Preserving Market Integrity

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Abstract

The work of equity research analysts has come under considerable scrutiny in the wake of a number of scandals involving serious misconduct by high profile members of the profession. The work undertaken by analysts is an important component of the market mechanism, and in particular, the efficiency and integrity of that mechanism. A number of recent regulatory reforms and policy pronouncements suggest improvements to the manner in which analyst activity and recommendations are managed, in the context of broader investment banking organisations in which many analysts are embedded. This paper reviews a number of these prescriptions, and also sets out the results of a survey of practices adopted at a number of investment banks employing equity analysts operating in the Australian market place. Some relevant policy prescriptions are yielded from this work and set out in the concluding section of the paper.

> *"It's difficult to get a man to understand something, when his salary depends upon his not understanding it"* Upton Sinclair

1. Introduction

The bull market of the 1990s both encouraged and concealed analyst misbehaviour. Never before had research analysts received so much negative media attention. At the centre of the media's attention were the revelations of serious misconduct by some high profile analysts[1]: namely Henry Blodget and Mary Meeker. While the majority of the allegations of analyst misconduct occurred overseas, mainly in the United States of America (USA), there were also allegations in Australia that conflicts of interest had compromised analyst research at one of Australia's most prominent investment banks[2]. Numerous press reports about a distinct lack of independence of research analyst recommendations resulted in overseas and local governments instigating investigations into the investment banking industry[3]. In Australia, the Australian Securities & Investment Commission (ASIC) launched a surveillance report on research analyst independence predominantly in response to public criticism and research by the International Organization of Securities Commission (IOSCO)[4]. The aim of this report was to provide an overview of the regulatory and compliance issues affecting research analyst and investment bank relationships in Australia and to work as a factual basis for policy guidance in relation to the Government's CLERP 9 legislation.

This paper investigates the role of analysts, factors that influence analyst independence, examples of analyst misconduct, and subsequently the current regulations and compliance policies recently implemented and put forward in Australia and overseas to deal with these issues. Next, this paper examines how several investment banks operating in Australia have sought to improve their research reports in response to the new regulations. To conclude, the paper offers suggestions to enhance further regulation of research analysts.

2. Research Analysts

The role of research analysts is diverse. Fundamentally, they are a significant component in the operation of informed and efficient markets. The principle role of research analysts is to collect, filter and analyse information about the economy, industries and business trends to assess the potential of various companies[5]. Research analysts may also assist in securing investment-banking transactions, through 'road shows' and other sources of marketing for Initial Public Offerings (IPOs), mergers and acquisitions and other corporate finance projects. Following their analysis, they form and communicate their opinion or recommendation about product issuers and investments to investors and the market in the form of research reports. These recommendations are commonly in the mode of 'buy', 'hold' or 'sell'. It is these recommendations or more so the preponderance of 'buy' over 'sell' recommendations that have been the focus of public scrutiny and concerns of regulatory bodies.

The integrity of investment research and recommendations is critical to maintaining investor confidence and market efficiency. Without the fair, accurate and transparent investment research, the integrity of financial markets and the investment professionals that serve them could be greatly jeopardised. Consequently, it is critical that research analysts, in particular the 'sell-side' analysts[6], manage the considerable number of conflicts of interest that they face in their day-to-day operations. Sell-side analysts are the people who work for the 'full-service' investment banks (i.e. a firm that engages in one or more of the following activities: investment banking, research and trading).

Previously, analysts performed research and analysis on a fee-for-service basis, however with the advent of the internet and the significant public dissemination of analyst reports via various forms of media, the majority of research performed is subsidised by other departments of the relevant organisation, most commonly the investment-banking department. This situation places the research analyst in a precarious position where the employer's interests may potentially conflict with his or her own. Moreover, a conflict of interest arises between the analyst providing objective and independent research and investment banking revenue.

Research analyst reports, especially from the highly regarded analysts, can significantly influence the prices of securities or other investments and place the analyst in a position of substantial influence[7]. Accordingly, analysts can use their recommendations to the monetary advantage of their investment banking firm or themselves. In these situations, the pressures from various market participants may unduly affect the independence and objectivity that underpins analytical research.

Importantly, market participants (i.e. investment professionals) have a mutual responsibility to create and maintain an environment that enables research analyst to fulfil their responsibilities with independence and objectivity, exercise due diligence and thoroughness in conducting research and taking investment action on behalf of their clients. Furthermore, research analysts must provide investment recommendations that have a reasonable and adequate basis and fully convey their true opinion. The best interests of the investing client must always take precedence over the needs of research analysts, investment managers, and their employers. Without this, investor confidence will deteriorate.

