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EU Financial Services Group Briefing

20 FEBRUARY 2003

The FSA's Proposed Response to Conflicts of Interest in Relation to Investment Research and Issues of Securities

BACKGROUND AND EXECUTIVE SUMMARY

Following the high profile investigations and corporate failures in the United States, the UK's Financial Services Authority (the "FSA") issued a discussion paper in July 2002 in which they discussed the nature of investment research, the conflicts of interest that could undermine its objectivity and how that might be addressed. The FSA invited responses from the industry. Separately, the FSA have also examined whether "laddering" and "spinning" in connection with the issue of securities are a feature of the UK market. The FSA have now issued their Consultation Paper 171, "Conflicts of Interest: Investment Research and Issues of Securities," in which they set out their detailed proposals on both of those issues.

Significantly, the FSA have concluded that whilst the UK has not witnessed corporate failings on the scale experienced in the US, the same potential conflicts and pressures do exist in UK investment banking, and they were not convinced that there was a sufficient understanding or acceptance in the market of the standards of conduct necessary to achieve and be seen to achieve proper management of conflicts of interest. In addition, the FSA were not convinced that investment banks' internal systems and controls were robust or consistent enough to deliver effective conflict management.

Having considered the responses to its discussion paper and other enquiries, the FSA consider that their current Principles-based regime does provide the right framework for addressing these conflicts of interest, but that there is a need for a clearer regulatory line to be drawn as to what is and is not acceptable within the current framework of Principles and its rules. This is proposed to be addressed by a combination of guidance on the FSA's Principles relating to conflicts of interest and limited conduct of business rule changes rather than through new, detailed and prescriptive rules.

Whilst the FSA also recognise the desire for their approach to be consistent, as far as possible, with regulatory responses emerging both in the US and in the EU, they conclude that "consistency does not mean uniformity," and that a number of the measures adopted in the United States are or may be unnecessary in the UK. At the same time, there is or will be a need for consistency with EU developments, particularly arising from the forthcoming Market Abuse Directive requirements.

The FSA's new proposals place prime responsibility for managing conflicts in the context of both investment research and the issuance of securities on the senior management of firms. In the context of investment research, they propose to tackle this through a combination of tighter internal management control and effective disclosure to the market. Those systems and controls must be designed to ensure that the firm's own interests or those of its corporate clients do not improperly influence the contents of research. The FSA's focus is upon the supervision of analysts, their involvement in marketing activity and reward structures and their susceptibility to pressure from subject companies. In addition, the FSA say this needs to be coupled with "more forthright" disclosure to improve investors' understanding of research and of the conflicts of interest that may lie behind it, a key focus being the nature of the firm's interest in the company that is the subject of the research.

In regard to "laddering" and "spinning" in relation to issues of securities, the FSA consider that those practices are inconsistent with their Principles and rules and again propose guidance on systems and controls concerning in particular pricing and allocation to ensure that conflicts do not affect firms' responsibilities to treat clients fairly. The FSA also propose to carry out further work on the use of "friends and family" lists and the impact on record keeping requirements in relation to securities issues.

INVESTMENT RESEARCH

The Main Themes in responses to the FSA's Discussion Paper

Three main themes emerged from the responses to the FSA's discussion paper on research. First, the responses confirmed the FSA's views that conflicts of interest were inherent in the role of the analyst in an integrated investment bank and that they can and do compromise the objectivity of investment research. Some of the more significant conflicts arose as a result of:-

- blurred reporting lines where, for example, research departments reported to heads of investment banking or other divisions;
- analyst remuneration structures, for example, where they were related to involvement in investment banking transactions;
- lack of accountability of analysts' track records;
- current or potential relationships between an issuer and an investment bank;
- exposure of the analyst, or the firm, to an issuer's securities; and
- the ability of investment banks to influence the behaviour of other market participants through their IPO allocation penalties.

At the same time, the respondents' "recognition that significant conflicts exist" was tempered by the view that investment research in the UK is overwhelmingly for institutional clients who can see through headline recommendations and the potential for bias.

The second theme was that any response should take account of the differences between the UK and US markets and the need for consistency with EU developments.

