

Chapter 3

Independence of Research and Conflicts of Interest

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Key points ■■■▶

- Potential conflicts of interest can occur in many ways. These include potential conflicts between sell-side research analysts and: i) their banking or corporate finance colleagues; ii) the clients for whom they provide research; and iii) the issuers whose securities they recommend.
- Traditionally, there has also been a perceived conflict of interest in the way credit rating agencies have been paid for their services.
- Sell-side research analysts should undertake research coverage for the benefit of their buy-side brokerage clients, and should be independent and unbiased.
- Analysts on the public side of “the Chinese wall” must base their views and conclusions on publicly available information.
- By receiving private or deal-related information or by giving overly favorable views on companies that are banking clients of the bank, an analyst’s independence and integrity would be compromised. Bankers should not ask for, and analysts should not promise to deliver, any favorable research on any company.
- Analysts should not help in bankers’ solicitations for business. Trilateral meetings between analysts, bankers and current or prospective corporate clients give rise to the appearance of a conflict of interest, and should be avoided. Meetings between corporate clients and analysts may be acceptable if they have been requested by the client, not the banker.
- Apparent or potential conflicts of interest should be managed appropriately. To avoid even the appearance of impropriety, any contact between analysts and bankers or their corporate clients should be managed through the compliance department or a gatekeeper, with records maintained.
- In published research, analysts should certify that their views are independent, and should disclose any interests in or relationships with the subject company.
- Regulators and courts don’t even need to understand the complexities in the arguments of analysts’ research or in the products being sold; they merely need to catch inconsistencies in the way they are being brokered or promoted.

Summary

The independence of research is an important enough subject to warrant its own chapter. Research analysts are potentially very influential—a good

research analyst or a particularly good research report might have the power to move the market. As such, various players might be tempted to apply pressure on analysts to write research that suits their own agenda. These might include banking and corporate finance colleagues (at least for the sell-side research analysts of the so-called bulge bracket firms, that is the major investment banks), sell-side clients, sales/brokers, proprietary traders and the subjects of research reports.

Analysts owe a duty to their client(s). As such, any decision to initiate coverage on a security should be driven by client demand, rather than by the requests of say banking or corporate finance colleagues.

The evident lack of independence was at the crux of the Global Research Analyst Settlements in 2003/04—the result of a campaign originally spearheaded by Eliot Spitzer, attorney general of New York, to uncover and address conflict-of-interest issues in the major investment banks operating in the U.S. In the first round in 2003, a total fine of US\$1.4 billion, made up of penalties, disgorgements and other payments, was meted out by the U.S. authorities to 10 major U.S. and global investment banks. The banks also made commitments to change the way they conduct business.

Furthermore, renewed accusations during the subprime-driven credit crisis in 2007 regarding the way credit rating agencies get paid may also have prompted, or at least accelerated, the SEC's approval of NRSRO (nationally recognized statistical rating organizations)¹ status for the first time to an agency that does not get paid by the issuer whose bonds it rates, as well as a review of regulations in both the U.S. and Europe, and even in markets like India (where, incidentally, issuers have had to obtain a credit rating as part of the IPO process).²

Separating research and banking

Sell-side securities-research analysts are on the “public” side of the so-called Chinese wall, and cater to their buy-side brokerage clients, for example mutual funds and hedge funds. Investment bankers are on the “private” side, and may be privy to non-public information about their corporate clients. While on the public side of this wall, analysts must base their views and conclusions on publicly available information; they should not let their independence be compromised by receiving private or deal-related information from their colleagues in the banking department.

Buy-side clients, whether institutional or retail, expect sell-side analysts and brokers to act in their (the clients') best interests, rather than in the interests of the investment bank. Apart from any consequences arising from regulatory breaches, it is surely also a matter of commercial common sense—if clients think they are being treated unfairly, they'll take their business elsewhere.

CASE STUDY

Conflicts of interest (global settlements)

Summary: The Global Research Analyst Settlements in 2003 and 2004 proved to be a turning point for the major global investment banks. Settlements were reached between the U.S. Securities and Exchange Commission (SEC), 12 Wall Street firms and two individual analysts. Specific charges brought against the settling firms varied but generally included one or more of the following:

- Inappropriate influence by investment banking over research analysts.
- Inadequate supervision of research and banking departments.
- Issuing research reports that were misleading, exaggerated or unwarranted, and/or that contained opinions for which there was no reasonable basis, and/or that omitted material facts, and/or that omitted warnings about investment risks, and/or that included insufficient disclosure of interests.
- Receiving payments for research without disclosing them.
- Failing to produce all e-mail communications promptly when requested (see the case study in Chapter 4).

In the first and main round in 2003, the institutional parties to the settlement agreed, without admitting or denying the charges, to pay a collective fine totaling US\$1.4 billion and to change the way they run their business, promising in effect that any actual or perceived conflicts of interest would be avoided or managed appropriately. Part of the fine was allocated as a distribution to customers, part for investor education and part for the procurement of independent research.

Details: The settling banks were: Bear Stearns; Citigroup (including Salomon Smith Barney); Credit Suisse First Boston; Goldman Sachs; J.P. Morgan; Lehman Brothers; Merrill Lynch; Morgan Stanley; UBS Warburg; Piper Jaffray; Deutsche Bank; and Thomas Weisel Partners. (The first 10 settlements were made in April 2003, with the other two being made in August 2004.) The individual analysts, who also settled in the first round, were Henry Blodget, then head Internet analyst at Merrill Lynch, and Jack Grubman, then head telecom analyst at Citigroup/SSB. Note that since these settlements, Wachovia has also agreed to a settlement with state regulators³ in respect to conflict-of-interest issues. As with the other banks, Wachovia neither admitted nor denied the allegations.

There's little need to examine all the cases individually, especially since they have been so well documented. Let's just take the employers of the two censured individuals as examples. Citigroup/SSB consented to censure, a total payment of US\$400 million and an undertaking to

Conflicts of interest (global settlements)—*cont'd*

ensure future compliance. Merrill Lynch also consented to censure, a total payment of US\$200 million and the same undertaking. They had been charged with issuing fraudulent and misleading research, and conflict-of-interest offenses.

The cases of the two individuals, Jack Grubman and Henry Blodget, have also been well documented. In April 2003, following NYSE hearings and related SEC actions, both consented to censure, were barred permanently from the industry and fined: US\$15 million and US\$4 million, respectively. The charges against them were that they issued fraudulent and misleading research, including views on investment banking clients that were contrary to their privately held views (for example, the infamous “piece of shit” comment in an e-mail from Blodget).

It was a couple of years later, in May 2005, that the NYSE took action against Grubman’s supervisors at SSB during the period in question: JH, director of global equity research, and KM, director of US equity research. They both consented to censure, a penalty of US\$120,001 each and a 15-month supervisory suspension for failing to supervise Mr. Grubman and preventing him from publishing fraudulent and misleading research. And, as we saw in the case study on co-authorship liability toward the end of Chapter 1, co-authors of research are not immune either. In that case, it was Grubman’s co-author of a research report on Winstar Communications who was fined.

Aside I: Separately, the *New York Post* reported on December 22, 2004, that, although UBS had a “buy” on HealthSouth while it provided them with investment-banking services, the analyst covering the stock told institutional investors privately in an e-mail that he “would not own a share” of the company. The analyst resigned from UBS. HealthSouth and its management have been the subject of their own fraud scandals.

Aside II: In addition to the settlements with the regulators, class action lawsuits have also been brought by investors in relation to alleged false and/or misleading research. These can take years to process. For example, a U.S. federal judge awarded class certification in August 2009 to investors who were suing Lehman Brothers, Morgan Stanley and Goldman Sachs for allegedly issuing misleading research on RSL Communications that artificially inflated the stock price in the hope of securing business. All investors who bought RSL common shares between April 30, 1999, and December 29, 2000, would qualify to join the class action.

Conclusions: Analysts must not lose sight of their independent role, and in whose interests they should be acting. Furthermore, it’s not just the brokerage firms and lead analysts who risk being censured and fined

Conflicts of interest (global settlements)—*cont'd*

over conflict-of-interest issues; colleagues, team members and supervisors are also personally accountable. The penalties now being meted out to offenders are much more significant than previously.

There's no such thing as a private or an internal e-mail. Any e-mail can find its way to clients, regulators, the courts and the press. If clients learn they are being treated unfairly, they'll take their business elsewhere; if the regulators, the courts and the press find evidence of wrongdoing or immoral behavior, they'll be keen to investigate further to see what other, perhaps more serious, skeletons they can find.

Incidentally, the concept of an analyst privately buying or not buying shares in a company he recommends, as raised by the UBS case, poses its own moral dilemma. Should an analyst practice what he preaches and own the shares he recommends? Some might argue that that's the best endorsement an analyst can give to support a recommendation. However, the counter argument is that an analyst who promotes shares that he owns may be putting his own interests ahead of those of his clients. Ultimately, regulations now invariably demand that analysts disclose whether they have material stakes in the companies covered (see the section on disclosures below).

The subprime-driven credit crisis of 2007–08 also generated conflict issues. The first criminal charges against Wall Street professionals during this period were made against the fund managers of the two Bear Stearns funds that collapsed early on in the crisis. These were similar to those made against Blodget and Grubman after the dotcom crisis, as detailed above.