3. Regulation of Australian research Analysts

Currently, Australia has no specific legal or regulatory requirements for research analysts; however, regulation relating to research analysts and conflicts of interest relating to their work is developing. Under the Corporations Act, S912A (1), a financial services licensee must do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly. Furthermore, there are a number of interconnected provisions which deal with false, misleading, and deceptive conduct in Part 10.2, Division 2 of Corporations Act 2001 (Corporations Act). These include:

i. Section 1041E(1) 'A person must not (whether in this jurisdiction or elsewhere) make a statement, or disseminate information, if: (a) the statement or information is false in a material particular or is materially misleading; and (b) the statement or information is likely: (i) to induce persons in this jurisdiction to apply for financial products; or (ii) to induce persons in this jurisdiction to dispose of or acquire financial products; or (iii) to have the effect of increasing, reducing, maintaining or stabilising the price for trading in financial products on a financial market operated in this jurisdiction; and (c) when the person makes the statement, or disseminates the information: (i) the person does not care whether the statement or information is true or false; or (ii) the person knows, or ought reasonably to have known, that the statement or information is false in a material particular or is materially misleading.'

ii. Section 1041F '(1)A person must not, in this jurisdiction, induce another person to deal in financial products: (a) by making or publishing a statement, promise or forecast if the person knows, or is reckless as to whether, the statement is misleading, false or deceptive; or (b) by a dishonest concealment of material facts; or (c) by recording or storing information that the person knows to be false or misleading in a material particular or materially misleading if: (i) the information is recorded or stored in, or by means of, a mechanical, electronic or other device; and (ii) when the information was so recorded or stored, the person had reasonable grounds for expecting that it would be available to the other person, or a class of persons that includes the other person.'

iii. Section 1041G(1) 'A person must not, in the course of carrying on a financial services business in this jurisdiction, engage in dishonest conduct in relation to a financial product or financial service.'

iv. Section 1041H(1) 'A person must not, in this jurisdiction, engage in conduct, in relation to a financial product or a financial service, that is misleading or deceptive or is likely to mislead or deceive.'

In order to address the recent international developments on research analysts and related conflicts of interest, in addition to the requirements of the Corporations Act, the Securities Institute of Australia (SIA) and the Securities and Derivatives Industry Association (SDIA) issued best practice guidelines for research analysts in November 2001[8]. Following the lead of the SIA and the SDIA, The Australian Stock Exchange (ASX) and ASIC have begun investigations into the need for specific rules related to conflicts of interest. This paper now looks at what developments have occurred in Australia in terms of dealing with conflicts of interest.

In September 2002, the ASX began work on a new regulatory framework for research related conflicts of interest after they released a Draft Guidance Note that called for various restrictions on research reports issued by financial services firms. At the same time, the commonwealth government issued a policy paper suggesting that certain changes to the Corporations Act would be forthcoming in the areas of corporate disclosure and the management of conflicts of interest. Additionally, the government requested that ASIC prepare a Policy Statement regarding research related to conflicts of interest to complement their expected revisions to the Corporations Act. The introduction of these actions followed the US Securities and Exchange Commission (SEC) national inquiry that commenced in April 2002 into market practices and the efficacy of existing mechanisms. In February 2003, the ASX issued a revised Draft Guidance Note following extensive comments from market participants.

In the August 2003 ASIC surveillance report on research analyst independence, identified a number of concerns including: whether conflicts of interest were being adequately managed and whether current disclosure levels were adequate. Initial interviews, in early 2001, with a number of investment banks, found that a number of conflicts of interest existed but there was a degree of uncertainty about the extent to which the conflicts were impacting on retail consumers and market fairness. The report identified a number of problematic areas: (1) pressure from companies and institutional clients; (2) inadequate separation of investment banking from equities and research functions; (3) analysts' remuneration; (4) analyst trading; (5) disclosure of conflicts of interest; and (6) research dissemination.

Following ASIC's surveillance report, the Commonwealth Government published, October 8th 2003, a draft of the Exposure Draft Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Draft CLERP Bill)[9]. This Bill sought to amend the Corporations Act and impose an obligation on licensees to have adequate arrangements to manage conflicts of interest under s912A (1) (aa). Furthermore, the ASIC policy proposal paper, also released in October, entitled *Licensing: Managing Conflicts of Interest* offered specific guidance for providers of research reports. The key suggestions put forward by ASIC, were that for licensees to comply with the conflict provisions, it was imperative to disclose and avoid conflicts of interest. Moreover, they should have measures, processes and procedures to identify conflicts of interest; assess and evaluate those conflicts; appropriately respond to those conflicts; and ensure that, regardless of any conflicts, the quality of the financial services they provide is not significantly compromised.

Schedule two of the *Licensing: Managing Conflicts of Interest* paper offers guidance that is more detailed on ASIC's expectations for research report providers, following their consideration of international and domestic developments. The ASIC proposals on analyst research reports cover:

a) Structure and general practices

b) Monitoring and supervision

c) Benefits and remuneration

d) Trading restrictions

e) Other steps to prevent inappropriate conduct

f) Special disclosure

g) Other disclosure issues

On 30 August 2004, ASIC released the Policy Proposal Statement 181, *Licensing: Managing conflicts of interest* with the aim of ensuring that financial service licensees manage conflicts in a way that enhances consumer confidence, fairness, honesty, professionalism and market integrity. While the policy statement did not offer any additional guidance for research report providers above that provided in original policy proposal paper, it set out to reinforce three key mechanisms (1) controlling conflicts; (2) disclosing conflicts; and (3) avoiding conflicts to ensure the prior mentioned outcomes. This obligation came into effect on 1 January 2005.