The third theme related to the identified impact of investment research on the retail market, particularly where such research found its way to retail investors in abbreviated or edited form through the media and the web, and where such retail investors were largely unaware of conflicts of interest that could lie behind such share tips and recommendations.

The FSA's response to industry input which is now described in CP 171 acknowledges the overwhelmingly institutional nature of the investment research market in the UK. The FSA also consider that their current Principles-based regime of high level standards does remain appropriate to tackle the issues. However, they do not believe that there is enough agreement or understanding in the industry on the practical steps necessary if firms are to be seen to be managing and controlling their conflicts of interest effectively in line with the FSA's Principles. Nor, based on the FSA's research and continuing supervision, do they consider firms' existing internal systems and controls and compliance culture to be sufficiently robust or consistent to deliver this; responsibility lies with senior management. Rather than making detailed, prescriptive rules, the FSA propose to issue guidance on the existing Principles for Businesses together with some limited conduct of business rule changes. Such guidance is not directly binding, but firms will in practice need to comply with it to avoid possible enforcement action by the FSA in respect of breach of its Principles for Businesses which are of course binding.

In terms of international consistency, in particular with regard to US and EU developments, the FSA consider their proposed approach is broadly consistent with changes in the US but is designed to fit with the UK's Principles-based regime and takes account of differences between the US and UK markets. It will also be influenced by implementation of the Market Abuse Directive throughout Europe, but FSA believe their proposals are likely to address the key concerns that might arise in that context.

In terms of retail market issues, the FSA believe that those concerns can also be addressed by proposals which are aimed at raising consumer awareness.

The FSA have also made clear that they had considered but have decided not to pursue the suggestion that all research should be labelled as marketing documentation so as to be treated with the same degree of scepticism as other promotional material, nor did it think it appropriate to impose the "approved persons" and qualifications regime on analysts; the latter aspect would be considered further.

The Detailed Proposals

In terms of the specific proposals for addressing potential conflicts of interest in investment research, the FSA

stress the need for both institutional and retail investors to be able to operate on the basis that research is factual and objective, and not biased because the investment bank that produced it had failed to manage or control the conflicts of interest to which it or its analysts may be subject.

1. Internal Management Arrangements.

Their proposal involves placing responsibility on senior management to put in place appropriate systems and controls focusing on:-

(1) supervision and management of the firm's analysts;
(2) analysts' involvement in investment banking and equity sales and trading;
(3) analysts' compensation and reward structures; and
(4) exposure to pressure from companies that are the subject of the research.

The FSA say that appropriate systems and controls are ultimately a matter for senior management, but at the same time propose that they should include where relevant the maintenance of effective Chinese Walls. To help firms make those judgements as to appropriate systems and controls, the FSA set out "what systems and controls should aim to deliver … together with examples of practices that would or would not be acceptable", namely:-

(1) *Supervision and management.* Reporting lines and accountability structures should insulate the work of research analysts against influence from other divisions within the investment bank. As a minimum, decisions on what stocks are covered, what is written and when, should not be subject to management control by the investment banking or equity sales and trading divisions of the firm. It is worth noting the reference to conflicts with equity sales and trading because US regulatory attention has been focused only on the conflicts with investment banking.

(2) *Analysts' involvement in other business activities.* Whilst in principle it is acceptable for a firm to draw on an analyst's skills to, for example, research investment banking opportunities and to provide information and advice to the firm's investment clients, such "over the wall" activities should be tightly controlled. The FSA believe analysts should not be used in *any* marketing capacity e.g. pitches or active marketing of new issues such as providing research recommendations or advice on sales to clients;

(3) *Analysts' compensation and reward structures.* Firms should avoid reward structures that create direct incentives for analysts to act in a way which would compromise their judgement. Whilst pay and benefits reflecting the general profits of the firm would be acceptable, any linkage to the analyst's contribution to profits on specific investment banking deals, or their remuneration being determined by managers in the investment banking or equity sales and trading divisions, would be regarded as unacceptable.