CASE STUDY

Conflicts of interest (collateralized debt obligations)

Summary: The allegations against the two Bear Stearns managers, RC and MT, were that they had been touting their funds as an “awesome opportunity” at the same time as they were privately telling colleagues about their concerns. Allegedly, one of the fund managers had switched about US\$2 million from the fund he was running into another one without disclosing this to investors. They were acquitted in respect to the criminal charges in November 2009, although the SEC said that it would continue with its civil case.

Conflicts of interest (collateralized debt obligations)—*cont'd*

Details: The *American Criminal Law Review* juxtaposes these two paragraphs, taken from the indictments against the two individuals:

- “The subprime market looks pretty damn ugly. If we believe the CDO report is anywhere close to accurate I think we should close the funds now. The reason for this is that if the CDO report is correct then the entire subprime market is toast. If AAA bonds are systematically downgraded then there is simply no way for us to make money—ever.”
- “So, from a structural point of view, from an asset point of view, from a surveillance point of view, we’re very comfortable with exactly where we are. The structure of the Fund has performed exactly the way it was designed to perform. It is really a matter of whether one believes that careful credit analysis makes a difference, or whether you think this is just one big disaster. And there’s no basis for thinking this is one big disaster.”

The first paragraph is a cleaned-up version of an e-mail allegedly sent by MT to RC’s wife, using his personal e-mail, on April 22, 2007. The second paragraph represents alleged statements made by the two managers to senior Bear Stearns executives two days later.

Separately, a hedge fund in Connecticut called Pursuit Partners sued UBS over their selling of CDO products while allegedly knowing that they were about to be downgraded. According to Reuters commentary on September 10, 2009, the judge heard evidence that Moody’s gave UBS a sneak peek into its decision-making process and that UBS used the information to its advantage. The judge cited an e-mail from a UBS employee saying he had “sold more crap to Pursuit”, according to the *Wall Street Journal* of September 11–13, 2009. “OK still have this vomit?” was another e-mail quote cited by Bloomberg. Hadn’t they learned anything from Henry Blodget? By way of a prejudgment remedy, the judge ordered UBS to set aside a bond of US\$35.5 million to cover likely potential damages.

Conclusions: MT and RC were declared not guilty in the criminal case. However, whenever a case goes to trial it really can go either way. The arguments presented still demonstrate that regulators and courts don’t necessarily need to understand the complexities of products such as CDOs to ascertain whether fraud is going on; they could just need to catch inconsistencies in the way fund managers, brokers or analysts promote their ideas.

Yet again we see that e-mails, even personal e-mails, can find their way into the public domain.

Please also see the “managing conflicts of interest” case study about Goldman Sachs later in this chapter.

We looked at cases of mis-selling of auction-rate securities (ARS) in Chapter 2. Below we look at allegations regarding research-specific conflicts of interest arising from these cases. At the end of this chapter we also look at conflicts with respect to credit rating agencies (see the example entitled “Paying for credit ratings”).

CASE STUDY

Conflicts of interest (auction-rate securities)

Summary: The auction-rate securities settlements in the autumn of 2008 also took into account evidence of conflicted research, according to Andrew Cuomo, the New York attorney general, as quoted in a Reuters article on August 22, 2008.

Details: Merrill Lynch had been accused by the Massachusetts secretary of state, William Galvin, of co-opting its research department to help place the securities with customers. In his testimony to Congress, Galvin spoke about “particularly egregious” actions at Merrill Lynch, which “co-opted its supposedly independent research department to assist in sales efforts geared toward reducing its inventory of ARS”, as reported by Securities Industry News on September 29, 2008. Galvin said that Merrill Lynch permitted its sales and trading department, including the ARS desk, to “unduly influence and pressure the research department in a number of ways”.

These included an instance in which a managing director in charge of the auction-rate securities desk e-mailed a research analyst stating that “research focusing on the high quality of . . . ALL tax status, auction municipal bonds and student loan-backed bonds . . . would be extremely helpful”.

Galvin added that Merrill Lynch sales executives also attempted to manipulate the way analysts responded to questions during sales calls, resulting in misrepresentations. Galvin continued: “Research analysts routinely soft-pedaled significant negative events, and omitted material information which a reasonable investor would need to form an objective opinion as to the suitability of an investment.”

In another instance quoted, the research department apparently agreed to retract and rewrite a note after the managing director of the auction desk had complained in an e-mail to the Financial Products Group that the research note may singlehandedly undermine the auction market. The e-mail was apparently written in capital letters.

Conclusions: The previous global settlements case study showed the potential conflicts of interests between analysts on the public side of the Chinese wall and their banking colleagues on the private side.

Conflicts of interest (auction-rate securities)—*cont'd*

This case shows how analysts also need to maintain their independence from other colleagues who are also on the public side, that is the product-origination desks and the sales and traders who deal in those products.

The case also demonstrates, as mentioned frequently elsewhere in this book, how there's no such thing as an internal e-mail; any e-mail can find its way into the public domain.

Inevitably, there will be some clients who are not fazed by conflict-of-interest issues; they are sophisticated enough to understand the issues involved, and to take them into consideration when sifting through brokers' recommendations. Such clients get to know which analysts they trust and which they don't. As mentioned at the beginning of the book, trust has to be earned.

In *The Super Analysts* by Andrew Leeming, Murdoch Murchison of Templeton says: "I think as responsible adults, we have to recognize the way the sell-side makes their money and make sure that as fund managers we fully understand that." The book was published before the Blodget and Grubman cases and it's unclear, to me anyway, whether Murdoch Murchison was referring to the potential conflicts arising from banking relationships or to some brokers' instincts to "churn and burn" to make money, or perhaps both. It doesn't really matter since, either way, the point is that some sophisticated fund managers are prepared to see through all that.

Furthermore, in their research, as reported in the *Financial Times* on May 26, 2006, Lily Fang of INSEAD and Ayako Yasuda of the Wharton School conclude that "the best way to prevent analysts from skewing their research is not by tying their hands with regulation but by linking their rewards to personal reputation".

Managing contacts between analysts and bankers

After the first round of global settlements the then chairman and CEO of the NYSE, Dick Grasso, famously remarked: "This historic settlement establishes a clear bright line—a banker is a banker and an analyst is an analyst. The two shall never cross." Some houses, especially those involved in the global settlements, have tried to bar any communication between analysts in the research departments and bankers in the investment banking, underwriting or corporate finance departments—at least not without an accompanying compliance gatekeeper as a chaperone. However, it seems impractical to do this completely—at least for companies not

involved in the global settlements, and a more reasonable approach might be to determine to what extent any meetings are appropriate, to manage them appropriately and to maintain records as an audit trail. After all, if the meetings are deemed appropriate, then there's nothing to hide. Regularly educating the analysts and bankers about these measures also helps in the understanding of the issues involved.

While not suggesting that this next scene would necessarily be an appropriate setting for a meeting, it helps to demonstrate the potential conflicts involved. . . .



Bilateral meetings between analysts and bankers and trilateral meetings between analysts, bankers and corporate clients must inevitably raise at least the appearance of conflicts of interest. However, there should still be some leeway for analysts to meet with banking clients, at the clients' request, provided that the motivation for the meeting is honest. For example, the corporate client may want to discuss with the analyst, strategist or economist their independent views on the sector, market or economy. Provided analysts discuss their already-published views, rather than provide new analyses and recommendations, then their own brokerage clients should not be disadvantaged or prejudiced.

Note that if a bilateral meeting between an analyst and a corporate client is convened at the request of the banker, rather than the client, then this might give rise to at least the appearance of conflict of interest. For example, it could be argued that the banker was merely enrolling the services of the analyst to help the bank solicit new business or to boost the bank's standing in front of the corporate client (with regard to the extent of services they can provide, for example).

There may also be occasions, such as widely attended industry conferences or gala events, which may be of interest to all parties independently. It's difficult to argue that, given the purposes of the gathering, individuals should be barred from attending merely because someone on the other side of the wall had accepted the invitation first.

Gatekeeper approval: It makes sense, however, for any exceptions to be approved by someone within the organization, such as a compliance officer or

a gatekeeper, who can be seen to be independent and who has no particular axe to grind. Such intermediaries should be trained to distinguish between what would constitute an appropriate meeting and what wouldn't, and then keep a record of the approvals given. Ultimately, a bad call on their part in approving a meeting that might border on the inappropriate can at least be put down to the poor judgment of a disinterested party, and the independence and integrity of the analyst can be kept intact.

Notwithstanding the above possible exceptions, analysts should remember the golden principle that, while they are on the "public" side of the wall, they should only discuss public information.

Disclosures of interests and relationships

Following the global settlements, regulators around the world have started to review and improve their regulations, specifically with regard to the disclosures that analysts must give in their research reports (and in other research communications, such as those made through television and radio). New regulations were introduced in the U.S. following the Sarbanes-Oxley Act, and since then new consolidated FINRA rules have been put in motion; the European Commission introduced its Market Abuse Directive and Hong Kong's SFC added new research-disclosure requirements to its code of conduct.

