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**COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE  
EUROPEAN PARLIAMENT**

**Investment research and financial analysts**

**{SEC(2006) 1655}**

# **COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT**

## **Investment research and financial analysts**

**(Text with EEA relevance)**

### **1. INTRODUCTION**

The purpose of this Communication is to take stock of, and to provide stakeholders with practical guidance on, the provisions of recent European legislation relating to investment research and financial analysts, and to respond to the report of the Forum Group on Financial Analysts<sup>1</sup>, which helped inform the drafting of that legislation.

For the most part, this Communication deals with the issue of conflicts of interest, and describes the main European legislation specifically addressing that topic. In the final section, other issues are addressed (analyst registration, independent research, issuer relations with analysts and investor education).

### **2. BACKGROUND**

#### **2.1. The role of investment research**

The ready availability of various types of financial information ensures appropriate pricing, helps issuers to raise debt and equity capital in primary markets, and ensures deep and liquid secondary markets for financial instruments.

The financial analysts who prepare investment research play an important role in the financial information ‘ecosystem’ that nourishes financial markets. Analysts synthesise raw information into more readily digestible research pieces. In turn the research will be used by investors to help them make their investment decisions, or by intermediaries to produce investment research, investment advice, or marketing communications.

Regulation of investment research and of the financial analysts who create it therefore needs to be sensitive to, and appropriate for, the many roles research plays. It is also of prime importance to ensure that any such regulation limit as little as possible the flow of information of potential value to investors.

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<sup>1</sup> Forum Group, Financial Analysts: Best practices in an integrated European financial market (September 2003). See [http://europa.eu.int/comm/internal\\_market/en/finances/mobil/finanalysts/index\\_en.htm](http://europa.eu.int/comm/internal_market/en/finances/mobil/finanalysts/index_en.htm).

## 2.2. Regulatory scrutiny of investment research

Since the collapse of the ‘new economy’ bubble in 2000 and several subsequent high-profile corporate collapses, the value and integrity of investment research, has been under increased regulatory scrutiny globally.

In Europe, the informal meeting of Economics and Finance Ministers in Oviedo in April 2002 discussed policy issues related to the Enron collapse in particular, and among other initiatives asked the Commission to consider possible regulatory action on investment research.

The Commission subsequently convened the Forum Group on Financial Analysts, composed of private sector practitioners, independent consultants, regulators and professional bodies, to consider the issue. The Group’s report was released in September 2003 and was subject to subsequent public consultation.

This Communication constitutes the Commission’s response to the Forum Group report and the public consultation. Before responding, it was first necessary to complete the European legislation dealing with research. This finally took place in September 2006, with the adoption of the implementing measures for the Markets in Financial Instruments Directive.<sup>2</sup>

Also in September 2003, the International Organization of Securities Commissioners’ Technical Committee (IOSCO) published a report<sup>3</sup> and a statement of principles<sup>4</sup> on analyst conflicts of interest. These documents are discussed further below.

The Forum Group’s report and the IOSCO report and statement of principles have helped to shape the regulatory debate on financial analysts. That debate has largely focused on the potential for poor conflicts management within firms that produce investment research to lead to biased research.

Research analysts face a variety of potential conflicts which can impair their objectivity. They may be exposed to interests of the firm, or of certain groups of clients, that conflict with the interests of those to whom the research is directed. Some examples of such interests include the interests of issuers in disposing of their securities, and of corporate financiers in attracting and keeping issuance- and placement-related business. The firm itself, if it is a proprietary trader, will have an interest in selling financial instruments. Where the firm conducts agency business such as equities broking on a commission basis, it will have a commercial incentive to generate orders. All these interests can impair the analyst’s objectivity.

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<sup>2</sup> See section 5 below.

