

ZENTRALER KREDITAUSSCHUSS

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Comments
of the Zentraler Kreditausschuss
on the
IOSCO Statement of Principles
for addressing sell-side securities analyst conflicts of
interest

03 December 2003

We share IOSCO's view that an adequate level of investor confidence is fundamental to healthy financial markets and therefore welcome the intention to strengthen this investor confidence. This applies to many of the mechanisms proposed in IOSCO's paper, which are aimed at safeguarding the independence of analysts and their research.

At the same time, we would like to point out that Germany already has an efficient set of rules and regulations to prevent possible conflicts of interest. This is evidenced by the fact that, unlike in some other countries, no cases of abuse involving securities research have come to light in Germany up to now. Moreover, along with national regulations (principally in the German Securities Trading Act), rules also exist in the Investment Services and Market Abuse Directives (including level 2 measures), which are soon to be implemented. Against this background, we strongly caution against overregulation. This would weaken the efficiency of the financial markets and create unjustifiable costs, which would ultimately have to be borne by those on the demand side – that is to say by investors.

It is regrettable that we were not involved in consultations on the Statement of Principles at an early stage. We believe it is important to have an opportunity to comment as early as possible in the interests of a satisfactory conclusion for all parties concerned.

I. Approach of the IOSCO paper

1. Geographical scope

IOSCO's proposed measures are aimed at its more than 100 member states worldwide. Since implementation is up to these member states and legal traditions and legal realities differ from one country to another, the possibility cannot be ruled out that the implementation process will result in some degree of legal fragmentation. The European Union should therefore advocate harmonisation at European level at least. It will be important to ensure, however, that any new rules are in line with the existing provisions of the Market Abuse Directive (cf. Article 6(5) and the relevant level 2 implementing measures) and the Investment Services Directive. A major objective of such pan-European harmonisation should be mutual recognition of research (European passport). The next step could then be to work towards the mutual recognition of research produced in EU member states and in third countries. Such

mutual recognition is also proposed by the Forum Group in its recommendations to the European Commission.¹

2. Material scope

In order to avoid uncertainty, the term research should be defined as clearly as possible. Unfortunately, IOSCO has refrained from attempting to draw up any definition in its paper. If the proposed measures are to be evaluated, however, it is essential to establish whether research is to be interpreted in the narrow sense of the term – as is assumed in the Forum Group’s paper, for example² – or in a broader sense. The considerable administrative work associated with the proposals can only be justified where research in the narrower sense is involved, that is to say a detailed analysis of an issuer within the meaning of the Forum Group’s paper. It is particularly important to draw a clear distinction between investment research and investment advice. Considerable uncertainties on this point are currently emerging in the drafting of implementing measures for Article 6(5) of the Market Abuse Directive.³

3. Personal scope

The same need exists to define the term analyst. It should, above all, be ensured that such a definition covers both analysts employed by investment firms and self-employed analysts.⁴ In the interests of a level playing field, there should be no special regulations applying to investment firms only.

¹ Financial Analysts: Best practices in an integrated European financial market, Recommendations from the Forum Group to the European Commission services of 4 September 2003, p. 9, p. 20 f.

² Financial Analysts: Best practices in an integrated European financial market, Recommendations from the Forum Group to the European Commission services of 4 September 2003, p. 17.

³ Cf. Article 1(4) of the Proposal for a Commission Directive implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest.

⁴ Cf. also Article 1(4)(a) of the Proposal for a Commission Directive implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest.

II. Comments on specific principles and measures

1. Analyst trading and financial interests

a) Core measures

- In principle, prohibiting analysts from trading contrary to their recommendations is a sensible measure.
- It is quite correct to prohibit an analyst from covering an issuer where he holds a senior position. A ban is preferable to a mere disclosure requirement since it would prove the more effective instrument. However, it should not extend to cases in which a person *related* to the analyst works for the issuer in a senior capacity. Such a rule would not be workable. It would be virtually impossible to define exactly who should be covered by the expression “individuals related to or associated with”, and monitoring violations of the rule would be hugely problematic.
- The above observations on prohibiting analysts from trading contrary to their recommendations also apply to a ban on trading ahead of publishing research.
- Disclosure of whether analysts have investment positions in the issuers they cover is not necessary. The other core measures are sufficient to address and avoid conflicts of interest. It must be borne in mind that an analyst may have securities under asset management and therefore has no possibility of influencing the type and scale of his investment. In this case, there is no conflict of interest. The same applies if internal compliance rules prohibit the analyst from trading in the securities he covers during a certain period before and after publication of his report. Irrespective of the above, the expression “financial interests” needs to be clarified.

b) Other measures

- A general ban on analysts trading in the securities or related derivatives of the issuers or industries they review would be excessive, in our view. As a regulatory measure, holding periods are both appropriate and sufficient. It should be up to the firm’s internal policy to prohibit trading at all if this is seen as being appropriate.
- In principle, the introduction of holding periods can be useful. However, they should not extend to any investments the analyst may have under asset management. In this case, no conflict of interest exists.