Different regulatory regimes around the world may have slightly different requirements, and those involved in the preparation and distribution of research need to ensure that specific regulatory requirements are addressed for the markets in which they publish and market their research. Usually, its legal and compliance department or external legal advisers will help a brokerage firm in drawing up disclosures to suit the requirements. As mentioned in Chapter 1, such advice may be needed to determine the extent to which disclosures are needed for credit research in specific markets. In general, regulations demand that research reports disclose whether the entity producing the research:

- has had an investment banking relationship with the subject company over the recent past (say, the past 12 months);
- expects to receive, or intends to seek, compensation for investment banking services in the near future (say, the next three months);
- has a financial interest in the subject company (say, over 1 percent);
- makes a market in the company's securities;

And whether the analyst writing the research and giving the recommendations:

- received compensation from the subject company in the recent past;
- has a financial interest in the company; or
- is an officer or director of the company.

Normally these disclosures would encompass members of the analyst's household and associates as well. Further disclosures required may include, as in the U.S., histories of recommendations.

CASE STUDY

Conflicts of interest (private trading contrary to recommendations)

Summary: The NASD announced on February 8, 2006, that it had imposed a fine of US\$350,000 against Sanford C. Bernstein & Co. LLC of New York and a fine of US\$200,000 against CBH, one of the firm's research analysts, for selling shares in Morgan Stanley and Lehman Brothers contrary to his recommendations, thereby violating NASD rules on conflict of interest.

Sanford Bernstein and CBH neither admitted nor denied the charges, but consented to the entry of NASD's findings.

Details: The press release stated that in 2004 Sanford Bernstein—at CBH's request—sought, unsuccessfully, an exemption from the rule prohibiting the sales, arguing that CBH's circumstances constituted a "hardship" and that he should be allowed to sell his holdings.

Thereafter, Sanford Bernstein developed a plan—approved by the firm's legal and compliance department and senior management—which it believed would allow CBH to sell his holdings in Morgan Stanley and Lehman Brothers without violating NASD rules. Under this plan, CBH issued what were purported to be his "final" reports on Morgan Stanley and Lehman on December 23, 2004. Those reports rated the two companies "outperform" (the firm's highest rating) and "market-perform", respectively, and purportedly "terminated" coverage, while indicating that CBH intended to resume coverage in February 2005 (after selling all of his holdings in both companies).

Separately, we see from FINRA's list of actions taken in June 2008 that PK, without admitting or denying the findings, consented to a fine of US\$200,000 (although much of this represented the disgorgement of unlawful profits). He was also barred from association with any FINRA member. The charges were that he'd executed securities transactions in a manner inconsistent with his research recommendations and that he'd opened a trading account at another firm without telling either that firm or his own employer about his relationship with the other.

Conclusions: Analysts should obtain research-management and compliance approval for any securities transactions, let alone those for companies

Conflicts of interest (private trading contrary to recommendations)—*cont'd*

they cover. (Some companies may have rules prohibiting analysts from undertaking personal transactions in the securities of companies they cover or that are in a relevant sector.) However, even if individuals believe they have the protection of the company and compliance approval, they can still be held liable if it can be demonstrated that their motivations were not sound or if they were trying to circumvent the rules.

When writing research on companies in their sector, analysts should ensure that full disclosure is made in their research reports.

Analysts terminating coverage need to be confident that they really do wish to terminate coverage and are not using termination as an excuse to side-step potential conflict-of-interest issues.

This case serves once again to remind analysts that it's not just the company that gets penalized for conflict-of-interest breaches—individuals do, too. At US\$200,000, personal fines are not token gestures, not to mention the risks to job security and reputation.

Analyst certification: U.S. regulations also demand that analysts certify that the research they have written accurately reflects their own personal views, and that their compensation does not or will not depend on how favorable their recommendations or views are.

CASE STUDY

Analyst certification

Details: In FINRA's round-up of disciplinary actions for July 2009, we see that Wedge Securities in Colorado was fined US\$20,000 for failing to include the required analyst certification regarding the analyst's compensation in a research report. Furthermore, the firm also failed to state "in a clear and prominent manner" that the views expressed in the report reflected the analyst's personal views. The firm neither admitted nor denied the findings.

Conclusions: Analysts in the U.S. don't just need to make these statements in their research reports, as required by Regulation Analyst Certification, but they need to make them clearly and prominently. This means that reference should be made on the front cover of the report.

Over-disclosing: The question sometimes arises as to whether it's possible to over-disclose in research. The point that over-disclosing (disclosing more information than is necessary) might mean that the disclosures that really should be highlighted get lost among the red herrings seems reasonable. However, disclosures in themselves are matters of fact (for example, "the analyst holds securities of this company"). Provided of course that the disclosures are factually correct and up-to-date, it's difficult to see how regulators can outlaw over-disclosing.

An analyst needs to be judicious in determining what disclosures really need to be made, paying regard to regulations and common sense (that is, readers' expectations). Ultimately, disclosures are required for securities or investment research, so again it goes back to the definition of "research" (see "The realm of research" in Chapter 1). In other words, disclosures are only really required where an investment implication is made for a security, rather than for mere passing references to a company. Furthermore, the NYSE/NASD joint memo of September 2003 that discusses and interprets rules says: "If a research report does not contain any rating—express or implied—of the subject company's stock, the report is not required to include the ratings distribution information required by the SRO Rules. In addition, if the report does not include either a rating or a price target for the company's stock, the report is not required to include a price chart."

CASE STUDY

Conflicts of interest (disclosures)

Summary: The *Financial Times* reported on July 1, 2006, that the French Court of Appeal had upheld a lower court finding that Morgan Stanley did not disclose its corporate relationships properly, although it overturned the finding that the bank's research was biased. This was in relation to a suit brought against the bank by LVMH, a luxury-goods maker. Both sides evidently claimed victory.

Details: LVMH had contended that a research report written by a Morgan Stanley analyst, CK, was biased against LVMH in favor of Gucci, a rival to LVMH and an investment banking client of Morgan Stanley. Although the bank was cleared of the charge of biased research, it was still found to have caused "moral and material" damage to LVMH.

The *Times* of November 27, 2002, gave some details of the allegedly misleading disclosures in Morgan Stanley's research report, particularly that the bank and LVMH shared a common director and that the bank could become an adviser to LVMH in future. LVMH disputed the validity

Conflicts of interest (disclosures)—*cont'd*

of these disclosures, and claimed that they gave the impression of a closer relationship between the two parties than actually existed.

Separately, various cases in the U.S. demonstrate the importance of providing accurate disclosures. Citigroup was found by the NASD in July 2006 to have failed to include numerous disclosures in technical and quantitative research, and was fined US\$350,000. Credit Suisse was found to have used unclear language in its disclosures to describe price-target valuation methods and the risks to those price targets. The firm was fined US\$225,000. Morgan Stanley was fined US\$200,000 for failing to disclose clearly and prominently the percentage of buy, hold and sell ratings as well as analyst-performance ratings. Deutsche was fined US\$950,000 by the NYSE in December 2006 for failing to include disclosures in research reports and for public appearances. This much larger fine was not just for inaccurate and inadequate disclosures but also for supervisory deficiencies—the publishing department had evidently repeatedly warned the research managers that their manual system of data collection was inadequate, but the supervisors failed to address the deficiencies. By November 2007, it was Wachovia's turn to incur the wrath of the U.S. regulators and it consented to a fine of US\$300,000 for deficient disclosures. None of these firms either admitted or denied the charges.

Conclusion: Although it is difficult to argue that one can over-disclose, these cases demonstrate that analysts, data managers, research managers and compliance officers need to ensure that disclosures are accurate, up-to-date and not misleading.

By the way, the wider issue of the capture and retrieval of data is a growing concern for many banks and brokerages, as they struggle to keep up with new regulations. Many regulators not only require all these relationships and cross-holdings to be disclosed, but now also require that best execution is achieved for clients (and demonstrated to them) when trades are made.

Writing research on banking clients

Investment banks tend to keep two lists of deal-related names. The first is a list of companies on which the bank imposes research restrictions (often called the “restricted list”) and would include names of companies where the bank is currently involved in a deal which has already been made public. Generally, to avoid conflict of interest, new research would not be permitted for such names.



The second, often called the “watch”, “gray” or “quiet” list, is a sensitive list of potential deals or new deals pending public announcement, which would represent “private” information. Only personnel who are “over the wall”, or at least on the wall, would be privy to this information, including compliance officers, gatekeepers and supervisory analysts.

Analysts who are not over the wall should be able to continue writing their independent research, notwithstanding that their banking colleagues may be in the process of pitching to the subject company in respect to a banking deal. In other words, the integrity of the Chinese walls should be presumed to be intact, at least until there is real risk of conflict of interest (see the Citi case study below).

Where one risk lies, from an appearance perspective at least, is where, for example, an analyst publishes a research report on a company more or less at the same time that the bank announces a financing or advisory arrangement with that company. If the analyst is, for example, initiating coverage with a buy recommendation or upgrading a recommendation to a buy, clients’ eyebrows might be raised if, lo and behold, the bank has just won a mandate to act for the company. The analyst could be accused of attempting to “condition the market” prejudicially ahead of the deal with a bullish report on the subject company. Local regulators and takeover panels may also have specific requirements whereby they need to give approval or at least be alerted when a firm wishes to publish research on a company that it is doing or trying to do business with. As such, it’s important for all research to be checked before publication to ensure that actual or perceived conflicts of interest are avoided or managed, as appropriate.