<sup>3</sup> IOSCO Technical Committee, Report on Analyst Conflicts of Interest (September 2003) at <http://www.iosco.org/pubdocs/pdf/IOSCOPD152.pdf>

<sup>4</sup> IOSCO Technical Committee, Statement of Principles for Addressing Sell-Side Securities Analyst Conflicts of Interest (September 2003) at <http://www.iosco.org/pubdocs/pdf/IOSCOPD150.pdf>

### 2.2.1. *The Forum Group's report*

The focus of the Forum Group's report was also on the prevention, management, monitoring and disclosure of conflicts of interest relating to investment research. The recommendations were focused in particular on: conflicts of interest resulting from analysts' involvement in securities offerings and other corporate finance work; best practice for companies issuing securities; remuneration of analysts; securities dealing by analysts; qualifications; and the distribution of investment research to the retail market. **Annex 1**<sup>5</sup> sets out the Forum Group's recommendations in more detail.

After the Commission invited comment on the Forum Group's recommendations, there was broad support for the principles-based approach suggested by the Forum Group, and for many of the Group's specific recommendations, including those focusing on the management of conflicts of interest. Some support was expressed for a European framework laying down minimum standards; however, the desire was also expressed that European standards should as far as possible be compatible with those adopted in other major jurisdictions.<sup>6</sup>

### 2.2.2. *The IOSCO Report and Statement of Principles*

While not legally binding on Member States or the Community as a whole<sup>7</sup>, IOSCO principles are nevertheless of persuasive force. They represent an attempt by IOSCO member regulators to reach consensus, at the level of principle, on important securities regulatory issues. In the field of investment research, where many research providers operate on a global basis, it is particularly desirable if regulators can implement consistent rules.

The Principles devised by IOSCO's Technical Committee focus on:

- the identification and elimination, avoidance, management or disclosure of conflicts of interest faced by analysts;
- the integrity of analysts and their research; and
- the education of investors concerning the actual and potential conflicts of interest analysts face.

The principles, and the respective core measures to implement those principles, are set out in **Annex 2**.

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<sup>5</sup> All Annexes referred to in this Communication are contained in the Commission Staff Working Document "Investment research and financial analysts – Annexes" (reference SEC(2006) 1655) (available only in English).

<sup>6</sup> For more details, see the summary of responses at [http://ec.europa.eu/internal\\_market/securities/docs/analysts/contributions/contributions-summary\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/analysts/contributions/contributions-summary_en.pdf)

<sup>7</sup> It is important to note in this connection that Europe is represented at IOSCO only at the level of regulators of certain Member States.

Although the principles focus on the activities of equity sell-side analysts (i.e. those working in integrated investment banks or broker-dealers), it is specifically mentioned that “sell-side analysts are by no means alone in facing such conflicts of interest and concepts developed in this work could be used in other areas”<sup>8</sup>; and the accompanying report does mention specifically “the conflicts of interest faced by sell-side analysts in the production of equity research and by the firms that employ them”.<sup>9</sup>

### 3. EUROPEAN LEGISLATION ADDRESSING CONFLICTS OF INTEREST IN INVESTMENT RESEARCH

Two major pieces of European legislation include provisions that address the issue of conflicts of interest relating to investment research. These are the Market Abuse Directive<sup>10</sup> and the Markets in Financial Instruments Directive<sup>11</sup> (the MiFID). The Market Abuse Directive and its implementing measures have come into force in all Member States. The MiFID and its implementing measures are due to be transposed by Member States by 31 January 2007 and applied to firms as from 1 November 2007.

#### 3.1. Market Abuse Directive

Article 6(5) of the Market Abuse Directive contains a requirement that persons who produce or disseminate information recommending or suggesting an investment strategy, intended for distribution channels or for the public, take reasonable care to ensure that such information is fairly presented and disclose their interests or indicate conflicts of interest concerning the financial instruments to which that information relates.

Directive 2003/125/EC<sup>12</sup>, which implements Article 6(5) of the Market Abuse Directive, sets out a comprehensive disclosure regime for conflicts of interest relating to research recommendations (see **Annex 3** for a summary).