4. International regulation of Research ANalysts

Undoubtedly, the regulation of research analysts has been most prolific in the United States of America, although there has been a resilient global effort. This came about because of a numerous serious allegations regarding the conduct of several investment banks and their employees. In particular, that Merrill Lynch tarnished its investment recommendations as a result of undisclosed conflicts of interest, namely that research analysts were acting as quasi-investment bankers for corporate issuers, regularly initiating, continuing, and/or manipulating research coverage with the intent of attracting and maintaining investment-banking clients. This meant that the research analysts became involved in producing misleading ratings/ investment recommendations that were neither objective nor independent, as they professed to be.

For example, the research analyst would publicly tout stocks as 'accumulate' although they internally disparaged them as a 'piece of shit' and 'such a piece of crap'. Even though Merrill Lynch policies reflected an understanding that a separation between the banking and research departments ('Chinese Wall') is critical for maintaining the integrity of recommendations, investigations revealed that their Chinese Wall had broken down. Contributing to the breakdown between the research and the investment department were revelations that investment-banking work determined analyst compensation.

During 1999, the SEC the United States Congress and the New York State Attorney-General began to examine research analysts' conflicts of interest. Of primary concern in their investigation was that investors who rely on analyst recommendations might not know that favourable research coverage assists in the marketing of the analyst firm's investment banking services, and that they might be unaware that analyst compensation may depend on the investment banking business they generate[10].

In response to the investigations and the concerns about potential misconduct, the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) introduced detailed and prescriptive rules, dealing with operational practices and procedures, remuneration, disclosure obligations and trading restrictions to regulate the behaviour of analysts. Nevertheless, these rules are restricted to analysts that are members of the NYSE and NASD[11]. Concurrently, the largest trade association for the securities industry in the United States of America, the Securities Industry Association (SIA), convened a committee composing of the heads of research of the major investment banks to develop a set of 'best practices' for research analyst and investment banks. This set of 'best practices' subsequently has served as a template for regulatory authorities around the world.

During 2002, the New York Attorney General and a number of U.S. state and federal agencies reached an 'in principle' settlement of allegations against Bear Stearns & Co LLC, Credit Suisse First Boston Corp, Deutsche Bank, Goldman Sachs, J.P. Morgan Chase & Co, Lehman Brothers Inc, Merrill Lynch & Co Inc, Morgan Stanley, Salomon Smith Barney Inc and Warburg LLC. The provisions of the settlement included:

1. The firms will physically separate their research and investment banking departments to prevent the flow of information between the two groups
2. The firms' senior management will determine the research department's budget without input from investment banking and without regard to specific revenues derived from investment banking
3. Research analysts' compensation may not be based, directly or indirectly, on investment banking revenues or input from investment banking personnel, and investment bankers will have no role in evaluating analysts' job performance.
4. Research management will make all company-specific decisions to terminate coverage, and investment bankers will have no role in company specific coverage decisions.

5. Research analysts will be prohibited from participating in efforts to solicit investment-banking business, including pitches and roadshows. During the offering period for an investment banking transaction, research analysts may not participate in roadshows or other efforts to market the transaction.

6. The firms will create and enforce firewalls restricting interaction between investment banking and research except in specifically designated circumstances.

7. To ensure that individual investors get access to objective investment advice, the firms will be obligated to furnish independent research. For a five-year period, each of the firms will be required to contract with no fewer than three independent research firms that will make available independent research to the firm's customers. An independent consultant for each firm will have the final authority to procure independent research.

8. To enable investor to evaluate and compare the performance of analysts, research analysts' historical rating and price target forecasts publicly available.

9. The ten firms have collectively entered into a voluntary agreement restricting allocations of securities in hot IPOs – offering that begin trading at a premium – to certain company executives officers and directors, a practice known as 'spinning'. This will promote fairness in the allocation of IPO shares and prevent firms from using these shares to attract investment-banking business.

In the United States of America, the CFA Institute[12] (formerly the Association for Investment Management and Research (AIMR)), which is a non-profit professional association of 75,000 securities analysts, fund managers and other investment professional in 120 countries has also taken a hard line on research analyst conduct. In their draft Research Objectivity Standards for brokerage and sell-side research firms, they accepted the following SEC requirements:

a. Aligning analyst compensation to the quality of research and the accuracy of analyst recommendations over time;

b. Segregating research from investment banking in ways that ensure that investment banking does not influence research or the resulting recommendations;

c. Establishing rating systems that help investors assess the suitability of a security to their own unique circumstances and constraints, rather than taking a "one size fits all" approach that treats all investors alike; and

d. Fully disclose all conflicts of interest of both the analyst and the firm, especially whenever analysts discuss their research and recommendations in public settings.