Compliance departments should also check these watch lists whenever employees wish to conduct their own personal trading.

CASE STUDY

Conflicts of interest (watch lists)

Details: Morgan Stanley, without admitting or denying the charges, agreed with the SEC to pay a US\$10 million settlement in June 2006 for failing to maintain proper procedures to prevent the misuse of insider information. One of the charges, detailed on the SEC's Web site, was that the bank "failed to conduct any Watch List surveillance on hundreds of thousands of employee and employee-related accounts".

Morgan Stanley's list-checking procedures were again in the lime-light in 2009, this time in Hong Kong. A former managing director in Morgan Stanley's fixed-income division, DJ, was charged with insider dealing in the shares of CITIC Resources, at a time when he was advising the company about financing for its acquisition of some oilfields in Kazakhstan. During the trial, it was revealed that a compliance officer had indeed approved DJ's purchase of HK\$87 million of shares in CITIC Resources. However, as reported by the *FT*, when she looked up the company on the internal watch list she had mistaken the company for its sister, CITIC Pacific. Furthermore, she had asked DJ whether he was working on anything in particular on the company, to which he apparently replied that it was not his daily job and that it was just a "relationship thingy". DJ was convicted of insider trading in September 2009, and jailed for seven years. While not accusing Morgan Stanley of any wrongdoing, the judge did criticize the firm for not having adequate staffing levels in compliance and for poor communications between the compliance department and the fixed-income team.

Conclusions: Irrespective of any potential liability on the part of an employee wanting to make a trade, compliance officers need to check lists carefully and need to ascertain the full extent of the prospective trader's knowledge or involvement in any business activity being undertaken by another part of the group.

A compliance officer might also want to query any instances of trading that seem inconsistent with the employee's normal trading habits.

Aside: The SEC in the U.S. had to tighten its own trading rules for staff following a probe into the stock dealings of two of its own enforcement lawyers. The lawyers allegedly made trades into companies that were, or

Conflicts of interest (watch lists)—*cont'd*

that became, the subjects of SEC investigations. The changes, introduced in May 2009, brought the SEC's procedures up to at least the standard that they expect banks and brokerages to adhere to. These include: a ban for all staff, whatever their position and level of inside knowledge, from trading in the shares of companies under investigation; pre-clearance for all their securities transactions; an authorization by staff for their brokers to supply the SEC with copies of trading statements; and confirmation by staff that they don't have any nonpublic information about the companies they're trading in.

Here's an interesting case to demonstrate various apparent conflicts at work.

CASE STUDY**Conflicts of interest (managing apparent conflicts)**

Summary: The principle that apparent conflicts between the public and private sides of investment banks can exist and can be managed was demonstrated clearly in June 2007 when the Australian Federal Court cleared Citigroup of the conflict of interest and insider trading charges brought against the firm more than a year earlier by the local regulator, the Australian Securities and Investments Commission (ASIC).

Details: The *WSJ* of June 29-July 1, 2007, summarized that ASIC had claimed that Citigroup failed in its fiduciary duty when it traded on its own account in the shares of Patrick Corp. while advising Toll Holdings Ltd. on a hostile takeover bid for Patrick. ASIC had also focused on a cigarette break during which a Citi prop trader had been instructed by his boss to cease buying Patrick shares just before the takeover bid was announced. The federal court judge ruled that there hadn't been any insider trading or conflict of interest: i) the contract between Toll and Citigroup specifically excluded a fiduciary duty on the part of Citigroup; and ii) Citigroup had "effective measures" to insulate traders from sensitive information known to the banking division.

Conclusions: The integrity of the Chinese wall can be relied on, provided appropriate measures have been installed. However, the exclusion of a fiduciary

Conflicts of interest (managing apparent conflicts)—*cont'd*

duty in this particular case is a crucial element. With such exclusion, the arrangement between two parties could be deemed to constitute a normal commercial contract where the parties could be presumed to be free to pursue their own interests. Without such exclusion, however, a bank involved in a deal could be held to owe its corporate client a fiduciary duty to act in the client's interests and to achieve the best price for the client.

Banks also always have to be mindful of any potential conflicts of interest with their own brokerage clients. As such, anything that a bank does that might affect the price of a transaction in which it is involved—from trading on its own account or encouraging brokerage clients to trade (including, for example, the publishing of research on the companies) could be deemed to be a conflict of interest between the bank and either its corporate client or its brokerage clients, or both. With all these forces at play, I would again reiterate how important it is for all research to be checked and approved before publication.

The case also again demonstrates that regulators are not omnipotent or infallible, and that they merely seek to stake out the parameters of their powers as widely as possible, just as any political, bureaucratic or commercial organization tries to do.

Aside: Separately, in the January 14, 2008, issue of *The Wall Street Journal*, Mark Maremont and Susanne Craig describe how J.P. Morgan had been accumulating shares in Rural Cellular Corp. at the same time as the bank had been advising Verizon Wireless on its takeover of Rural. A spokesman for J.P. Morgan said that the purchases were on behalf of clients and were totally appropriate. By reviewing stock-ownership and deal records the *WSJ* also identified dozens of other similar situations where investment banks including Citigroup, Credit Suisse, Goldman Sachs, Merrill Lynch and Morgan Stanley appeared to be buying shares in target companies at the same time that their bankers were advising the acquirers. These firms either declined to comment or said they found no problems with the trading. The article also cited the example of the takeover of Centura Banks by Royal Bank of Canada in January 2001. Credit Suisse was apparently the adviser to both firms, and apparently traded in the shares of the target company as well. Credit Suisse declined to comment.

In *Asiamoney's* Brokers Poll 2007, Goldman Sachs was voted as having the least independent research, for the sixth year running. Paul Bernard, managing director of Asia-Pacific investment research for Goldman, commented that the perception that the firm is the region's least independent

brokerage was unfair. Goldman analysts around the world adhere to the standards set under the Global Research Analyst Settlements; they personally confirm that their research is independent; they need to convince the investment research committee of their views; and their published research makes clear the distribution of buy, hold and sell ratings, and how many buys, holds and sells have been assigned to companies with which the firm does investment banking business or in which it has investments. Having worked for many years in the same type of environment myself, I appreciate the regime that analysts need to follow.

But the perceptions continued to plague Goldman. On the one hand the company was widely praised in December 2007 for having bucked the trend among global investment banks by generating profits out of the sub-prime crisis through short-selling collateralized mortgage/debt obligations (CMOs/CDOs). On the other hand the firm was criticized for selling such toxic paper to its clients.

This leads us on a slight detour from the subject of conflicts between research and bankers to look at Goldman's specific conflict issues, which involve alleged misstatements and omissions to clients.

CASE STUDY

Conflicts of interest (managing apparent conflicts)

Background: Lloyd Blankfein, the CEO of Goldman Sachs, conceded that the industry had “let the growth and complexity in new instruments outstrip their economic and social utility as well as the operational capacity to manage them”, as reported by the *FT* on September 10, 2009. This echoed a comment by Lord Adair Turner, the chairman of the U.K.'s FSA, that many investment bankers perform a “socially useless activity”.

The infamous quote made by Matt Taibbi in *Rolling Stone* magazine in July 2009 that Goldman Sachs is “a great vampire squid wrapped around the face of humanity” graphically represented one prevailing view about the company. (Taibbi apparently went on to apologize for defaming such a beautiful creature as the *Vampyrotheutis infernalis*.)

Details: Even so, the market was not prepared for what happened on April 16, 2010. The SEC formally charged Goldman Sachs and one of the firm's vice presidents with fraud. The SEC alleged that Goldman Sachs did not disclose to investors that it had allowed one of its major hedge fund clients, Paulson & Co., to heavily influence which mortgage securities to

Conflicts of interest (managing apparent conflicts)—*cont'd*

include in a CDO investment portfolio being marketed to clients, and that Paulson & Co. was shorting the CDOs in a bet that their value would fall. The SEC's enforcement chief, Robert Khuzami, issued this statement: "The product was new and complex but the deception and conflicts are old and simple." Goldman denied the accusations. The firm's share price fell over 12 percent on the day, dragging down other banks with it.

Conclusions: As we saw with the CDO case earlier involving the Bear Stearns fund managers, regulators don't even need to get to the bottom of the complexities involved in the products being sold; they can bring charges for the way they are being sold or presented to clients. The same principle must also apply to research analysts' output, however complicated the research arguments might be. I reiterate again how important it is to make sure disclosures are accurate and up-to-date.

It remains to be seen whether Goldman is successful with its defense and whether the firm has indeed been able to manage these apparent conflicts of interest. It also remains to be seen which other firms are yet to face the music. Ultimately, lawmakers need to determine how useful to society side bets using such derivatives really are and how transparent the information about the trade needs to be, not just to both sides of the trade but also to the wider market.

Aside: Meanwhile, J.P. Morgan and HSBC were the targets of a *New York Post* scoop in April 2010 that also had the potential to disrupt markets, albeit involving commodities rather than securities. A whistleblower named Andrew Maguire, as it happens an ex-Goldman commodities trader, had come forward to spill the beans on how these two banks were able to manipulate the gold and silver markets. Would these allegations have enough weight to tarnish these banks' reputations or would the story be just a conspiracy theory?