The Market Abuse Directive and its implementing Directives 2003/124/EC<sup>13</sup> and 2004/72/EC<sup>14</sup>, also restrict issuers from disclosing price-sensitive

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<sup>8</sup> See paragraph 2 of the IOSCO Statement of Principles.

<sup>9</sup> Section V, p. 14 of the IOSCO Report.

<sup>10</sup> Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse). O.J. L 096 12.04.2003, p.16.

<sup>11</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC. O.J. L 145 30.4.2004, p. 1. As amended by Directive 2006/31/EC of the European Parliament and of the Council of 5 April 2006 amending directive 2004/39/EC on markets in financial instruments, as regards certain deadlines. O.J. L 114 , 27.04.2006, p. 60.

<sup>12</sup> Commission Directive 2003/125/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest, O.J. L 339, 24.12.2003, p. 73.

<sup>13</sup> Commission Directive 2003/124/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the definition and public disclosure of inside information and the definition of market manipulation, O.J. L 339, 24.12.2003, p. 70.

information to selected analysts ahead of its release to the rest of the market place.

The Market Abuse Directive and its implementing measures are not restricted to investment firms within the meaning of MiFID<sup>15</sup> and affect other producers of recommendations, such as independent research houses, credit institutions and the like.

### 3.2. The MiFID

The MiFID sets out *inter alia* organisational and operating conditions for authorised investment firms. Where an investment firm provides investment services on a professional basis to third parties, it will normally need to be authorised under the MiFID and comply with all its requirements. This also covers the provision of ancillary services such as that of ‘investment research and financial analysis or other forms of general recommendation relating to transactions in financial instruments’<sup>16</sup>. The provisions that relate specifically to investment research are contained in an implementing Directive under the MiFID (the MiFID implementing Directive)<sup>17</sup>.

#### 3.2.1. Conflicts of interest – general

MiFID tackles the issue of conflicts of interest generally by requiring investment firms to:

- take all reasonable steps to identify relevant conflicts of interest arising in the course of providing investment or ancillary services;<sup>18</sup>
- maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest from adversely affecting the interests of their clients;<sup>19</sup>
- where those organisational arrangements are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, to clearly disclose the general nature and/or sources of conflicts of interest to the client before undertaking business on its behalf.<sup>20</sup>

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<sup>14</sup> Commission Directive 2004/72/EC of 29 April 2004 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards accepted market practices, the definition of inside information in relation to derivatives on commodities, the drawing up of lists of insiders, the notification of managers’ transactions and the notification of suspicious transactions, O.J. L 162, 30.4.2004, p. 70

<sup>15</sup> As defined in Article 4(1)(1) of MiFID.

<sup>16</sup> Investment services are those services set out in Section A of Annex 1 to the MiFID. Ancillary services are those set out in Section B of that Annex.

<sup>17</sup> Commission Directive 2006/73/EC implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms, and defined terms for the purposes of that Directive. O.J. L 241, 2.9.2006, p. 26.

<sup>18</sup> Article 18(1).

<sup>19</sup> Article 13(3)

<sup>20</sup> Article 18(2).

The MiFID implementing Directive specifies that investment firms should adopt a written policy in relation to conflicts of interest setting out the methods by which they propose to manage conflicts of interest arising in the course of their various investment and ancillary activities, including the provision of investment research.<sup>21</sup> A further key requirement is the need to ensure an appropriate level of independence between persons engaged in different business activities involving a conflict of interest entailing a risk of damage to the interests of a client.<sup>22</sup> The Directive also sets out a series of organisational measures to ensure the requisite degree of independence in appropriate cases, such as the separation of supervision or remuneration between different activities.<sup>23</sup>

### 3.2.2. *Conflicts of interest – investment research*

Apart from these general provisions, the MIFID implementing Directive contains specific rules<sup>24</sup> relating to the provision of investment research. They apply to investment firms which produce or arrange for the production of investment research that is intended or likely to be subsequently disseminated to clients or to the public under their own responsibility or that of group members.