Additionally the CFA Institute proposed the following practices and guidance for sell-side firms.

e. When discontinuing coverage, brokerage firms should issue a "final" research report and recommendation, explaining the reason for doing so, rather than quietly discontinuing coverage to avoid putting a negative rating on a stock.

f. Firms should prohibit research analysts from participating in marketing activities, including "road-shows," for corporate clients issuing new shares of stock.

g. Sell-side firms should adopt a "three-dimensional" rating system that communicates risk and a time horizon in addition to the "buy-hold-sell" recommendation itself.

h. Sell-side analysts who give media interviews or make other public appearances discussing their research recommendations should make the full research report available to the public at a reasonable price.

More recently in November 2004, the CFA Institute launched the CFA Centre for Market Integrity to continue their crusade on the key issues affect the integrity of capital markets around the world, including amongst others, ethical standards, research objectivity, market fairness, openness, transparency, competent, fair and efficient investment practice. The core guiding principle of the CFA Centre is that all market participants have an ethical responsibility to place the interests of investors first. Moreover, the CFA Institute will aim to enforce the obligations on all their charterholders.

In step with the SEC in the United States and ASIC in Australia, the Financial Services Authority (FSA) in the United Kingdom took a considerable interest in conduct of research analysts. Their interest resulted in the production of Consultation Paper 171 Conflicts of Interest: Investment Research and Issues of Securities (CP 171) following site visits and surveillance of investment banks. The FSA CP 171 proposed comprehensive rules regulating analyst conduct, including trading restrictions, restrictions on ownership of securities covered, conflicts disclosure, quiet periods around securities issues and controls on dissemination of research. They also suggested that it might be appropriate for analysts to be restricted from covering securities that they own. Their suggestions are almost identical to those made in the United States and Australia.

Additionally, to deal in part with research related conflicts of interest, the European Union established two directives and appointed a Forum Group on Research Analysts to examine the need for new regulations and/or best practices for research analysts in the European context.

At the international level, IOSCO commenced a Project Team, in early 2001, on Securities Analysts to examine how the securities regulator could address the conflicts of interest faced by sell-side research analysts. IOSCO Statement of Principles on Security Analyst Conflicts of Interest sought to deal with the standards of disclosure of conflicts of interest, limitation or management of such conflicts, reporting and compensation systems, elimination of outside influences and the integrity and competence of research analysts. Their development of high-level principles were proclaimed to be used as the basis for new regulations regarding research analysts and research related conflicts of interest in all IOSCO jurisdictions.

5. Conflicts of Interest and Research Analysts

The ASIC surveillance report, in addition to similar international investigations, identified a number of problematic areas with respect to conflicts of interest with analysts and their investment research. In the following, this paper investigates each of these areas and offers arguments for increased regulation.

Inadequate separation of investment banking from equities and research functions

The importance of income from investment banking to the profitability of an investment bank has been critical to offset the decline in brokerage. Consequently, allegations have been made to the effect that investment firms pressured analysts to issue highly favourable research on current and prospective investment banking clients. There is no problem with research analysts releasing favourable research, so long as the company rightfully deserves it.

Furthermore, the trouble arose as analysts participated in 'road shows' and other marketing activities without conflicts being adequately or effectively managed or disclosed. The traditional approach for dealing with potential conflicts of interests is the erection of 'firewalls' or 'Chinese walls' which separate the two functions of investment banks: investment banking and investment research. Furthermore, it is critical that the investment bank instils a culture that facilitates and encourages independence and objectivity and protects their analyst from the pressure of their investment banking colleagues.

Critical to the success of separation of investment banking from the research function is independent reporting structures for personnel within the investment banking and research functions. Under no circumstance should investment-banking personnel have authority to approve, disapprove or make changes to research reports or recommendations. Furthermore, it would be appropriate for the investment bank to review their policies and procedures regularly to ascertain whether conflicts are minimised and disclosures are transparent.

Pressure from Companies and Institutional Clients

Research analysts do not only receive pressure from their firm's investment-banking division to issue favourable investment research. It can come from the corporate issuers who are averse to downgrading of their company's securities and additionally from institutional clients of the research and brokerage divisions (i.e. fund managers) who are also averse to downgrades of stocks that they hold in their portfolio. Furthermore, a 2001 Reuters survey[13] found that 88 percent of U.S. research analysts feared company executives would 'retaliate' if they issued a negative recommendation. Retaliatory practices reported in the study included companies bringing legal suit against analysts personally and/or their firms seeking monetary damages for the economic effects of negative reports and recommendations. Even though not all companies engage in such behaviour, the discernment that a reprisal is possible is a realistic concern for analysts.

Analysts' Remuneration

When analyst remuneration is determined by investment banking relationships, then it is evident that the research analysts have a motive to ensure that current or prospective investment banking clients receive supportive research. As a solution, analyst compensation should not be linked either directly or indirectly to investment banking relationships. This solution would minimise the pressures on research analysts to issue biased research and if the compensation plan is well structured it should reward research objectivity and the accuracy of the analyst's research.