Note that regulators have only recently started clamping down on commodities markets. In its first commodities-related market abuse case against an individual, the FSA fined a former broker with Sucden Financial £100,000 in June 2010 for manipulating coffee futures prices. In April 2010, Moore Capital agreed to pay the Commodity Futures Trading Commission (CFTC) US\$25 million for attempting to manipulate the platinum and palladium markets, and Morgan Stanley and UBS agreed to pay US\$14 million and US\$200,000 respectively to settle charges that they had concealed block trades of crude oil. (Interestingly, Morgan Stanley paid US\$4.4 million dollars in 2007 to settle allegations that it had charged clients storage fees for metals that they didn't physically own. Nice one.)



Being “over the wall”: Sometimes, if allowed, an analyst with specialist knowledge might be asked to be brought over the Chinese wall to help bankers in a particular project. In such situations, the analyst might be exposed to private information and cannot therefore hold himself out to clients as an independent research analyst. He would thus be restricted from writing independent research until the information to which he is privy becomes publicly available or is no longer relevant or price-sensitive.

“Pre-deal” research

In some regulatory regimes the research departments of syndicate banks that are helping a company to raise capital by selling new shares in the market may be able to publish research on those companies ahead of the offering, subject to conditions. Whereas U.S. regulators regard this practice as being unacceptable on the grounds of conflict, some regulators have taken the more relaxed view that any information on a hitherto privately held company can be useful to the market, even if prepared by someone closely associated with the transaction.

In deciding whether to issue so-called pre-deal research, research management needs to be satisfied that the motivation for doing so is to help their buy-side clients in their information-gathering exercise before they make their investment decisions. The research department’s motivation in being involved in pre-deal research should not be to help the bankers in their business. Any pre-deal research report should not be regarded as a marketing document for the deal; it should be independent and unbiased. When bankers are soliciting for new business, neither they nor research personnel should make any promises regarding the publishing of research, and should certainly not promise that any such research will be favorable.

By the way, bankers also have to undertake their own due diligence in bringing companies to market or advising their corporate clients in M&A situations. For an example of what can go wrong in this regard, see the case study on ICEA Capital and Deloitte Touche Tohmatsu in Chapter 2.

EXAMPLE

Conflicts of interest (pre-deal research)

Summary: A *Financial Times* article of January 3, 2006, looking at initial public offerings (IPOs) in the U.K. quotes the FSA as saying: “The process in which a company chose its bank only after it had seen some research might encourage issuers to exert pressure on competing banks to produce analysis that was favorable or that justified a higher valuation price.”

Details: Specifically, on November 8, 2005, Reuters had reported that the U.K.’s Financial Services Authority (FSA) was looking into the way Inmarsat handled its initial public offering. The article suggested that the company had asked banks to compete for roles in the IPO by coming up with valuations and research before bookrunners were chosen. A later Reuters article, however, of November 22, 2005, reported that Inmarsat was not being investigated.

The *Sunday Times* reported on May 28, 2006, that Permira, Europe’s largest private equity group at the time, was preparing a flotation of business-travel firm Hogg Robinson, employing a controversial technique that has been scrutinized by the FSA. The newspaper continued that the firm had hired Lazard and Merrill Lynch to advise on the timing of the float, and planned to appoint several other banks to “prepare research on Hogg Robinson before deciding on the bookrunners”.

Conclusion: I would make no prejudgment about any research prepared in these examples. However, I would say that, generally speaking, the so-called beauty-parade bidding process—where allowed—could put pressure on analysts to produce favorable reports on the companies to which their bank was pitching, thereby exposing the analysts and their firms to potential charges of conflict of interest. Analysts need to take care that their independence is not compromised.

Securities of non-U.S. companies can only be offered in the U.S. by being registered under the Securities Act of 1933 (which involves jumping through hoops of fire) or by being exempted from registration. The main exemption mechanism is Rule 144A, a safe harbor permitting the resale of certain restricted securities within the U.S. to qualified institutional buyers (QIBs), sophisticated institutional investors who don’t need the same level of protection as retail investors. As resale, these would constitute private placements, that is in the form of global depositary receipts (GDRs), rather than public offerings of new shares from issuers. As such, they represent an indirect way that foreign companies can raise capital in the U.S. The QIBs can usually trade the securities between themselves.

(Rule 144A issues are not to be confused with “Private Investments in Public Equity”, or PIPEs, which are private placements targeted more at a smaller number of “accredited”, that is high-net-worth, investors through a Regulation D registration exemption mechanism. Investors are restricted from selling the securities on until the securities are registered or the lock-up period has ended.)

Regulation S of the 1933 Act is a safe harbor provision in respect to offers or sales of foreign securities not being listed in the U.S. or being registered under U.S. laws. Under this provision and in the jurisdictions where the practice is allowed, pre-deal (IPO) research can be published for restricted distribution, with distribution specifically restricted from the U.S. and U.S. persons (with similar exclusions normally applying for Canada and Japan at least). As such, capital is not raised at all in the U.S.

Given the potential liability for the company and analysts producing the research, legal guidance should be followed in each case. A special disclaimer and disclosure page should be added upfront, stating the bank’s involvement in the deal and which safe harbor provision is being invoked. Restrictions and provisions invariably apply, especially with regard to the distribution of the reports, with the location and level of sophistication of the clients being factors for consideration, as mentioned above. Normally a footer would be added at the bottom of each page stating which markets the report cannot be distributed to. Furthermore, pre-deal research reports would normally be individually numbered as an extra distribution control measure.

As for the content, the analyst should appreciate that he should be looking only at the company and its business, not its securities. Recommendations, valuations and forecasts by the analyst should normally be avoided. However, exceptions could perhaps be made for limited valuations and forecasts, provided they are given for indicative purposes only, and are not presented as implied recommendations for the securities. For example, valuations could be expressed as a range for the whole company, and any forecasts limited to two years. As usual for any independent research, the analysis should be balanced, with risks drawn to readers’ attention. As mentioned in Chapter 1, more thorough due diligence than normal would be required because the analyst would not have a history of public records such as stock exchange filings to rely on.

One question I’ve been asked is to what extent an analyst can have access to the draft prospectus when preparing his pre-deal research report. For regular IPOs the analyst is formerly brought over the wall and made an insider for the time being. Whatever information he receives from the company is usually private information anyway, because the company hasn’t been listed and hasn’t therefore needed to make any information public. Note that technically speaking it’s not really “price-sensitive” information at that stage anyway, since the shares aren’t being traded. As such, there shouldn’t be any problem whatever information analysts are made

privity to, including the draft prospectus. However, steps have to be taken to ensure that the analyst's published research does not contradict anything in the prospectus when that document is eventually published and when the security is priced, because henceforth any material information not published by the company would constitute "price-sensitive" information. It's at that point that the regulator gets concerned, and that's a reason why external lawyers get involved—they vet the research to make sure there is nothing that contradicts the prospectus.

My former colleague, Paul Hedley, cautions though that there may be a higher risk for spinoff situations where the already-listed parent company spins off a subsidiary. Because the parent is already trading, any private information gleaned before the stock is priced and starts trading might actually be "price-sensitive". Nevertheless the same principles still apply.

So, either way, there shouldn't be any problem with the analyst getting access to the draft prospectus (and any other hitherto non-publicly available information), as long as the eventual research is not based on any information that is inconsistent with information contained in the prospectus.

Incidentally, I would also remind readers of the insider trading case in Chapter 1 involving Mark Cuban. We concluded from that case that if you bring someone "over the wall" by sharing inside information with them, you should ensure that they not only agree to keep the information confidential but also agree not to trade on the information. Also, as we saw from the Moore Europe and Dresdner Kleinwort bond-trading cases, traders can no longer rely on the historic practice of trading after being "sounded out" on a potential new deal.

When the blackout period starts ahead of the sale of the securities, and the company fully enters the regulators' purview, then the analyst should not publish anything more on the name. Even passing on factual press commentary on the name could prompt some critics to argue that the analyst was trying to offer biased support for the transaction by, for example, only passing on positive press commentary.

When the blackout is over, up to 40 days after the closing of the offering/settlement date,⁴ then regular research can be distributed to clients. This would be billed as a regular initiation, and can include a formal recommendation or rating, a target price and per-share numbers. As a formal initiation there would be no reference to the pre-deal version or to any changes of earnings estimates from that version. The special restricted distribution disclaimer and footer would be replaced by regular disclaimer and research disclosures.

Note that pre-deal research reports are not to be confused with "pump-and-dump" spam e-mails that circulate, often ahead of IPOs. These schemes might promise huge or guaranteed returns, perhaps based on some rumor or information that isn't yet known to the market. Invariably the spammer

exhorts the reader to act immediately, otherwise they'll miss this once-in-a-lifetime chance! Such e-mails have no legitimacy, and invariably break securities laws and regulations on multiple counts (that is circulating rumors to manipulate the market prices of securities, trading on inside information, using promissory or exaggerated language, not drawing risks to investors' attention or not having a reasonable basis for views).

Influencing of analysts by issuers

In maintaining their independence, research analysts have to guard against the persuasive influences not only of their banking colleagues but also of the companies they write about. To this end, most developed markets have rules to deter issuers from bribing analysts with cash payments or excessive gifts or entertainment.

