly aimed at preventing challenges to the integrity of research analysts within their firm.

5.2 Importantly, our review did not identify actual contraventions of the Corporations Act, nor did it identify the types of selling practices or market manipulation that occurred in the United States of America. Necessarily, such a conclusion relates only to the specific entities we reviewed and the limited time period we considered.

5.3 We did observe some systemic weaknesses in the ability of entities to adequately identify, manage and disclose conflicts of interest. There also appears to be limited consistency in compliance practices and procedures across the investment banking industry in relation to sell-side research analysts. Again, such a conclusion relates only to the entities reviewed in this campaign.

### Grey and restricted lists

5.4 Most entities with investment banking departments create lists to nominate stocks that may be the subject of investment banking/corporate finance business. There are essentially two kinds of list: those known as restricted, embargoed or black lists, and those known as grey or watch lists.

5.5 Restricted/embargoed/black lists are usually distributed within a firm and contain stocks in which all trading by the firm as principal and its employees is prohibited or restricted for the time that the entity is on the list. The content of grey or watch lists is usually only known to members of the compliance team and others who are over or above the “Chinese wall” and contains stocks in relation to which the investment banking department is presently mandated or otherwise active.

5.6 Both types of lists act as a compliance measure. In the case of restricted/embargoed/black lists, they ensure that, where staff are aware of other business being conducted within the firm, they cannot trade on that information. In the case of grey/watch lists, the compliance department often monitors staff and proprietary trading by the firm against those lists and they are therefore a helpful tool in detecting leaks in the Chinese wall.

5.7 Firms adopt different practices for placing stocks on a restricted list or a watch list. Some entities argue that placing a stock on a restricted list that is distributed inside the firm confirms the existence of investment

banking activity or inside information. This may prevent advisers, dealers or analysts from advising clients on the relevant entities. Accordingly, these firms prefer not to place stocks on a restricted list until an investment banking transaction is publicly announced and monitor, rather than prohibit, staff and proprietary trading in the relevant stocks in the meantime.

5.8 The review indicated that in some instances, grey and restricted lists are compiled by the legal and compliance area within the firm; however, they rely on the investment banking division informing them of the securities that should be placed on the lists and the applicable degree of sensitivity regarding the publication of research. This indicates a risk that securities will not be placed on the list in a timely manner or even at all. It is possible that the investment banking division may have a lack of sensitivity about the issue and could even use the process as a deliberate attempt to prevent the imposition of research restrictions.

5.9 In some cases it was confirmed that no research watch lists or embargoed lists currently operate within some firms. Other firms have introduced a limited “grey list” with the purpose of ensuring that corporate finance staff do not trade on inside information. However there is significant risk that if corporate finance staff generate and maintain the “grey list” independent of the legal and compliance function it could indicate a lack of independence and the potential for manipulation of the list.

5.10 Furthermore it is of concern that in many cases where grey lists operated they only related to stocks relative to corporate finance staff trading. Other areas that may have warranted a watch list include house and other staff trading and, in particular, the research area.

While we do not regard the existence of a grey list as a complete panacea in itself, where a restricted list is used it should be utilised efficiently and properly. This review did not indicate that to be the case in all firms surveyed. Where securities are added to a restricted list by the investment banking arm, this exposes this conflict mechanism to potential abuse and manipulation. It may also mean that securities are not placed on the list either at all or not in a timely manner. Additionally a restricted list that only applies to one specific area such as corporate finance does not address the risk inherent in other areas such as research and investment banking.

Restricted lists only add value as a compliance tool when they are employed strategically. Necessarily this also entails a proper process of review and supervision if they are to be implemented properly.

## Analyst remuneration

5.11 Analyst remuneration is often a combination of a base salary and bonus linked to set performance criteria. Where an analyst's likelihood for promotion or financial bonus depends on his or her ability to promote the firm's investment banking business or securities that are the subject of some other internal transaction, the independence of the research may be tainted.