2. Firm financial interests and business relationships

2.1 Firm financial interests

a) Core measures

- If IOSCO is proposing that market making should be publicly disclosed, it should be clearly defined what is meant by the term “market making”. We would recommend adopting a definition along the lines of Section 34b (1) sentence 2 number 3 of the German Securities Trading Act.⁵ Regarding IOSCO’s proposal to require disclosure of the investment firm’s significant financial interests in the issuer, we believe such a requirement should apply only to firms that do not already have organisational mechanisms such as Chinese walls in place to ensure the confidentiality of their research departments’ work.
- The “associated individuals” should be dropped from the proposed requirement to disclose if individuals “employed by or associated with” investment firms hold a senior position at a company reviewed by their analysts. As mentioned above in the comparable context of including related individuals, this would lead to problems of defining who should be covered and monitoring would be problematic.
- Regarding the ban on firms improperly trading in securities ahead of publishing research on the issuer, we would point out that at universal banks, possible conflicts of interest between research and investment departments can generally be prevented most effectively by organisational mechanisms such as effective Chinese walls. If “improperly trading” is to be understood as exploiting the information contained in a research report, the proposed ban is unnecessary. Access to such information can be prevented from the outset with the help of internal organisational mechanisms.

b) Other measures

- Prohibiting research in the event that a member of the analyst’s firm also works for the issuer would go too far and is to be rejected. The complex legal interrelationships between companies in Germany would easily lead to situations in which it proved impossible to carry out research at all. Disclosure of these relationships is highly preferable to a ban.

⁵ Market making on the basis of a contractual relationship with the issuer.

- We feel requiring research reports to be publicly disclosed after a certain period of time has elapsed would make little sense; this measure is therefore to be rejected. Disclosure would offer investors no discernible added value since the research would be out of date in many cases. Moreover, the German Federal Financial Supervisory Authority (BaFin) can inspect research reports on demand anyway.

2.2 Firm business relationships

a) Core measures

- Chinese walls have proved an effective means of using internal organisational mechanisms to prevent possible conflicts of interest.
- Even though it has never been common practice in Germany to promise issuers favourable research in return for a business relationship, IOSCO's proposed ban is to be welcomed.
- There should be no blanket ban on analysts participating in sales pitches and road shows. In practice, sales pitches depend on the participation of analysts. Investment banks bidding for a mandate to underwrite corporate actions are normally expected to present their expertise in the research department. Analysts therefore have to be taken along to sales pitches. Prohibiting analysts from participating in road shows at all would also be inappropriate. The analyst should of course not be in possession of any inside information at the time the road show takes place. Rather, it can be necessary for analysts to take part. They represent a link between investors and the underwriting bank. Investors listen to their opinion and advice. We believe it is sufficient in both cases for a firm's compliance department to have controlling mechanisms in place, as suggested by the Forum Group.⁶

b) Other measures

- Regarding the proposed requirement to disclose investment banking relationships between the analyst's firm and the issuer, it should be remembered that, for universal banks offering both research and investment banking services, organisational mechanisms offer the most effective means of avoiding potential conflicts of interest. There is then no need for disclosure. Furthermore, mandatory disclosure would unreasonably force companies to divulge trade secrets to their competitors.

⁶ Cf. Financial Analysts: Best practices in an integrated European financial market, Recommendations from the Forum Group to the European Commission services of 4 September 2003, p. 29 ff.

- The proposed introduction of “quiet periods” can only be supported if the length of the period is harmonised throughout the EU. In addition, exemptions should be considered for cases in which new research becomes necessary to react to major new developments.⁷
- The proposal relating to the disclosure of coverage criteria and the cessation of coverage needs clarification.
- The introduction of an analysts’ oath is rejected on the grounds that it is alien to the European legal system.

3. Analysts’ reporting lines and compensation

a) Core measures

- The ban on analysts reporting to the investment banking division should apply only below board level. Otherwise small banks, in particular, would experience organisational difficulties in the event that one board member was responsible for several departments.
- It makes good sense to prohibit analysts’ pay from being linked to specific investment banking transactions. We would point out that such linkage has never been common practice in Europe.
- The introduction of internal mechanisms to safeguard the independence of analysts is to be welcomed. We assume that IOSCO is referring to mechanisms already familiar in Germany such as Chinese walls, internal guidelines and trading bans.
- In principle, we welcome IOSCO’s recommended ban on making the publication of research dependent on approval by the investment banking department. In exceptional cases, however, certain existing business relationships may make pre-approval necessary. It should therefore be possible for the board member responsible for investment banking at least to approve *whether* the research can be published *at all*. On no account, however, should this board member be permitted to influence the content of the research in any way.

b) Other measures

- Disclosure of analysts’ remuneration and reporting lines is unnecessary. Possible conflicts of interest with regard to pay are already prevented by the ban on linking compensation to

⁷ Cf. also Financial Analysts: Best practices in an integrated European financial market, Recommendations from the Forum Group to the European Commission services of 4 September 2003, p. 30, 31.

investment banking transactions. And organisational mechanisms such as Chinese walls already prevent possible conflicts of interest with regard to reporting lines.