CASE STUDY

Conflicts of interest (bribes)

Summary: As widely reported in the press in May and June 2005, an analyst at UBS at the time of the offense was sentenced to two years in prison for accepting a bribe of HK\$1 million to publish a favorable stock report on a Hong Kong-listed textile-manufacturing company. The analyst had denied the charge. Three other defendants, including a director of the textile company who had offered the bribe and an ING fund manager who had been bribed to buy and hold the shares, were also sentenced.

However, in September 2006 the analyst's conviction was overturned when the court of appeal determined that recorded evidence from meetings at which he was not present should not have been used against him, and should merely have been regarded as hearsay.

Conclusions: In this case the analyst was eventually cleared. Irrespective of any monetary thresholds for gifts that may be prescribed by regulations and company policies, analysts should be able to detect when they are being compromised. Indeed, the more lavish the gifts offered, the more the analyst should question the reasons why a company would feel the need to present such gifts.

By accepting bribes, analysts risk not only being caught by the regulatory and legal system but, in extreme cases, exposing themselves to blackmail and extortion at the hands of the bribers.

Here's a slightly different situation, but you get the picture.



EXAMPLE

Conflicts of interest (favors)

Summary: In the July 27, 2007, issue of the *FT*, Francesco Guerrera and David Wighton reported interesting findings of research undertaken by James Westphal of University of Michigan and Michael Clement of University of Texas. Between 2001 and 2003 the researchers carried out a study on 1,800 equity analysts and hundreds of company executives in the U.S. They found that executives significantly reduced the chances of analysts downgrading a rating on their company's stock by offering them favors. These favors included introductions to executives at rival firms, career advice, and agreeing to meet with the analysts' clients. In the same issue of the *FT*, Guerrera also noted that Wall Street observers say there is anecdotal evidence that some CEOs and CFOs have begun using coded hand movements to pass on additional financial information to particular analysts.

Conclusion: The Spitzer investigations and the global settlements focused primarily on conflicts between analysts and their banking colleagues. The foregoing case study on bribery demonstrates that there are also serious conflicts of interest between analysts and the companies they write about, and that analysts can still be found liable for giving in to such temptations. This research on favors granted to analysts demonstrates that these conflicts can manifest themselves in more subtle ways as well.

Another subtle form of influence that analysts need to be mindful of is when company executives try to steer them to focus on or ignore particular businesses or particular line items of the P&L, for example during a results presentation. The investor relations officer might try to persuade

analysts to ignore the net earnings result this year when valuing the company because of certain unusual factors, and instead concentrate on operating profit or other recurring earnings measures.

EXAMPLE

Conflicts of interest (issuers guiding analysts)

Details: My former colleague Diego Marconato, founder of Asia Technicals, remembers Cisco Systems trying to explain to analysts in April 2001 how the group had to write off US\$2.5 billion of excess inventories (in the form of new Internet switching components) as an unlucky once-in-a-hundred-year occurrence, when the company reported its first quarterly loss in its 11 years of trading as a listed company. Diego couldn't help but be amazed that the company was trying to couch the exceptional item in terms other than what it really was—just a bad loss-making business decision that directly affected the bottom line, not an exceptional item to be conveniently explained away as a one-off. According to the *FT* of April 18, 2001, Nikos Theodosopoulos, networking analyst at UBS Warburg, felt the same way: "They made a big bet on continuing high demand, and it didn't pay off."

Separately, Barclays had a tough time convincing the market about its on-going profitability when it reported pre-tax profit of £6.1 billion for 2008, a year when international bank profitability had gone out of style. Simon Nixon of the *WSJ* noted that without one-offs such as a £2.2 billion gain from the Lehman acquisition and gains on the value of its own debt the bank would have reported a loss.

Conclusion: Analysts need to be satisfied in their own minds that whatever earnings measures they focus on are appropriate for that particular company at that particular time. In any case they owe it to their clients to explain their choice of valuation methodology and also to provide valuations based on alternative or more standard methodologies any way for their consideration.

Another interesting situation is where an analyst covers an issuer and is then hired by that company. At what point during the recruitment process should the analyst put his or her hands up and say, "Sorry, I can no longer cover this company objectively"? It seems reasonable enough to me that a securities firm should not be blamed for something outside its knowledge or control. The onus must surely lie on analysts to recuse themselves once they are in a situation of conflict. The personal challenge

for an analyst, of course, is how to tell his current employer that he can't write objectively on an issuer while he's still in negotiations with that company over a job. Perhaps a simple "I am in possession of some confidential information that precludes me from writing about this company at this time" might keep the less-inquisitive among management, compliance and sales at bay. Clearly, once an employee gives his termination notice, to leave either for a competing securities firm or for a covered company, he is conflicted and can no longer write independent securities research. As always, let's see how regulators deal with the problem in practice.

CASE STUDY

Conflicts of interest (employment)

Details: The NASD issued a news release on June 27, 2007, to the effect that it had fined Wells Fargo Securities US\$250,000 for failing to disclose an analyst's employment with a covered company, that it had fined its former director of research, DvD, US\$40,000 and imposed a supervisory suspension against him for 60 days, and that it had filed a complaint against the analyst involved, JJ. Wells Fargo and DvD consented and settled without either admitting or denying the findings. The complaint concerns the issuing of positive research reports by JJ on Cadence Design Systems while she was in negotiation to join the company and after she had agreed to join the company as vice president of investor relations, but without any disclosure as to her conflicting position. At least one of the reports was published after JJ had already told the director of research and others at Wells Fargo.

Two years earlier, on June 23, 2005, the *Wall Street Journal* reported the timeline of events surrounding JO, a research analyst at HSBC Securities, and his subsequent employment by a covered company, Mittal Steel, as their head of investor relations. JO tells a news service on April 26, 2005, that the company's first quarter was "a very good result in line with expectations". Three days later he finalized plans to join the company, and on May 5 the company announced that it had hired him. The *WSJ* quoted an HSBC spokesman that the bank can't address such possible conflicts of interest "until and unless an employee informs us of his intention to resign".

Separately, entries on the SEC's Web site dated July 16, 2004, and April 26, 2006, give details of a research analyst employed by Connecticut Capital who wrote research on a company, CyberCare, while simultaneously being employed by CyberCare's PR firm. The extremely bullish research report—the rating was "strong buy" with a 12-month target

Conflicts of interest (employment)—*cont'd*

price at US\$52 per share, more than four times the price at the time of US\$11.25—did not disclose this relationship. Both Connecticut Capital and the analyst consented to the SEC's findings without admitting or denying the allegations. CyberCare entered into its own settlement with the SEC, again without admitting or denying the findings, with respect to charges that it had issued false and misleading press releases regarding non-existent or grossly exaggerated agreements.

Here's an interesting one: From FINRA's round-up of disciplinary actions for April 2009, we see that an analyst was fined US\$10,000 and suspended for 12 months for making false, exaggerated, unwarranted or misleading statements. The findings stated that she was also in a "romantic relationship" with an executive of one of her covered companies, without disclosing this fact, thereby creating a conflict of interest. The lady consented to the findings, without admitting or denying them. (I can think of a couple of ways a romantic relationship disclosure could be worded, but I doubt the editors would accept them.)

Conclusions: It may be unreasonable to expect an analyst to disclose every time he or she has a job interview. What does seem clear is that as soon as an analyst has decided to take a job with a covered company, or has any other ongoing relationship with that company (or with an executive of that company), then the analyst needs to make full disclosure in any research report on that company.



Independent research firms

As part of the global settlement in 2003, the research departments of the settling organizations have to be separated from the investment banking departments. In addition, in respect to each security they covered and

rated, they had to offer a recommendation or rating from an independent research house. For example, of the US\$400 million penalty imposed on Citigroup, US\$75 million was designated to be used for the procurement of independent research. This idea was evidently greeted with mixed enthusiasm.

Over the next few years not all the firms managed to comply with the terms of the settlement. For example, Credit Suisse agreed in August 2009 to pay a fine of US\$275,000 to FINRA to settle charges that it had failed to make all the required current independent research available to its customers, and then for failing to implement measures to prevent additional failures.

With some relaxation in July 2009 to the terms of the agreement imposed on the settling banks (those that survived the financial crisis at any rate), independent research firms will need to look to their laurels to stay competitive.

Even independent research houses cannot escape charges of conflict of interest, as separate lawsuits in the U.S. brought by Biovail, Overstock and Fairfax Financial against hedge funds and independent research analysts demonstrate. These were initiated even before the stories of abusive short-selling by hedge funds hit the headlines during the subprime crisis in 2007–08, which are detailed in Chapters 1 and 2.

CASE STUDY

Alleged conflicts of interest (independent research firms)

Summary: The *New York Times* of March 26, 2006, reported: “At the heart of Biovail’s racketeering lawsuit . . . is an audacious claim: that some of the nation’s biggest hedge funds colluded with independent research firms and analysts at big banks to produce purposely misleading research with the sole object of driving down a company’s stock price.” Similar charges have been made separately by Overstock.com and Fairfax Financial against hedge funds and independent research analysts.