5.12 Some firms advised that previously all research analyst remuneration was made up of a base salary plus an incentive component paid half yearly. The incentives were often calculated via a collective incentive pool representing the performance of the firm's research area and in consideration of a number of factors such as:

- research share of available commission and incentives;
- individual analyst ratings;
- retail feedback;
- analyst experience;
- size of sectors covered;
- number of stocks covered;
- base salaries; and
- the external market environment.

5.13 We found that there was often no indication of weighting given to the various factors used in determining the incentive payments or the way these factors are actually used to calculate an incentive payment.

5.14 It was also unclear how the research bonus pool was determined and whether it is in any way linked to the investment banking division performance.

5.15 There is a risk that this may actually result in a remuneration policy more closely aligned with investment banking revenues than research performance.

5.16 Furthermore there were some concerns that investment performance will remain one of the criteria for evaluating analyst performance, which could generate a conflict of interest.

5.17 Importantly where a bonus pool is derived from the performance of the firm it indicates that revenues generated by the investment banking division influence the total bonus pool available to the research area and

hence may have the ability to influence the bonus amount received by research analysts.

The industry standard indicated analyst remuneration is comprised of salary and bonus. The bonus calculation is not always transparent. Our findings suggested that the bonus was either linked to overall firm profitability and or the profitability of the investment banking/corporate finance areas of the entity.

While this now appears to have been rectified to some extent, recognising the valuable work that analysts perform for other business areas is always going to cause concern. Depending on how it is calculated, paid and allocated, the bonus that is offered as a reward for work performed may also unduly influence an analyst.

Reporting lines were in some cases unclear or misunderstood by both staff and management. In particular, the ability of the research arm to have either solid or dotted line reporting responsibilities to the trading or corporate finance areas necessarily pollutes the independence of the research arm.

## **Analyst trading**

5.18 Rules on personal trading by research analysts can be applied to particular securities or industries and for set periods of time. These rules are generally used to manage the potential conflict of interest that an analyst may have in relation to the securities that they provide research on and that may be the subject of investment banking transactions.

5.19 The entities indicated to us how they applied rules on staff trading (i.e. purchasing, holding, selling back activities in trading of securities). In many cases analysts were not permitted to purchase securities in sectors they research. However often there appeared to be no consideration of procedures to identify, control and monitor (including remedial action/penalty system) analysts' conduct in instances of non-compliance with trading rules and non-authorized trades.

5.20 Some rules were stated as "not enforceable", which made it difficult to understand how the firms encourage staff to comply and what action the firm may take where staff do not comply.



We noted with concern the heavy reliance on staff integrity, without other objective compliance and risk management systems. Some entities have no documented processes for managing staff trading at all. Others had strong written documented processes but little evidence of stringent and effective implementation in practice. Similarly we had concerns that documented procedures were inadequately explained to staff or tested and reviewed. This should be a normal part of any sound compliance regime.

The trading policies were not tailored to research analysts and thus were both difficult to comprehend and to enforce. Where policies existed and were breached some firms had serious sanctions; in other firms the breaches went undetected or worse, the policy was unenforceable and carried no penalty.

Heavy or singular reliance on staff integrity, coupled with weak or unenforceable staff trading policies, carries an unacceptable risk that conflicts will occur and go undetected.

## Research process

5.21 Reviewing the research process included analysis of how research is commenced, created, reviewed and signed off, as well the entity's processes for cessation of coverage. There are risks where research is not reviewed and signed off by appropriate people and also where coverage is ceased rather than recommendations being downgraded.

5.22 We found that research areas within some firms use set criteria and formula to determine a recommendation with analysts then permitted "subjective decision" to re-weight criteria scores. In some cases no vetting of research recommendations is conducted by anyone else within the research team. This raises risks that analysts do not maintain objectivity in their recommendations, particularly if there is no independent review of analyst recommendations in light of this "subjective" re-weighting of scores.

5.23 Some firms do not conduct any review of the research or testing of supporting assumptions before research is published. Instead post-release review of research appears to be more common, which creates a risk that readers will rely on inaccurate or compromised research reports.

