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Financial analysts in CAPITAL MARKETS

regulation

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Before the strong bull markets in equities in the late 1990s, financial analysts did not draw much attention from regulators. Analysis was concentrated within regulated investment bank houses. Unaffiliated research may have existed but was hardly noticeable. The European Investment Services Directive treated research as ancillary activity to the so-called core activities of investment banking. During that bull market phase, however, a certain number of prominent financial analysts misunderstood their function. Conflicts of interests were solved to the detriment of the investor. Objectivity was sacrificed to the aim of supporting their employers' selling efforts and their own remuneration interests. Although such blatant abuses might have been practised only by a relative small number of analysts, the integrity of the entire profession was questioned.

To restore the confidence of capital markets, legislators in many jurisdictions addressed the issues of objectivity, integrity and transparency in research. In the US, the Sarbanes-Oxley Act imposed strict rules on investment banks and the research profession. In Europe, legislation was introduced on the European level and by national legislators.

THE PRESENT SITUATION IN EUROPEAN LEGISLATION

The Market Abuse Directive (MAD) and its implementing Directive mandate the fair presentation and disclosure of conflicts of interest in research. This regulation is aimed

at the end product of research, i.e. the research report disseminated to the public.

The financial analyst as the provider of research services is not directly regulated. Furthermore, the European legislation has been, or will be, implemented by the individual national jurisdictions. To a certain extent the Directives allow national jurisdictions to choose different methods of how to supervise the presentation of research in their markets and how to enforce those rules.

The Investment Services Directive has been replaced by the Markets in Financial Instruments Directive (MiFID). The new Directive has not altered the status of research.

Research has not been promoted to a core activity, but remains an ancillary activity to the so-called core activities of investment firms. Research activities affiliated to investment firms are governed by the rules laid down in the MiFID. The Committee of European Securities Regulators has recently advised the European Commission (January 2005) to include in the future implementation of provisions of the MiFID a requirement for each investment firm to establish and implement “an effective written conflicts policy that sets out the details of its organisational and administrative arrangements for identifying conflicts of interest and for preventing and managing material conflicts of interest in order to prevent damage to the interest of its clients”. This also applies to the affiliated research activities. Unaffiliated research firms are not governed by the MiFID.

In some jurisdictions, financial analysis and research are subject to a separate licence. Yet in most jurisdictions, this does not yet require any licence, but might be subject to an information registration or notification requirement, or none at all. Financial analysis and research integrated into an investment firm are regulated and supervised together with the firm’s core activities. As such, then, the rules for the conduct of business and for the organisational structure correspond with each other.

UNSOLVED ISSUES

Distinction between analysis and other information

The MAD imposes its rules of fair presentation and disclosure of interest on all recommendations whether linked to a research report or other information. Financial analysis as a professional activity requires high standards in education, training, research and presentation. Research reports are perceived in the capital markets as a systematic and structured study of an issuer and their issues. There is a certain danger that the approach of legislation to cover all market

recommendations without properly defining a ‘financial analysis’ blurs the distinction between financial analysis and ‘other information’. The quality label ‘financial analysis’ may be attached to many documents or communications that do not deserve the label ‘analysis’. Thus, the standing of financial analysts could be jeopardised by dilution.

European passport

The status of financial analysis as an ancillary activity under the MiFID presently prevents a claim for a European passport for proper research activities. Thus, financial analysts are separated into two classes: those operating within an investment firm, and those operating without affiliation. The former benefit from the European passport of their investment firm. They are subject to the principle of home state supervision. Unaffiliated research firms may carry out their activities within the European Union based on the general freedom established by the European treaties and should, in principle, not be discriminated. Their actual status in different national jurisdictions, however, is all but clear. Are they subject to licensing in those jurisdictions in or into which they wish to operate? Who controls their research reports under the MAD, the country of origin or the country of recipient? This lack of a simple regime burdens the cross-border activities of unaffiliated research firms.

This issue is not to be neglected. Unaffiliated research firms might still represent a minority within the research community. However, their ranks are growing. They play an important role in the European’s capital markets. The cost-cutting drives and concentration policy of investment firms have significantly reduced the coverage of small and medium-sized enterprises (SMEs) in the capital markets by investment firms. This segment of the market is the natural turf of unaffiliated researchers. The simplification and security of status provided by a European passport could increase the coverage for SMEs in cross-border activities.