Details: Biovail alleged that Gradient Analytics, an independent research firm, published in June 2003 a negative report on the Canadian pharmaceutical company to its clients, but only after it had given enough time for SAC Capital Advisors, who had originally requested the research, to build up a short position in the company. Biovail contested, by my interpretation, that the issue was not a sour-grapes reaction on their part to a negative recommendation by a research firm and to the short-selling of the stock, but, rather, argued that it was a case of market misconduct

Alleged conflicts of interest (independent research firms)—cont'd

whereby the client had persuaded the research firm to write negative research, and that the research firm held up publishing the research more widely to give the client time to build up a short position.

Both Gradient and SAC denied the allegations. Herb Greenberg noted in the Dow Jones News Service on March 30, 2006, that Gradient's research is private and subscription-based, and pointed out that "Gradient discloses clearly to its clients that its reports may have been the result of custom reports that were done for another client".

Both this case and the similar Overstock case took on wider implications when the SEC issued subpoenas to journalists, requesting related communications. The SEC admitted that this request had been extraordinary, and proceeded instead to issue subpoenas directly to Gradient, requesting their communications with reporters. It was then reported by the press on February 15, 2007, that the SEC had declined to bring charges against Gradient, without giving reasons for the decision. However, Biovail said it would not drop its lawsuit against Gradient and SAC.

Then it was the turn of Biovail to be on the receiving end of the SEC's investigations, and this culminated in a March 2008 settlement by Biovail, without admission of guilt, to the tune of US\$10 million. The accusations by the SEC and the Ontario Securities Commission against Biovail and four executives related to accounting fraud, specifically that the executives "overstated earnings and hid losses in order to deceive investors and create the appearance of achieving earnings goals". This seemed to vindicate the analysts, and on April 24, 2009, Dow Jones reported that, with little fanfare, Biovail had pared down its claims against SAC Capital and Gradient. Indeed the boot was now on the other foot, with SAC Capital and Gradient filing their separate complaints against Biovail in February 2010 for malicious prosecution.

Separately, an investigative report by Bethany McLean published by *Fortune* on March 19, 2007, and one by Anthony Effinger in the October 2007 issue of *Bloomberg Markets* examine the case of Fairfax Financial, which had accused hedge funds and independent research analysts of attempting to drive its stock price down to benefit short positions. SAC Capital is also a defendant in this case. The defendants denied the accusations.

Aside I: The twists and turns of these cases provide interesting reading, what with Fairfax effectively admitting its own accounting irregularities when it restated earnings to correct five years of errors, and with one of the analysts, SC of MI4 Reconnaissance, being arrested on separate

Alleged conflicts of interest (independent research firms)—cont'd

federal charges of embezzling money from a former employer (which SC denied). Another analyst, JG, was dismissed by his employer, Morgan Keegan for “violation of a firm policy relating to his apparent advanced disclosure of his initial research report on Fairfax”, as reported by Dow Jones Newswires on September 11, 2008.

Furthermore, Biovail’s lawsuit against Gradient and SAC for racketeering was originally filed as a response to its own shareholder lawsuit, in which shareholders claimed they lost money from the share price decline as a result of fraudulent statements made by Biovail. In December 2007, without admitting guilt, Biovail settled this action by agreeing to pay US\$138 million. Biovail’s woes continued with the firm agreeing to pay US\$24.6 million to settle a case involving its heart drug, Cardizem LA.

Aside II: In a similar vein, *Barron’s* reported on May 26, 2008, how Lehman Brothers had reacted to criticisms raised by David Einhorn, the founder of Greenlight Capital, a hedge fund, regarding the valuations that Lehman had assigned to the CDOs on its own balance sheet. In a statement, Lehman said that Einhorn “cherry-picks certain specific items from our 10-Q (its quarterly filing to the SEC) and takes them out of context and distorts them to relay a false impression of the firm’s financial condition”. Greenlight was short Lehman stock at the time. For more on Greenlight and the controversies surrounding short-selling, please see Chapter 2.

Conclusions: In 2006, the *New York Times* said that the Biovail case would either open another chapter of corruption and greed on Wall Street or it would just be a case of another company resorting to lawsuits to silence its critics. Gradient believes they have been vindicated by Biovail’s 2008 settlement with U.S. and Canadian regulators, hence their countersuit. One conclusion on this basis would be that companies should think twice about suing analysts or complaining about analysts who criticize them or who have sell ratings on their stocks. (Also see the example in Chapter 2 where a Morgan Stanley analyst was barred by OCBC from attending their analyst briefings.)

Of course there may be times when the company may be justly grieved. As reported by the *WSJ* on March 29, 2008, Andrew Calamari, associate director of the New York office of the SEC, said: “They (short-sellers) are not . . . just shorting a stock to bring it down, but they’re shorting because they think it’s a bad company. Sometimes they’re right;

Alleged conflicts of interest (independent research firms)—*cont'd*

sometimes they're wrong." Analysts need to make sure they have valid reasons whenever they criticize a company or assign a sell rating to their securities.

It remains to be seen how the Overstock and Fairfax cases turn out, and it will be interesting to see who, if anyone, comes out smelling of roses.

Paying for sell-side research

As mentioned in the Introduction, it's not really my place to foresee how the world of securities research will evolve, from a business perspective. However, I have included some comments arguing the case for and against fundamental research in the section on Analyst Surveys in Chapter 1. Furthermore, it may be appropriate to end the chapter on conflicts of interest by looking at developments in the way sell-side research is actually paid for by buy-side clients.

The traditional way of rewarding brokers for their research is the so-called soft-dollar practice of bundling together fees for advice (that is, for the research) with the commissions generated for transactions. The major concerns of these methods include conflict of interest and lack of transparency. Justin Schack, in his comprehensive article entitled "Sins of commissions", published by *Institutional Investor* on December 14, 2005, succinctly describes soft dollars as the "use of customers' money to pay brokers for buying and selling stocks in funds and then using what amount to kick-backs from those commissions to buy everything from analyst reports to data feeds to office furniture".

However, some might think that the use of soft dollars is the most practical compromise despite the drawbacks. As Winston Churchill said about democracy, that it's the worst form of government except for all the others, so too some might describe the use of soft dollars as a form of compensation for brokerage services. After more than a year of consultations and assessment of soft dollar practices, the International Organization of Securities Commissions (IOSCO) concluded in its final report on the subject published in November 2007: "Soft commission arrangements present a challenge to regulators. The arrangements can provide useful benefits to CIS (collective investment scheme) investors, but can be subject to abuses. SC5 (IOSCO's standing committee on collective investments) will continue to monitor regulatory developments related to soft commission arrangements to determine whether general principles can be developed." So there you have it.

During its consultations, IOSCO ascertained that most regulatory regimes permit soft commission arrangements so long as they follow either specific regulations, or, if there are no specific regulations, so long as the arrangements generally follow fiduciary principles (including best execution) and that conflicts are disclosed. For example, the European Commission recommends member states “to identify as soft commissions any economic benefit, other than clearing and execution services, that an asset manager receives in connection with the fund’s payment of commissions on transactions that involve the fund’s portfolio securities”.

In terms of what can be included in soft commission arrangements, most jurisdictions allow the inclusion of goods and services that benefit the client in the investment process. These would include execution as well as research and analysis, but not salaries, travel expenses and office equipment.

Of course the disclosure requirements represent major conditions in themselves. The need to make detailed disclosures means that permitted costs relating to execution and research should be separately identified anyway, and these costs would therefore in effect be unbundled.

Ultimately, the market itself may be the best arbiter. One example to demonstrate this is Japan. Although there is no regulation of soft commission arrangements in this jurisdiction, IOSCO noted that it is common practice that securities companies provide institutional investors with their internal research material free of charge. The following example also shows that, whatever may or may not be happening in the regulatory world, market participants are finding their own commercially-driven solutions.

EXAMPLE

Transparency in paying for research

Summary: As we saw at the beginning of Chapter 1, Anthony Bolton, the famed fund manager from Fidelity, stated in his book that he has always been a proponent of using the best outside research to complement Fidelity’s in-house research. So how does Fidelity pay for this outside research?

First we must understand that Fidelity comprises two major companies: Fidelity Management & Research (FMR), which services the US market; and Fidelity International (FIL), which services international clients.

Details: The *Wall Street Journal* of May 19, 2006, reports how Thomas Weisel Partners has agreed with Fidelity (FMR) to separate the fees it

Transparency in paying for research—*cont'd*

charges for research and stock trading, following similar agreements to unbundle fees already made between Fidelity and both Deutsche Bank and Lehman Brothers. Thomas Weisel said Fidelity “will separate payments for research products or services from trading commissions for brokerage services and will pay for research directly in cash, instead of compensating these firms through trading commissions as under soft-dollar practices”.

This may have been an attempt on behalf of the parties concerned to keep pace with anticipated changes in the regulatory environment. However, as seems likely from a Greenwich Associates study, as reported by the *FT* on August 9, 2007, the pendulum may now have swung the other way, with some big investors lifting their use of soft dollars as the expected crackdown by regulators failed to materialize. (Following the financial crisis the regulators have had their hands full anyway with other issues, such as bank capital adequacy, securitization, credit rating agencies and executive remuneration.)

Meanwhile, another development involves commission-sharing arrangements (CSAs), whereby a fund manager pays a commission for the execution of a trade, but part of the commission is passed on to the research house (such as an independent or boutique research firm), which provided the investment or trade idea. Fidelity International adopts the CSA route.