5.24 There was an indication that a "gatekeeper" process existed within some firms. In these instances, research prepared by the research team

was reviewed (if it is on the embargoed/restricted list) by either the compliance area or executives from corporate advisory, who were then able to suggest changes.

5.25 Theoretically most firms had a process for managing contact between corporate advisory and research, generally using the compliance area; however it appears that this arrangement has resulted in the breakdown of Chinese walls in some cases. This situation clearly indicates a conflict of interest and suggests that the research is not independent of the investment banking function.

5.26 A general review of the spread of recommendations indicated a very small percentage of sell recommendations, which may indicate a recommendation mentality in some circumstances.

The process by which research is commenced, written, reviewed and released varies throughout the industry. Generally research security selection does not, of itself, create a risk of conflict. Rather it is the final research report (and its preparation and review), which generates that concern.

In the worst instances research recommendations can be overridden or subjectively re-weighted by an analyst and publicly released without review. From a market integrity and consumer protection perspective, such a deficiency in practice is entirely unacceptable or indefensible.

In other instances research reports were subject to potential interference by other business areas. While there is a basis for a factual accuracy review, it should not extend to a review for embarrassing or client sensitive information.

We would expect that the compliance function within investment banks would both police and coordinate this process. Our review revealed that inadequate consultation or supervision by compliance officers had occurred on an ongoing basis in some firms.

Few entities revisit research recommendations in the light of new information or in consideration of the age of a report. In the worst instances research reports remain “live” even when the market has significantly downgraded a security price. On other occasions, research reports are only withdrawn or revised well after the market has become aware of and acted upon price sensitive information.

We found that when research was ceased there was little, if any, information given to market participants or investors. Most entities simply ceased covering a security, often in lieu of downgrading a

recommendation. In the course of the review, a number of entities had begun publishing lists of current status of coverage and recommendations.

## Supervisory Analyst Processes

5.27 The review indicated that only a small number of firms have supervisory analysts. Often the research department had a fairly flat structure with direct reporting to the head of research.

Where firms did use supervisory analysts this role seemed to act as a reviewer and mentor, and appeared to add value to the research process. We regard such a gatekeeper role as both sound and effective, particularly as a buffer against interference from non-research areas.

## Disclosure

5.28 Where a firm recognises a potential conflict of interest it has a responsibility to disclose this conflict to any parties that may be affected by it. Disclosure must be relevant, meaningful and presented in an understandable manner.

5.29 A number of firms use standard disclosure on each of their research reports. The content and style of the disclosure is identical across all reports; often it is so general as to provide no meaningful information to consumers of the research and hidden at the back of the report.

5.30 The risk with this “boiler plate” style disclaimer is that it does not adequately reflect the interest that a firm may have in the research recommendation published.

5.31 At the outset of the review only one firm appeared to have two forms of disclosure. The first is used where the firm was not involved with the issuer as an investment banking client. In these instances the report contained a standard form of disclosure of interests, frequently used in the industry, stating that the firm’s employees, or directors, may have a position in the relevant securities. The second form was used when the firm has a corporate advisory role in relation to the company issuing the stock. In this case there is a comprehensive process in place to ensure that appropriate disclosures are made on research reports about those stocks.

We were disappointed to observe disclosure in form rather than substance. Meaningless, boilerplate disclosure hidden in tiny font at the back of the report was standard practice. However, by the time we concluded the review, more factual and concise disclosure was being used by most entities.

We do not regard the extent of disclosure (as opposed to content) to be adequate. Disclosure at an analyst level did not appear to be utilised by any firm and not all firms had enforceable trading restrictions for their analysts.

## Organisational structure

5.32 It is vitally important that an organisational structure conducive to managing and disclosing conflicts of interest is in place. Clear and appropriate reporting lines and a strong compliance culture will assist in this process.

5.33 In some firms it appeared that the main research function was a part of the investment banking group, often along with the corporate advisory/corporate finance areas. It seemed that the funding for some research areas was coming directly from the corporate advisory/corporate finance area.

