

FSA PROPOSALS REDUCE COMPANY PRESSURE ON CITY ANALYSTS

Since the end of the dotcom boom a lot of attention has focused on the role of investment banks and their analysts in pumping up share prices, particularly where the bank has a corporate relationship. New FSA proposals provide guidance on what companies can expect from their investment bank and the analysts.

The Financial Services Authority issued a discussion paper in July 2002. The regulator has now issued its proposals in *Consultation Paper 171: Conflicts of Interest: Investment Research and Issues of Securities*. Comments on the paper should be sent to the FSA by 12 May 2003. New rules are expected in the summer.

Principles

The FSA's consultation paper (CP) reiterates the principle that regulated firms are required to act with integrity, manage conflicts of interest fairly, to organise and control its affairs responsibly and effectively with adequate risk-management systems. The CP adds there is a strong case for guidance on these principles, and that the Conduct of Business (COB) rules need to be amended to provide clearer standards.

Investors should be able to operate on the basis that analysts research is at least factual and objective – ie, not biased because the responsible investment bank failed to manage or control conflicts of interest to which it or its

analysts may have been subject. Banks should ensure that their analysts are as free as possible from conflicts of interest that might improperly influence the content or objectivity of their research. Effective Chinese walls are part of such systems.

The FSA recognises that analysts have information that is useful to other parts of the investment bank – to research investment banking opportunities or to provide ideas to sales and trading for example. But drawing on this will take the analyst "over the wall" and should be controlled. However, analysts should not be used in a marketing capacity, either to pitch for new investment banking mandates or in marketing of new issues (whether by issuing research recommendations or advice to clients).

Company pressure

The FSA says that pressure from companies could affect the objectivity of the research produced about them. While clearly companies have a "keen interest" in the content of analysts' research, it would be improper for a company to make access to company information (eg, briefings, company visits) conditional on the production of favourable research. It is permissible to send a draft report to a company before publication to check for factual errors – "and what falls under this heading will be for the firm to establish in discussion with the company". But the bank should not surrender effective editorial

control to the company, and shouldn't include either the recommendation or the share price target in the draft report. Furthermore, neither the recommendation nor the timing of the research release should be changed as a result of feedback from the company, unless justified by material new information, in which case the bank should keep a proper record of the reasons for such a decision.

If a bank cannot resolve differences of opinion, then it may have no alternative but to cease coverage of the company concerned and should disclose this fact to investors.

There should be clearer disclosure of any actual or prospective bank relationship with a company that could compromise the objectivity of the research.

Quiet periods

UK practice is for the lead investment bank in an initial or secondary public offering to publish research circulars around the time of the new issue. But to avoid any confusion with the prospectus (or listing particulars), the FSA proposes that US-style "quiet periods" be introduced, prohibiting banks from publishing research for a period of time before and after a primary issue. But the FSA believes that such quiet periods would be unfair for secondary issues, since it could prevent publication of routine post-results circulars, for example.

Disclosures

The FSA expects greater disclosure to be part of the regulatory response. In particular the FSA is proposing that banks should:

- provide a clear explanation of ratings and recommendations and the time period they are intended to cover;

- show the bank's spread of ratings/recommendations globally and by sector, together with percentages for the firm's corporate clients;
- say whether the bank has had any investment banking or new issues mandates in the last 12 months or whether it expects any in the next six months;
- say whether the bank acts as a market-maker or corporate broker to the company;
- include a three-year share price chart showing when ratings/recommendations changed to reveal the analyst's track record.

New issues

The FSA recognises that investment banks and their corporate clients disagree on pricing and allocation of new issues: the client wants to sell securities at a high price and has views about its shareholding base. The bank will want to ensure the issue is successful for the corporate client and attractive to its investment clients and perhaps its own trading desk. The FSA says that a bank's traders, for example, should not be involved in pricing issues. It also says that banks should review the appropriateness of the pricing after a new issue is completed, especially if the securities have gone to a large premium, and the results of the review should be disclosed to the corporate issuer. It is for the issuer to decide securities allocations, in light of recommendations by the bank's corporate finance executives.

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www.financialdirector.co.uk/briefing

Useful links

- The FSA's consultation paper is available at www.fsa.gov.uk/pubs/cp