Disclosure of Conflicts of Interest

Transparency and disclosure are critical for investors to identify whether conflicts of interest may affect the research-analyst investment recommendations they receive. As mentioned previously the actions of the investment-banking department have played a role in determining investment recommendations. Thus, research analysts are encouraged to disclose the investment-banking relationships that their organisation has with the company they are covering, so that current or potential investors are alert to a potential bias. Additionally, the objectivity of investment research could result from the personal investments of research analysts (or their immediate families). Personal investments could adversely affect a research analyst's ability to issue independent and objective research and recommendations.

The question is should a research analyst be allowed to hold investments in companies they follow? Most investment professionals would believe that research analysts should own the securities of the companies they follow and recommend as it displays their confidence and that it is their right. Although, there is nothing inherently unethical in research analysts owning stock in the companies they cover, the problem is whether the analyst can hold their clients' interest foremost.

To ensure that analysts maintain their fiduciary duty to clients, investment firms should implement clear policies for personal investment and trading by research analysts. These policies should enforce disclosure of an analyst's investments, and include a review and approval of procedures for research reports and recommendations. Effective policies and procedures should eliminate the potential for analysts to manipulate ratings and recommendations for their own benefit. Investment firms must regularly monitor their policies and employees to ensure compliance, and specifically disclose both firm policies and analyst personal investments to investors. Personal investments should be permitted although subject to constraints.

Research Dissemination

In recent times, sell-side research has increasingly become available to all investors, mainly through brokers, the media and the Internet. Previously, the predominant users of research were institutional investors. Institutional investors are aware of and understand the difficult conflicts of interest that affect research analysts and can factor this knowledge into the assessment of the quality and objectivity of research.

The typical investor is not 'sophisticated' and is unable to discern facts from opinions and reasonable judgements about the quality of any research as well the suitability of investment recommendations. Analyst research reports commonly are many pages in length however often they are reduced by brokers and the media to one-word ratings (i.e. 'Buy', 'Hold', 'Sell') or recommendations that do not provide sufficient information to justify buying and selling a security. Furthermore, research analysts should clearly disclose any conflicts of interests (such as conflicts stemming from personal or firm holdings or investment banking relationships) to journalists and make reasonable efforts to ensure that journalists make such disclosures public.

Rating systems are often criticised[14] for being ambiguous and complicated. In addition, the differences between the rating systems of various investment banks can be significant and often confusing for the investing public. In response, either the investment firms should be required to explain their rating systems or alternatively it may be appropriate to establish standards to ensure that there are consistent rating systems. Nonetheless, another solution would be to abolish ratings system altogether and rely strictly on the content of the research report. However, with no 'BUY' or 'SELL' signals, it would be necessary to assume investors could interpret the content and import of financial research product. Furthermore, the tone of the research would have to remain objective such it does not offer recommendations intuitively. In this situation, the effects from conflicts of interests from investment banking relationships would be minimised.

6. AUSTRALIAN INVESTMENT BANKS and Conflicts of Interest

Following the U.S. scandals, Australian investments banks have receive heightened media attention regarding the potential conflicts of interests that stand between the research analyst recommendations and investment banking business. Ian Ramsey, Professor of Corporate Law and Director of the Centre of Corporate Law at Melbourne University, expressed the view that[15] 'There can be a real conflict between the financial imperatives, which is certainly driven by corporate finance and the ethics of independence…Chinese walls don't always work and sometimes they've been found to be low and not sufficiently rigorous'. In the same article, Peter Morgan, the [now former] head of equities at Perpetual Funds Management, opines that there is a clear conflict of interest for analysts: 'The fact that none of these analysts have any accountability for their calls in the first quarter of 2000 is a disgrace'

In response to the outrage of the media and the public about analyst conduct, a key objective of the research project reported in this paper was to investigate what major investment banks in Australia have done to address the new Corporate Law requirements following the Financial Services Reform Act and ASIC's recommendations. For the purposes of this study, a number of investment banks operating in Australia (several of which had been part of the settlement with the New York Attorney General) were contacted, and questions put to their representatives about the issues of interest in the context of the research. An inspection was also made of publicly available documentation on the websites of these organisations.

The objective was to ascertain a policy statement or comments that address how the investment firm deals with conflicts of interests and analyst conduct and the secondly observe how they present their investment research and recommendations in light of concerns regarding its ambiguity. This task was relatively difficult, especially given the reticence of a number of the organisations to make available their policy statements on this issue. In all, eight organisations were contacted and the results of the review of their policies and research recommendations is set out below.

At Bank 1, the Executive Director Corporate Communications questioned the motive for requesting this information then said that 'after checking with the relevant people that they were unable to assist with the request'. Furthermore, he said that while 'Bank 1 has extensive and detailed policies governing every aspect of analyst conduct and behaviour, these policies are internal references and therefore cannot be distributed externally'. Nevertheless, on their website they detail their 'Client First Policy'. Part of this policy is to ensure each of [their] client's best interests are upheld without compromise and that our investment recommendations are made with absolute objectivity.