5.35 Often analysts were employed by the broking firm, and not by a separate legal entity. Furthermore the reporting structure indicated that in some instances the head of research reported to the head of equities, which may skewer the alignment of research to the firm's objectives, at the expense of objectivity and independence.

It is possible that weaknesses in structure could permit corporate finance to exert undue influence on the research area, leading to questions about the independence of research. Such weaknesses may also cause conflicts of interest between the research published and a firm's business goals and objectives

## Complaints management

5.36 A history of complaints about research or management of the research function could be an indication of poor management of conflicts

of interest. Poor complaints management processes can result in systemic problems remaining unidentified.

5.37 The review did not indicate large numbers of complaints about research but did indicate that suitable processes for addressing complaints may not always be used. The general theme of the complaints showed that clients were dissatisfied with the recommendations provided in research reports and that some had suffered loss by following recommendations. A number of complaints alleged that research analysts had maintained positive recommendations even after companies announced earnings downgrades.

5.38 Often there did not appear to be adequate investigation of the issues within the complaint nor satisfactory resolution. It was often unclear how complaints matters were reported to senior management and the board and in most cases complaints registers did not appear to be adequately utilised for identifying trends or systemic issues.

The review did not indicate a high level of complaints about research generally. Reviewing complaints-handling processes was not within the scope of this project, nor did we undertake any enquiries of relevant external dispute resolution schemes. Instead complaints were reviewed to identify the levels of, or any trends in, consumer concerns about research reports or recommendations.

The review of complaints suggested some systemic problems with favouritism towards certain securities and incorrect recommendations as compared to various other market positions.

Our complaints database did not indicate any trends regarding research reports or analysts.

## **Chinese wall procedures**

5.39 Chinese wall procedures are internal controls designed to insulate one work area from another so as to provide security and the appearance of independence. With respect to research, Chinese walls should protect the work of research analysts from the potential influence of other areas so as to not improperly influence the content of research reports.

5.40 Most firms have Chinese walls in place around the research area, as well as processes for bringing analysts across the walls. Analysts have crossed the Chinese wall for a number of reasons, often to allow them access to corporate finance staff/documentation in order to facilitate the rapid publication of research.

5.41 In this situation there is a risk that this access may bias the analysts towards a favourable recommendation on the relevant company as they may put undue weight on the documentation provided by the corporate finance function.

5.42 A review of the compliance breaches register indicated that most firms had experienced a breach of Chinese wall crossing procedures at some time.

All firms reviewed had some form of Chinese walls in place to notionally separate research from the investment banking business within the firm. However the better practices also involved physical separation and appropriate systems security for email, telephones and desk location.

We were disappointed in the heavy reliance on the existence of a Chinese wall structure as a holistic conflict management mechanism. Such mechanisms must be both tailored to the exigencies of the business, properly documented, implemented, enforced and reviewed, and must form part of a complete matrix of compliance tools in order to be effective.

## **Conflicts of interest management**

5.43 Where conflicts of interest exist, appropriate processes for identifying, managing and disclosing conflicts should be in place to ensure that research viewed by investors is factual and objective and has not been influenced by some other purpose. As with any compliance measure, a documented and supported procedure is recommended.

5.44 An analysis of the recommendations in research reports indicated that there were a small number of sell recommendations in respect of the securities in which research was published.

5.45 Most firms provided research on companies that were also corporate clients. Analysis of this research showed that the majority had neutral ratings with minimal underperformance ratings. This may not suggest that research analysts were aware of or influenced by corporate advisory businesses but rather indicates a reluctance to issue negative ratings.

5.46 The ratio of positive versus negative recommendations made by research analysts calls into question the independence of analysts and the integrity of their reports and recommendations.

5.47 Communication lines between corporate finance, research and investment banking departments (although often physically separated and subject to Chinese walls) were often not apparent from organisational charts.