There is no inherent principle that links a European passport to a core activity being covered by a MiFID licence for research and analysis. The market impact of the activity of financial analysts is basically covered by the MAD and its secondary legislation. There is no need to have identical implementing legislation in the national jurisdictions under the MAD. It should suffice that the rules to control the financial analysts' output be equivalent in different jurisdictions. CESR, the clearing organisation of European regulators, already has a major influence in guaranteeing equivalent application and enforcement practices under legislation dominated by European directives and ordinances. Solvency considerations, which play an important role for the establishment of a European passport for investment firms under the MiFID, do not and should not apply to financial analysts. Other aspects influencing the freedom of cross-border activities in the form of a European passport could be covered either by the authorities of the home state, or by self-regulation through professional bodies.

The importance of professional societies and self regulation

Since the MAD legislation controls only the output of the research activity, but not the activity itself, many areas remain blank in European legislation. This concerns, in particular, the personal qualifications of financial analysts, their professional and ethical training, the professional standards required to distinguish a research report from 'other information', the relationship between financial analyst and issuer. National legislators might not be willing and national regulators might not be able to pre-empt these important parts of the framework in which a financial analysts ought to operate.

There exist competent professional societies and associations which can fill the gap left by legislative and administrative rules. These professional bodies are internationally organised and form a network on different geographical levels (global, regional and national). Among them, a world-wide umbrella

organisation for national professional societies is the ACIIA. EFFAS is also part of this network and represents the common interests of European professional societies and their members.

Through its members this network of professional societies provides a programme for training and continuing education for financial analysts, which leads to the CIIA designation. This programme has the advantage that it is taught in a number of languages. It covers globally-accepted research standards world-wide, but also recognises, as needed, regional and local standards, rules and practices. In the European context, this programme covers the common basis, but also the different national environments and practices. This is especially important for multifaceted capital markets like the European markets. The professional codes of conduct and ethics issued on these different levels by the member societies and their umbrella organisations integrate and supplement the international, European and national legislation and regulation efforts. Foremost should be mentioned the ACIIA Principles of Ethics which incorporate and supplement the IOSCO Statement of Principles for addressing sell-side securities analysts' conflicts of interest. While the ACIIA principles are directed at individual investment analysts, and CIIA holders in particular, at the same time they aim to set a benchmark for everyone in the profession, thus contributing to the integrity of global capital markets as a whole. They also become the core part of regional and national codes and permeate the activities of the entire profession.

This training in the ethics of the profession cannot be estimated highly enough. Financial analysts are frequently under pressure from other departments in the investment firms or from issuers. The training in the principles of ethics will sharpen the awareness of analysts and highlights potential conflicts and traps which an analyst might overlook in his daily routine. Furthermore, it will give the analyst the necessary competence to counter any improper pressure exerted by those interested in the outcome of the research.

Nonetheless, the activities of the professional bodies and the support given by them to their members will also be of psychological or emotional help for the analyst, who knows that he/she does not stand alone against those exerting improper pressure. We should not forget that the last strong bull market which tempted some firms and persons servicing capital markets will not be last one. History teaches us that the painful lessons of the past are fading and are possibly entirely forgotten by a new and younger generation of professionals. It is the task of professional bodies to ensure that this does not happen.

Legislation and enforcement are necessary. The members of the profession and their professional organisations understand that the common goal is to preserve the integrity of the markets, which are the cornerstone and the basis for the existence of financial analysis and research.

OUTLOOK

Financial research and analysis are recognised as an independent part of the many services operating in the capitals markets. Research and analysis have left the position of an annex or 'ancillary' part of other services, to which they might have been subordinated in the past, regardless of whether they are affiliated or unaffiliated to such other services. They are perceived as a market force. This evolution of the profession translates into a heightened interest among legislators, even though it may be still treated in some aspects as a business ancillary to other activities. This evolution is accompanied by growing discussion of the role of the analyst.

This changing outside perception also forces the members of the profession to re-evaluate their position and self-perception.

The financial analysts must assume more responsibility for their activities. This responsibility cannot be delegated to employing investment firms, to issuers or to legislators and regulators. Financial analysts must take part actively in the shaping of the legislation on, and regulation of, capital markets.

In a situation in which markets are said to go global, financial analysts must become globally-oriented, without losing sight of those enterprises and market segments which are, and will remain, regional or local. They will have more influence in defining the intellectual and ethical foundation of their activity.

We are in the midst of this process. We are convinced that this process will continue and that the profession will pass such a stress-test when the markets offer the same temptations as those which triggered this development in the past.



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