In doing so, Bank 1 maintains several internal policies with which all employees must comply: First, 'Client Focus', the first obligation of every Bank 1 adviser is to understand each client's investment objectives. By understanding the goals of each client, they aim to make appropriate recommendations that help realise our client's goals. Second, 'Sector Prohibition', means that the research analysts (and members of their immediate families) are prohibited from transacting in shares in the sectors they research — the prohibition extends beyond the particular companies the analyst researches and is applied to the entire sector(s). These measures are imposed to avoid the possibility of conflicts of interest.

Third, 'New Issues', requires Bank 1 staff members to not receive preferential access to placements or company floats. Staff members are not allowed to apply for new issues until access has been made available to the general public. Last, 'Staff Purchases', requires each Bank 1 staff member who transacts in shares to have each transaction authorised by approved representatives of the firm. In addition, staff members who purchase shares are not permitted to sell the shares within three months of the date of purchase.

The form of the research recommendations published by Bank 1 is unique in the sense that the bank uses ratings definitions that are dependent on time period. For example, for short term investments, they use Underperform (UP) (Stock is expected to underperform the S&P/ASX 200 on a 0-6 month timeframe), Marketperform (MP), Stock is expected to perform in line with the S&P/ASX 200 on a 0-6 month timeframe and Outperform (OP) Stock is expected to outperform the S&P/ASX 200 on a 0-6 month timeframe and for long term investments they use Sell (S) (Stock is expected to underperform the S&P/ASX 200 for beyond 6 months), Hold (H), (Stock is expected to perform in line with the S&P/ASX 200 for beyond 6 months) and Buy (B), (Stock is expected to outperform the S&P/ASX 200 for beyond 6 months). No specific policy addressing conflicts of interest policy could be found.

Bank 2 was also uncooperative in providing information about their policy for dealing with conflicts of interest. However, an email from one of their compliance officers contained the following disclosure:

> ***Analyst Certification****: The views expressed in this research accurately reflect the personal views of the analyst(s) about the subject securities or issuers and no part of the compensation of the analyst(s) was, is, or will be directly or indirectly related to the inclusion of specific recommendations or views in this research. The analyst principally responsible for the preparation of this research receives compensation based on overall revenues, including investment banking revenues, of Bank 2 and its wholly*

owned subsidiaries ("the Bank 2 group") and has taken reasonable care to achieve and maintain independence and objectivity in making any recommendations.

An analysis of this disclosure statement reveals that there is the potential for conflicts of interest to influence analyst reports. The fact that analysts responsible for the preparation of research receive compensation-based investment banking revenues of Bank 2 provides a clear incentive for all analysts within the bank to provide favourable research and subsequently maximise investment banking revenues and their compensation.

Following the scandals in the U.S. and worldwide public concern regarding the analyst research, it appears that Macquarie Bank has decided to changed their recommendation definitions which were previously, sell, hold and buy to underperform (return >5% in excess of benchmark return), neutral (return within 5% of benchmark return) and outperform (return >5% below benchmark return), respectively. Additionally, Bank 2, since 2002, has started to include information about the risk of the particular stock for which they have released recommendations. The risk of individual stocks is now measured by Bank 2 using a 'Volatility Index' with five definition classifications that have been calculated from the volatility of historic price movements: *Very High - Highest Risk*, where the stock should be expected to move up or down 60-100% in a year. Investors should be aware that this stock could be highly speculative. *High Risk*, where the stock should be expected to move up or down at least 40-60% in a year. Investors should be aware that this stock could be speculative, *Medium Risk*, where the stock should be expected to move up or down at least 30-40% in a year, *Low/Medium Risk*, where the stock should be expected to move up or down at least 25-30% in a year. *Low Risk*, where the stock should be expected to move up or down at least 15-25% in a year.

At Bank 3, the Director of Compliance contended that he would not provide any information about how they deal with conflicts of interests within his firm. However, the in discussion with the researcher, the director highlighted the intense scrutiny the media has 'unfairly' put on investment banks in Australia. He stated that the events that occurred in the United States were definitely not replicated in Australia. Australia, he claimed, does not have the same tight knit investment banks, where the investment banking division and research analysts work together in promoting deals.

Furthermore, he mentioned an internal paper that he had written attacking the myth of bias in investment banking research. He said that his paper argued that preponderance of 'buy' over 'sell' recommendations is due to the larger appeal of 'buy' recommendations than 'sell' recommendations and that investors prefer to see 'buys'. Moreover, the audience of a 'sell' recommendation is limited to those who already hold the stock or may wish to short-sell the stock as opposed to a 'buy' which every investor can potentially act upon. Also as a result of limited resources investment banks prefer to look for buy recommendations which they can provide their clients and that research analysts are interested in covering.