We would expect that for entities operating in this market, there would be some form of systematic, documented and consistent conflicts of interest management procedure. It was therefore surprising to discover that there was no universal adherence to such procedures.

Again we identified an unacceptable level of reliance on staff integrity in some entities. In addition there were also instances where staff were uncertain about procedures for declaring and managing conflicts. We regard this as an important challenge for compliance staff in educating operational areas.

## **Compliance and operational testing**

5.48 Policies and procedures are a critical tool in compliance but need to be tested and monitored to ensure that they remain effective and are being adhered to. In many instances comprehensive policies were made available but overall testing and monitoring of the policies and procedures was inadequate.

5.49 Moreover the policies indicated a heavy reliance on self-notification of conflicts of interest or breaches and gave little indication of what sanctions might apply if breaches occurred.

We reviewed some very comprehensive and considered formal compliance procedures. By themselves and without proper implementation or supervision, such procedures are potentially meaningless. The review indicated a lack of compliance and operational testing across a number of entities. With one exception, no entity reviewed in stage 2, adequately or comprehensively monitored, tested and reviewed its compliance procedures in a manner satisfactory to us. In particular there was no proactive policing of policies such as staff trading and restricted lists.

## Changes in light of US regulatory requirements

5.50 Changes to US regulatory requirements have had a far-reaching effect domestically. Of the entities reviewed three were US-based and for the purposes of regulatory compliance consistency have adopted the changes globally. The others have indicated that unless they are prepared to accept the changes they may be at a competitive disadvantage on a global basis.

5.51 Importantly, the principles-based regime in which the licensees in Australia must operate differs considerably from the prescriptive rules-based regime in the US.

The changes to US regulatory requirements had significant impact on firms over the course of the review and in many cases these changes have addressed concerns that were raised by us very early in the review. While we are pleased that the timing of these compliance improvements has been concurrent with our review, that does not of itself obviate the need for any entity operating within Australia to comply with legislative and regulatory obligations in this country.



## Section 6: Conclusion

6.1 Our findings in relation to the compliance deficiencies and improvements across the entities we reviewed will form a basis for our policy guidance once the Government releases its proposed CLERP 9 legislation. At the time we begin to prepare our policy proposal paper, we will take note of the factual findings and recommended enhancements emanating from this review.

6.2 None of the findings contained within this report are presently indicative of breaches of the law. They do suggest that there is some risk that research analysts (and their employers) do not adequately avoid and manage conflicts of interest when they do arise.

6.3 In concluding that there were no specific instances of breaches of the law amongst the targeted entities during the period reviewed, nothing in this report should be interpreted as a conclusion that the industry is without flaw or is immune from misconduct. This review was not an investigation.

6.4 The compliance deficiencies we identified are most acute in relation to an unreasonable level of reliance by investment banks on their staff both to identify and then manage and disclose those conflicts. We are concerned that while conflict management is an often expressed aspiration of both management and staff, the effective implementation of such an ideal has been found to be disappointing.

6.5 This is particularly the case where management expectations are not documented, where staff do not understand what management expects and where analysts' day-to-day practice differs from documented policies. The risk is most acute where banks' compliance functions do not regularly and properly monitor their own controls.

6.6 ASIC seeks a market which is both transparent and fully informed. Where conflicts exist and cannot be avoided, good regulation demands that they be disclosed and managed effectively. Consumers (whether they be institutional or retail) are entitled to trust the integrity of the research and advice which they pay to receive.

6.7 In undertaking this project we have had the benefit of consultation not only with the targeted entities but also relevant industry associations, overseas regulators and co-regulatory authorities in Australia.

6.8 Our review suggests that the industry guidelines, which were developed in 2002 by the SDIA and SIA, have not been adopted as uniformly and closely as is appropriate. Even if fully implemented, ASIC

does not believe that those guidelines adequately address the deficiencies identified in this report. For that reason the recommended policy position, which we will publicise after the release of the draft legislation is intended both to raise standards and assist industry to improve its own best practice. Such a policy position will be consistent with IOSCO principles.