(4) *Subject company pressure*. Systems and controls should be designed to ensure that neither the firm nor its officers or analysts either offer or accept any inducement to provide favourable research in order to retain or secure any business or information from the subject company. The FSA say it would be improper for a company to seek to influence an analyst's judgement by making access to company information conditional on a favourable report. Whilst not prohibiting firms from sending research to a company before publication, they say the proposed recommendation or price target should be excluded from any draft and the firm should not cede effective editorial control. The FSA also say they would not expect to see a change in the proposed recommendation or its timing unless properly justified and recorded. They suggest that where a firm cannot resolve differences of opinion, it "may" decide the only realistic option is to cease coverage of that company's securities.

(5) *Quiet periods around securities offerings.* The FSA propose to introduce a new quiet period for primary issues during which no research would be published on that company either by the lead or co-manager of the issue or any member of an underwriting syndicate. The period would run from the time of issue of the prospectus until a reasonable period after the securities are admitted to trading (the FSA suggest 30 days). In relation to secondary issues, whilst the FSA do not suggest any formal quiet period or prohibition, firms would have to justify the publication of any research on the company in question, being careful to ensure it does not contain information that is designed to "condition the market" in favour of the issue.

(6) *Analysts' own dealings and holdings.* There already exist detailed personal account dealing restrictions, but the FSA propose further specific limitations on personal dealings by analysts, prohibiting them from

dealing both in securities of companies they cover and of other companies in the same sector, including exposures through derivative positions. Firms will also need to adopt anti-avoidance measures designed to circumvent the blanket restriction.

The FSA's proposals, if implemented, will involve some radical changes in the way in which analysts operate in some firms.

2. Specific Disclosures.

In addition to the systems and controls recommendations, the FSA also propose that additional disclosures should be included in research clarifying the significance of ratings used in research reports, the relationship between the firm and the subject company and the track record and personal interests of the analysts. These disclosures should be prominent - not small print. Specifically, the FSA propose to require that reports should:-

- include clear and unambiguous explanations of any ratings or recommendations and the period they are intended to cover;
- show the spread of the firm's ratings or recommendations globally and by relevant sector together with percentages of the firm's corporate clients;
- state whether the firm has had any investment banking mandates or has managed securities issues for the subject during the previous 12 months or expects to do any such business during the next 6 months;
- state whether the firm is a market maker in the company's shares or acts as a corporate broker;
- include a 3 year historical chart showing price movements against recommendations to demonstrate the analyst's track record on the security concerned; and
- state whether the analyst or any associate has a financial interest in the securities (although this would be unnecessary if the proposal against personal account dealing is adopted).

Any holding of 1% or more that the firm has in the company covered or which the company covered has in the firm would also be disclosable under the FSA's proposals. They also propose this should also extend to debt instruments and derivatives positions.

The FSA also propose that in order to help investors understand the significance of research reports, such reports should clearly indicate for whom the report is principally intended, distinguish fact from opinion or estimates, reference sources of data used, give the date when the report was first released and, where the firm is ceasing coverage of a company, the report should say so.

Overall, these disclosure obligations are extensive and may prove difficult to meet in practice.

The FSA had considered the new US requirement for self-certification by analysts but was not convinced that it would be a useful additional feature.

3. Dealing Ahead of Published Research.

The FSA considered that its existing rules prohibiting dealing ahead of published research included exceptions that were too wide. In particular, they now propose to delete the current exception where the firm concludes publication could not reasonably be expected to affect significantly the price of the security concerned, and two other exceptions.

4. Retail Investors.

The FSA were concerned that many retail investors acted upon articles and tips in newspapers and the like which derived their material and recommendations from investment banking research which might be out of date, out of context and potentially misleading. However, rather than mandating third parties who reproduce research to include the same disclosures that the FSA propose to require to be included in research reports themselves, they will mount a campaign to improve consumer awareness of the issue.

5. No Funding of Independent Research.

The FSA had also considered the US settlement which involved investment banks agreeing to fund the provision of equity research by external agencies. The FSA consider that such an arrangement would not in its view necessarily produce high quality research, that it could not be imposed in the UK in the absence of a settlement here, and that the FSA's other proposals would, in its view, satisfactorily deal with the conflicts issue. Their approach, therefore, is fundamentally different from that adopted in the US.