Upon queering the reasons as to why research analysts continue to promote stocks as 'buys' even though there was public criticism of their recommendations, the Director of Compliance responded that 'market exuberance' or the 'tech boom' was almost non-existent in the Australia during the 1990s and 2000. In support of the research analysts' failure to predict the market reversal, he said that financial analysis is not a science and that predictions are not perfect. Moreover, he stated that generally research analysts are independent, comprehensive and objective in the production of research and that ASIC's recent efforts to regulate the investment banking industry was publicly excessively strict even though privately they had been in support of the investment banks conduct in dealing with conflicts of interest over the last 5 years. Lastly, all attempts to source Bank 3's policy regarding their issuance of investment recommendations were unsuccessful.

On the international website (which serves as the homepage for the Australian branch) for Bank 4, a highly detailed six-page document entitled 'Managing Conflicts of Interest' appears. This document clearly presents the Bank 4 policies for managing conflicts of interest in connection with investment research. In summary, the document concerns: (1) Investment Research; (2) Integrity; (3) Identification of Conflicts; (4) Supervision and Remuneration of Analysts; (5) Analysts' Activities; (6) Inducements and Inappropriate Influences; (7) Method and Timing of Publication; (8) Disclosure of Interests and Personal Account Dealing.

The policy states that Bank 4 will only publish investment research that is impartial, independent, clear, fair and not misleading. Their analysts are required to ensure that they have a reasonable basis for their analysis and recommendations. Bank 4 analysts are restricted from roles that could prejudice, or appear to prejudice the independence of their research or conflict with their duties to the recipients of their research, but are otherwise free to use their expertise for the benefit of Bank 4's clients.

Bank 4's policy on managing conflicts of interests required that research reports contain disclosures as required by various legal and regulatory requirements. Such as:

- An explanation of the rating system used by Bank 4;
- Whether Bank 4 holds 1% or more of the securities of companies referred to in research reports;
- Whether Bank 4 acts as a market maker in the securities of companies referred to in research reports;
- Information regarding any directorships or other material relationships of individual officers of Bank 4 with companies referred to in research reports;
- Any personal interest of the analyst or close relations of the analyst in securities of companies referred to in research reports;
- Past significant relationships of Bank 4 with companies referred to in research reports, including investment banking or other advisory assignments or relationships; and
- Subject to legal and confidentiality constraints on disclosure, current or perspective relationships between Bank 4 and companies referred to in research reports, or the fact that such relationship may exist.

In a similar vein the practice of Bank 4, Bank 5 publishes a 'Code of Business Conduct and Ethics of the UBS Group' which specifies the policies and practices that are expected, such as standards of fairness, honesty and integrity. Additionally, their Code of Business Conduct specifies that the firm is required to disclose information fully, fairly, accurately, timely and understandably in reports and documents.

At Bank 6 all that could be found were their latest definitions for their rating system: *Overweight* - Over the next six to twelve months, we expect this stock will outperform the average total return of the stocks in the analyst's (or the analyst's team's) coverage universe. *Neutral* - Over the next six to twelve months, we expect this stock will perform in line with the average total return of the stocks in the analyst's (or the analyst's team's) coverage universe. *Underweight* - Over the next six to twelve months, we expect this stock will underperform the average total return of the stocks in the analyst's (or the analyst's team's) coverage universe. Bank 6's decision has also been to move away from the buy, hold and sell recommendations that caused so much controversy.

Intriguingly, at Bank 7 the current rating system still resembles that which other investment banks have attempted to do away with, namely, the Buy, Hold and Sell categories. While prior to September 9, 2002 Bank 7 had Strong Buy, Buy, Market Perform, Under Perform, Not Rated, Suspended Ratings classifications their more recent rating are as follows: *Buy* - Total return expected to appreciate 10% or more over a 12-month period, *Hold* - Total return expected to be between 10% to -10% over a 12-month period, *Sell* - Total return expected to be between 10% to -10% over a 12-month period, *Not Rated* - There is no investment rating and target price for this security, and *Suspended* - The investment rating and price target, if any, for this security, have been suspended. The previous investment rating and price target, if any, are no longer in effect for this security and should not be relied upon.

Consistent with the majority of the investment banks that operate in Australia, Bank 8 failed to provide any information on their research analyst policy. However, on their website they state that they maintain the highest professional standards and principles in publishing research and to ensure that all our clients are fully informed, Bank 8 has established a special website that contains important disclosures relating to its research on companies. Additionally, stock recommendations at Bank 8 include a risk rating and an investment rating. First, the Risk rating, takes into account both price volatility and fundamental criteria, are: Low (L), Medium (M), High (H), and Speculative (S). Investment ratings - Buy (1), Hold (2), and Sell (3) - are based upon Bank 8's expectation of total return (price appreciation plus forecast dividend yield) within the next 12 months, and take into account the risk rating and second the investment rating represents the opinion of the analyst and thus should not be construed as guarantees of quality and/or performance.