Conclusions: The *WSJ* article goes on to report that Thomas Weisel said that if the unbundling trend continues within the industry, it could force commission prices lower, although the firm was unable to predict whether the arrangement would affect future trading volume with Fidelity.

It remains to be seen what changes in regulations may ensue, but evidently Thomas Weisel and Deutsche Bank see practical benefits in agreeing to adapt to the wishes of such an important buy-side client as Fidelity.

There will no doubt always be a demand for good investment ideas, whether these come from bulge-bracket firms or independent research houses, but how these ideas are monetized will continue to be a challenge going forward.

Aside: I just can't resist including a reference to the US\$8 million fine that Fidelity in the U.S. paid to the SEC in March 2008 to settle claims that employees accepted lavish gifts and entertainment from brokers in exchange for business. One particular event allegedly included a dwarf-tossing competition. I'm not making this up.

Managers at firms that employ a soft dollar policy need to determine what expenses can be covered by the arrangement and what should not be. As we see from the following case study, it's important for the policy to be clearly disclosed and managed.

CASE STUDY

Transparency in paying for research (inappropriate payments)

Summary: Terra Nova Financial was fined US\$400,000 by FINRA in November 2009 for “making more than US\$1 million in improper soft dollar payments to or on behalf of five hedge fund managers, without following its own policies to ensure the payments were proper”. Three officers of the company, including the chief compliance officer, were suspended and fined a total of US\$45,000.

Details: FINRA’s press release stated that Terra Nova made the payments without receiving adequate documentation or conducting an adequate review to determine that the payments were for expenses authorized by fund documents. The bulk of the payments were for ill-defined consulting fees and expenses. However, specific items included meals, clothing, auto repairs, parking tickets, limousines, airline tickets and hotel stays, often paid for by credit card. The most notable item was US\$13,700 for seven trips by a hedge fund manager to a “gentlemen’s club” over a two-week period.

Conclusion: There’s too much of this going on, and I’m not having any of it. Seriously, as FINRA’s chief of enforcement, Susan Merrill, said in the context of this case: “Broker-dealers that collect soft dollars and make payments for their hedge fund clients must possess and implement adequate procedures that govern their soft dollar practices.” Transparency is key.

A similar tug-of-war to that discussed above for equity research is being played out in the world of credit rating agencies. Apart from perhaps some sort of government control or subsidy, the two free-market ways of paying for credit rating agencies’ services boil down to either the “issuer pays” or the “investor pays” model. In recent times at least, it has

been the issuer who has paid, and as we saw at the end of the risk section in Chapter 2 (see the example on Bridgewater property group), there has been an evident conflict of interest in this method. However, an “investor pays” model is not without its flaws either since this might result in an elitist system where only institutional investors might be able to afford the research. At least with the “issuer pays” model, all investors can get access to the ratings for free. New developments and measures at least look like they will increase competition and disclosure, which can only be good for investors.

EXAMPLE

Paying for credit ratings

Background: *Barron's* in the U.S. published a comprehensive article about credit rating agencies on December 24, 2007, written by Jonathan R. Laing and entitled “Failing Grade”. The article identified the various issues involved and suggested solutions. One of the ideas offered was that the way agencies get paid should change. Traditionally agencies get paid by the issuers, and one complaint has been that the issuers will only commission the agencies to start with if the rating will be positive. *Barron's* cites former Clinton secretary of labor, Robert Reich, who wrote in his blog that the system is tantamount to movie studios hiring critics to review their films and paying them only “if their reviews are positive enough to get lots of people to see the movie”. The article also referred to a certain rating service called Egan-Jones that had been trying for a decade to win official agency status. The interesting point to note about this firm is that it does not get paid by the issuer whose bonds it rates, but by institutional investors.

The *WSJ* of June 4, 2008, quoted the former president and chief operating officer of Moody's who acknowledged that “what the market doesn't know is who's seen certain transactions but wasn't allowed to rate those deals”. In another startling revelation, Elliot Blair Smith in his *Bloomberg* article of September 24, 2008, quotes a former Standard & Poor's managing director saying that S&P's executive committee had ordered him to grade a real estate investment that he'd never reviewed. The rater stated that relying on a competitor's analysis was one of a series of shortcuts that undermined credit grades issued by both S&P's and Moody's.

The *WSJ* of October 24–26, 2008, reported how internal documents and e-mails released at a House of Representatives hearing showed

Paying for credit ratings—*cont'd*

how far Moody's and Standard & Poor's went to accommodate bond issuers that generated giant fees for the two firms. Executives were torn between maintaining the integrity of the ratings and easing standards in an effort to win more business. The infamous comment by one Standard & Poor's analyst that a deal could be structured by cows and they would still rate it says it all.

In Europe too, regulators evidently appreciated the need for change, as noted by Gillian Tett reporting for the *FT* from the World Economic Forum in Davos, Switzerland, in January 2008. Charlie McCreevy, European Union financial commissioner, said, ". . . we have put them [credit rating agencies] on watch that things cannot stay the same". Similarly, Malcolm Knight, the head of the Bank for International Settlements, remarked: "The whole question of the role of ratings in the regulatory system does have to be looked at."

The example relating to New Zealand's Bridgewater property group, detailed in Chapter 2, also demonstrates how global the problem had become.

Developments: In May 2008, IOSCO published various amendments to its Code of Conduct for Credit Rating Agencies. Note that IOSCO does not have statutory authority in any one market or over any particular credit rating agency. However, it does exert an influence on all its members, which include the main securities regulators around the world. Among the amendments were recommendations to:

- Encourage the differentiation between ratings for structured products and those of regular bonds.
- Discourage "ratings shopping" by issuers for credit ratings.
- Ensure appropriateness and transparency in methodology.

In the U.S., Egan-Jones was approved as a nationally recognized statistical rating organization (NRSRO) at the end of 2007. It was the first agency to be approved by the SEC as an NRSRO in the U.S. that does not get paid by the issuer whose bonds it rates, but by investors who subscribe to its services.

The SEC announced in July 2008 the findings of their investigation into Fitch, Moody's and Standard & Poor's. As reported by Paul Davies, Joanna Chung and Gillian Tett in the *FT*, the SEC chairman, Christopher Cox, said: "We've uncovered serious shortcomings at these firms, including a lack of disclosure to investors and the

Paying for credit ratings—*cont'd*

public, a lack of policies and procedures to manage the rating process and insufficient attention to conflicts of interest.” Note that a month earlier the New York attorney general, Andrew Cuomo, had reached a settlement with these three firms under which they would get paid for their review even if their ratings weren’t eventually used by the issuers. They would also need to disclose the fees that they are paid for nonprime-mortgage-backed securities. The SEC announced measures in December 2008 that would “ensure that firms provide more meaningful ratings and greater disclosure to investors”. However, one criticism that was not addressed was the fact that the need to use credit ratings is hard-wired into, that is mandated by, securities regulations. The SEC went some way to address this concern when it announced in September 2009 that it would eliminate references in “certain SEC rules and forms”.

Meanwhile in Europe, German Chancellor Angela Merkel called for the creation of a European credit rating agency to challenge the dominance of the U.S. agencies. The European Commission announced in November 2008 that it would be formally regulating credit rating agencies. The commission’s aims, as reported by *Newsweek*, were to:

- Ensure that credit rating agencies avoid conflicts of interest in the rating process or at least manage them adequately.
- Improve the quality of the methodologies used by credit rating agencies and the quality of ratings.
- Increase transparency by setting disclosure obligations for credit rating agencies.
- Ensure an efficient registration and surveillance framework, avoiding ‘forum shopping’ and regulatory arbitrage between EU jurisdictions.

Conclusions: The issue is evidently a global one, and as such really needs a globally applicable solution, perhaps resulting in more involvement with IOSCO.

The new measures and new competition will hopefully go some way to address the concerns regarding conflicts of interest, at least in the U.S. and Europe. It remains to be seen what measures are adopted elsewhere in the world, and whether the markets are happy with the arrangements.

In defense of rating agencies, Vickie Tillman, executive vice-president of Standard & Poor’s in New York, says in her letter to the

Paying for credit ratings—*cont'd*

FT of June 20, 2008: “The acid test of how effectively a ratings firm manages potential conflicts, of course, remains its track record—that is, the historic correlation between ratings and defaults.” S&P’s later introduced 27 internal practical steps to strengthen its rating process, including the in-house credit analyst certification program mentioned in the continuing education section in Chapter 1 and the setting up of a risk assessment oversight committee, as reported by Rebecca Knight in the *FT* on January 4, 2010.

Endnotes

1. Following the passing of the Credit Agency Reform Act in the U.S. in 2006, the SEC introduced in June 2007 an oversight system for credit rating agencies. These now need to be formally registered as “nationally recognized statistical rating organizations” rather than being passively recognized as such through so-called “No-Action Letters” issued by the SEC, as had been the case since 1975.
2. See Securities and Exchange Board of India (Disclosure and Investor Protection) Guidelines, 2000.
3. See NASAA.org press release of July 5, 2006.
4. In the U.S., where pre-deal research is not permitted, FINRA proposed in October 2008 that the post-IPO blackout period for FINRA-registered broker-dealers involved in a deal should be reduced from 40 days to 10 days, and that for secondary offerings the blackout period, previously 10 days, should be eliminated altogether.

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