Finally, in terms of research, the FSA propose that in principle its measures should extend to the production of non-equity research. In this respect, the FSA appear to be ahead of the US regulators who have (with the exception of the Analyst Certification rule) focused only on equity research.

CONFLICTS IN ISSUES OF SECURITIES

The Main Themes

In the context of possible abuses in relation to issues of securities, the FSA indicate that they do not have evidence of comparable abuses to those in the United States having taken place in the UK. They do, however, propose to introduce guidance to make clear how the existing regulatory regime applies to pricing and allocation practices when arranging issues of securities. Whilst the first type of alleged abuse, "spinning" (the allocation of shares in hot IPO's to senior executives of investment banking customers as an inducement to obtain investment banking business) is well understood, the FSA describe their understanding of the second type of alleged abuse, "laddering", as involving allegations that investment banks underwriting IPO's sought to re-capture profits made by investors receiving allocations by charging abnormally high commissions on unrelated dealings.[1] This would allegedly enable the firm to capture some of the investor's profits arising as a result of significant price increases once dealings had started (they say this could be achieved by under pricing or by hyping the attractiveness of the issue).

The FSA conclude that both practices would be contrary to its Principles. In order to ensure that firms and senior management understand the application of those Principles and certain of the existing conduct of business rules which are relevant, the FSA again propose to issue additional guidance.

In its analysis of the problems, the FSA highlight the significance of IPO discounts (the difference between the issue price and the price when the securities begin trading which was the key to potential abuse) and indicate that their own UK research showed large price increases, averaging 23%, at the height of the TMT boom.

In terms of the FSA's own enquiries, they had in early 2002 undertaken some investigative work including visiting a number of investment banks and investors who had received allocations of shares in IPO's. Whilst they identified some anomalies in share price movements and suspicions of unsatisfactory practices were raised, there was no clear evidence of abusive practices. The FSA's enquires were said to have been hampered by the fact that firms had kept few records relating to IPO applications. In October 2002, the FSA had written to a number of investment banks seeking further information and it had become clear to them as a result of the combined exercise that internal procedures and systems and controls to address the conflicts involved varied markedly between different firms.

The FSA's analysis of the potential conflicts that might arise concluded that large public offerings involving both institutional and retail offerings would usually describe the basis of allotment in the prospectus and thus allowed less discretion in the allocation process. In contrast, in a placing or bookbuilding, there was far greater discretion allowed to the investment bank as to allocation, and this could facilitate abusive practices. The FSA mention the potential for conflicts between issuers' desires to achieve a high issue price and investors' preference for a low price, firms' commercial interests in ensuring its investment customers are not dissatisfied by the outcome of an issue, firms' own proprietary interests in receiving under-priced securities and their firms' desire to maximise distribution. The FSA identified in particular four potential conflicts that might arise between the firm acting on behalf of its issuer client and:-

- its own interest in receiving an allocation in securities via its proprietary desk;
- its own interests in facilitating its distribution capability;
- the interests of its investment customers in receiving a suitable investment; and
- its own interests in attracting future investment banking mandates.

The Detailed Proposals

In order to meet these concerns, the FSA propose that firms should put in place systems and controls to ensure that those potential conflicts are identified and managed effectively. Again, they indicate that what constitutes appropriate systems and controls is a matter of judgement for the respective firm's senior management. However, in order to assist firms, they describe "what the systems and controls should aim to deliver in 3 specific areas":

1. Supervision and Management.

Firms' systems and controls should ensure that the interests of the firm itself and its investment clients do not

1 We would note that the FSA's understanding of "laddering" is different from the US concept of "laddering," which is the practice of tying allocations in an IPO to purchases of the same IPO security in the aftermarket at predetermined increasing prices.

improperly influence its servicing of the issuer and vice versa. In this context, the FSA believe that firms should separate staff servicing these different customers by Chinese Walls. Those not servicing the issuer (including proprietary traders) should not be involved in the process of recommendations on pricing to be submitted to the issuer, and the role of those servicing investment customers should be limited to providing information and feedback. Equally, the firm's arrangements should ensure that the interests of the issuer do not improperly impact on servicing the investment customers and in particular the FSA refer to compliance with its rules on suitability.