- It is not necessary to disclose whether analysts' compensation depends wholly or partly on the firm's investment banking revenue. Direct linkage is prohibited anyway. If indirect interdependencies are meant, disclosure would be equally unhelpful. Such interdependencies will always exist at universal banks. Drawing attention to this fact would merely be stating the obvious and would not strengthen investor protection. Indeed, it could possibly even weaken it, since investors might attribute more importance to such a statement than it deserved.
- A general ban on analysts participating in investment banking activities would not be desirable. As outlined above, there are certain activities such as sales pitches where the presence of analysts is normal practice and indispensable.

4. Firm compliance systems and senior management responsibilities

- Internal compliance guidelines regulating how actual and potential conflicts of interest are to be addressed make good sense and already exist.

5. Outside influence

a) Core measures

- Generally speaking, there are no objections to requiring disclosure of whether the issuer or another third party has provided any payments or other benefit in connection with research. In the interests of legal certainty, however, it must be made absolutely clear what is meant by "other benefit".
- The proposed ban on issuers selectively disclosing material information should avoid the rather vague expression "material information". If insider information is meant, the practice is already banned under German law (cf. Section 14 (1) no. 2 of the German Securities Trading Act). If information going beyond this is meant, details need to be spelled out.

b) Other measures

- The requirement to disseminate reports simultaneously is not comprehensible as such. What are the – different? – reports that shall be disseminated simultaneously? If the

requirement refers to reports for different groups of clients, it should apply only within each individual target group. As far as the contents of such reports is concerned there should be the possibility to tailor research to the specific needs of the relevant group. The knowledge and experience of retail clients is completely different to that of professional investors and even the retail clients' investment behaviour may differ from that of wholesale clients. Finally, it must be borne in mind that research often is a service investment firms perform on the basis of specific contractual relationships. Whether they want to extend the service to customers outside this relationship, or even to non-customers, is a business policy decision in which there must be no interference.

Finally, we would like to point out that research reports are normally disseminated via media such as Reuters and Bloomberg – albeit generally somewhat later than the reports are made available to wholesale customers and in the bank's sales and trading department. In principle, therefore, retail customers have access to the research as well.

- We reject any requirement to disclose how research reports are disseminated since this would constitute excessive regulation. Whether or not to disclose dissemination procedures is a business policy question falling within the responsibility of each individual bank. Irrespective of this point, the Federal Financial Supervisory Authority can examine a firm's dissemination procedures in the course of a supervisory review.
- Separate payments to analysts by issuers or other outside parties should be prohibited. A ban is likely to be more effective than a mere requirement to disclose such payments and is thus the preferable option. For reasons of legal certainty, however, it must be made clear what kind of compensation is prohibited.

6. Clarity, specificity and prominence of disclosure

- The type of mandatory disclosure proposed here is too absolute and too rigid. As our comments above demonstrate, it is preferable to have a flexible system which allows different conflicts of interest to be dealt within different ways. Disclosure may certainly be recommendable in certain circumstances. But in many cases organisational mechanisms (Chinese walls etc.) and bans are likely to prove more efficient tools. If mandatory disclosure is considered in certain cases, standards should be harmonised throughout Europe to enable research to be mutually recognised.

7. Integrity and ethical behaviour

a) Core measures

- The obligation to act fairly and the ban on acting with intent to deceive reflect the legal position in Germany.

b) Other measures

- The proposed tests, examinations and disclosure of analysts' disciplinary records, professional credentials, real names and licence statuses are not only alien to the German legal system at least, but also raise data protection and privacy concerns.
- In contrast, we welcome the proposal to require analysts to define the terms they use, if this is appropriate in the special case. This is also advocated by the Forum Group.⁸
- Disclosure of a breakdown comparison of the buy, hold and sell recommendations made over a given period should not be mandatory. Nor should disclosure of a comparison between forecasted target prices and actual prices. Statistics of this kind can easily be misleading. This applies especially to comparisons of forecasted target prices and actual prices. A broad match between the two sets of figures is not necessarily indicative of high-quality research and vice-versa.⁹ It should be up to each individual firm to decide whether or not to publish such statistics.
- The proposed requirement for analysts to include a discussion of the assumptions underlying their recommendations in their reports needs to be spelled out in greater detail. In any case, overregulation has to be avoided.

⁸ Cf. also Financial Analysts: Best practices in an integrated European financial market, Recommendations from the Forum Group to the European Commission services of 4 September 2003, p. 45.

⁹ Cf. also Financial Analysts: Best practices in an integrated European financial market, Recommendations from the Forum Group to the European Commission services of 4 September 2003, p. 51.