Furthermore, for securities in developed markets (US, UK, Europe, Japan, and Australia/New Zealand), their investment ratings are: Buy [1] (expected total return of 10% or more for Low Risk stocks, 15% or more for Medium Risk stocks, 20% or more for High Risk stocks, and 35% or more for Speculative stocks); Hold [2] (0% 10% for Low Risk stocks, 0% 15% for Medium Risk stocks, 0% 20% for High Risk stocks, and 0% 35% for Speculative stocks); and Sell [3] (negative total return).

Bank 8 also adds that Investment ratings are determined by the ranges described above at the time of initiation of coverage, a change in risk rating, or a change in target price. At other times, the expected total returns may fall outside of these ranges because of price movement and/or volatility. Such interim deviations from specified ranges will be permitted but will become subject to review by research management. Lastly, Bank 8, consistent with all banks reviewed, alerts its clients that their decision to buy or sell a security should be based upon your personal investment objectives and should be made only after evaluating the stock's expected performance and risk.

A comprehensive stock rating system introduced by Bank 8 on September 12, 2003 aims to differentiate their research and demonstrate their commitment to providing research of the highest quality. Moreover, the new methodology is more rigorous and robust, also aims to expose the underlying components of the rating within the research. This transparency hopefully will allow the investor to quickly assess the various risks and expected returns that go into the rating and apply these factors to your own investment criteria.

The rating system is a significant departure from its predecessor where stocks were rated on a *relative* basis. This means that stocks will no longer be rated relative to others in their industry or to the analyst's universe of coverage. In contrast, the rating system will be *absolute* in nature. Investment ratings are determined based on expected total return and risk rating. Ratings are independent of relative performance to other stocks.

In addition to an improved rating system, Bank 8 has also constructed a 'Conflicts Policy – Equity Investment Research' paper addressing their policies in relation to the 'Identification of Conflicts', 'Structural Separation', 'Supervision and Remuneration of Equity Analysts', 'Involvement of analysts in other activities', 'Avoiding Inappropriate Influences', 'Means and Timing of Publication' and 'Disclosures'. In light of this, Bank 8 could be argued to have established a benchmark for all Australian investment banks to follow to ensure that investment research and recommendations are unbiased and independent and that clients are aware of their companies' policies for dealing with conflicts of interests.

In summary, the failure of a number of the major investment banks in Australia to produce open policy documentation regarding their methods of dealing with conflicts of interest and analyst conduct is extremely concerning. It does little to alleviate the concerns of particularly the many first time investors that suffered dearly in the collapse of the prior tech bubble. Establishing clear and rigid policy documentation would be highly reassuring to any current or potential client of these investment banks. Additionally, it could work towards alleviating the perception that investment banks issue subjective and biased research.

Only the NYSE and NASD rules on analyst conflicts of interest and the Global Research Settlement that has required their Member Firms to disclose in their research reports any conflicting relationships that analysts and/or the Firm may have regarding individual companies. These disclosures require detailed information on company ratings as well as a description of the firm's rating system and ratings distribution. This includes discussion on the valuation technique and a supporting rating and price target (if any), and a discussion of risks to the rating and price target (if any). Without the structured rules and guidelines, it would appear unlikely that the investment firms, as evidence by Australian investment banks, would disclose this necessary information.

Ultimately, the federal government, ASIC, other regulatory bodies and shareholder groups have a role in requiring that all Australian investment banks involved in production of analyst research and carrying out investment banking produce and present policy statements regarding conflicts of interest and analyst conduct to the public rather then just offering relatively loose guidelines. Formalised and consistent policy statements could also prove useful in reducing future investor apprehension about the affects of lax monitoring of potential conflicts of interest.

7. Conculsion

Although the current guidelines provide a suitable framework for addressing conflicts of interest, sell-side institutions and investors require a more defined line on the acceptable standards of conduct within the current framework of the principles and rules. Furthermore, as investment firm take on a global presence it is also important that the respective financial regulatory bodies around the world similar address the concerns of conflicts of interest and investment research in a consistent manner (potentially with the IOSCO principles) to restore investor confidence. Thoroughly targeted international proposals would also be effective in promoting enhanced standards of independence and objectivity whilst avoiding a disproportionate compliance burden.

While all the attention has focused on regulatory requirements dealing with conflicts of interest with equity investment research it is critical not to forget that research in respect to non-equity investment instruments must also fall within the same regulatory requirements. This includes non-equity investment research, such as, bonds, hybrid securities, managed funds and derivatives, which must also be objective and free from the effects from conflicts of interest.

Continued efforts by regulatory authorities around the world to address the issues regarding investment analyst research are critical to ensuring financial market integrity. It is imperative that all market participants continue to play a role in creating an environment that supports, facilitates and encourages research objectivity. This includes removing the major incentives that encouraged research analysts to issue biased research in the past, strict rules and regulations governing analyst conduct and serve financial penalties for non-compliance.

At a minimum, without transparency and disclosure, investors have the right to doubt that investment firms are serious to addressing the concerns about conflicts of interest, something which raises justifiable concern about the quality of their research product and the extent to which markets integrity is in fact being promoted and protected by dint of analyst scrutiny.

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