2. Allocations.

The systems and controls which the FSA's proposals identify are that:-

- the issuer should be provided with relevant information about the firm's proposed allocation policy before the firm accepts the mandate, including details of the issuer's objectives, the process by which recommendations and allocations are formulated and the target investor group;
- prior disclosure should be made in the allocation policy of any proposal to place securities with investment customers of the firm, others to whom the firm provides services or for its own proprietary account;
- the issuer should agree to the proposed policy;
- allocation should be controlled by senior corporate finance personnel, overseen by compliance, and not by staff servicing investment clients. The issuer should be invited to be fully involved in the allocation process. The FSA say expressly that the actual or likely level of business that the firm can expect from its investment client or clients should not be taken into account when determining allocation;
- the corporate issuer itself should ultimately decide on allocations based on recommendations by the firm;
- firms will need to address conflicts that can arise where a private client obtaining securities in an issue could be an officer of an existing or potential investment banking client of the firm. The FSA propose that allocation to private clients should be made as a single allocation to the private client department and not on a named basis. The corporate finance team should not have access to the identities of private clients to whom allocations might be made;
- where an allocation is made to a private client who is a senior executive of any listed company or a potential or existing investment banking customer, private client management in the firm should obtain confirmation from that company's audit committee that it knows of the relationship between the senior executive or officer and the firm concerned; and
- allocations to the private client division and to any proprietary training desk must be consistent with the allocation policy.

3. "Friends and Family" Lists.

The FSA do not think as a matter of principle that allocations directed on the instructions of the issuer itself will ordinarily give rise to regulatory concerns, but consider that in some circumstances, their Principles and rules will be breached, namely:-

- where the allocation is made as an inducement for payment of excessive compensation in respect of unrelated services provided by the firm;
- an allocation to a corporate officer of an existing or potential client in consideration for the future or past award of corporate finance business; or
- an allocation which is expressly or implicitly conditional upon receipt of orders or the purchase of any other service from the firm by the investor or any body corporate of which the investor is a corporate officer.

4. Pricing Review.

The FSA propose that firms should put in place arrangements to review pricing after an issue is completed, particularly where the discount is large, and the results of that review should be disclosed to the corporate customer.

THE PROPOSED DRAFT GUIDANCE AND RULE CHANGES

The draft guidance and rules which the FSA propose reflect the points made above. In addition, in the context of inducements and commission, the FSA propose further guidance making it clear that an offer or agreement to publish investment research or change of public recommendation in a favourable manner is an example of offering or accepting an inducement which is likely to conflict to a material extent with the firm's duties to its other customers.

In terms of guidance on corporate finance business issues, and in addition to reflecting the FSA's proposals, the

draft guidance makes clear that when carrying out the mandate to manage an offering of securities, the firm's duties for that business are owed to its corporate finance client, not its investment clients. At the same time, the firm's responsibility to provide its services to its investment clients are unchanged. It refers in particular to putting a Chinese Wall between individuals servicing the two different sets of clients.

Significant changes are proposed in relation to Conduct of Business Rule 7.3, dealing ahead of investment research, and also in relation to personal account dealing insofar as they concern analysts under Rule 7.13.

SUMMARY

The FSA's proposals in response to analyst independence and IPO pricing and allocation issues seem on the whole to be both measured and sensible. The fact that they do not go so far as introducing a number of the measures which have been adopted in the US is, on the one hand, a virtue. On the other hand, it means that investment banks operating on a global basis will have to meet different standards in different jurisdictions. The impact of European legislation and in particular the Market Abuse Directive may result in yet further changes. A number of the measures that the FSA propose are also Principles-based and in the form of guidance. More prescriptive, detailed rules may be unattractive to the industry, but Principles and guidance in more general terms can also lead to uncertainty.

Many investment banks will already have introduced some measures to meet some of the FSA's proposals in any event. Nevertheless, the proposals if implemented could result in significant changes in how some firms and their analysts operate. Responses to the FSA's proposals need to be with the FSA by 12 May 2003.

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