Investment research is defined<sup>25</sup> as a sub-category of recommendations as defined in Article 1(3) of Directive 2003/125/EC. In order to qualify as investment research, such recommendations must be labelled or described as investment research, or otherwise presented as objective or independent, and must not constitute investment advice (i.e., the provision of personal recommendations, which are presented as suitable for the recipient, or based on a consideration of the circumstances of that person).<sup>26</sup>

Where the provisions apply, there are two consequences:

- the investment firm must ensure that it implements all the organisational measures set out in the MiFID implementing Directive in relation to analysts and other persons<sup>27</sup> whose responsibilities or business interests may conflict with the interests of recipients of the research; those measures require effective separation between business functions that serve different client or business interests<sup>28</sup>; and
- investment firms should take other specified steps designed to ensure the objectivity of the investment research. Importantly, the firm must prevent

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<sup>21</sup> Article 22 of the implementing Directive.

<sup>22</sup> Article 22(3) of the implementing Directive.

<sup>23</sup> Article 22(3) of the implementing Directive.

<sup>24</sup> Article 25 of the implementing Directive.

<sup>25</sup> Article 24 of the implementing Directive.

<sup>26</sup> Article 4(1)(4) of MiFID and Article 52 of the MiFID implementing Directive.

<sup>27</sup> Recital 30 of the implementing Directive explains that those other persons should include corporate finance personnel and persons involved in sales and trading on behalf of clients or the firm.

<sup>28</sup> Article 22(3) and Recital 36 of the implementing Directive.

certain dealings in financial instruments by relevant persons<sup>29</sup> who have knowledge of the timing or contents of relevant investment research that is not public;<sup>30</sup> as well as certain personal transactions contrary to outstanding recommendations.<sup>31</sup> There are also restrictions<sup>32</sup> on the acceptance of inducements in relation to investment research, the promising of favourable research coverage, and on who may review drafts of investment research and for what purposes.

The requirements which apply to the production of research also apply to the substantial alteration of investment research produced by a third party.<sup>33</sup> However, a firm which simply disseminates research which has been produced by a third party is not bound by the consequences mentioned above, provided that the disseminating firm does not substantially alter the research, and verifies that the producer of the research is subject to requirements, or has established a policy, equivalent to the requirements of the MiFID implementing Directive.<sup>34</sup>

### 3.2.3. *Disclosure of conflicts and relation to the Market Abuse Directive regime*

As regards disclosure of research conflicts, the MiFID supplements the detailed regime in the Market Abuse Directive by requiring:

- disclosure where organisational arrangements are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented;<sup>35</sup> and
- disclosure of the conflicts of interest policy of the investment firm.<sup>36</sup>

It is intended that the MiFID and the Market Abuse Directive should operate together seamlessly. The field of “recommendations” within the meaning of the Directive 2003/125/EC (where produced by an investment firm) should exclusively contain investment research for MiFID purposes or marketing communications for MiFID purposes. Recommendations of an investment firm that do not constitute investment research must be clearly identifiable as marketing communications<sup>37</sup> and must contain a clear and prominent statement that (or, in the case of oral recommendations, to the effect that) they have not been prepared in accordance with standards designed to promote the objectivity of investment research.<sup>38</sup>

The diagram in **Annex 4** explains the relationship between recommendations, marketing communications, investment advice and investment research.

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<sup>29</sup> This term is defined in Article 2(3) of the implementing Directive.

<sup>30</sup> Article 25(2)(a) of the implementing Directive.

<sup>31</sup> Article 25(2)(b) of the implementing Directive.

<sup>32</sup> Article 25(2)(c)-(e) of the implementing Directive.

<sup>33</sup> Recital 35 of the implementing Directive.

<sup>34</sup> Article 25(3) of the implementing Directive.

<sup>35</sup> Article 18(2) of the MiFID.

<sup>36</sup> Article 19(3) of the MiFID and Article 30(1) of the implementing Directive.

<sup>37</sup> Article 19(2) of MiFID.

<sup>38</sup> Article 24(2) of the implementing Directive.



#### 4. OTHER ISSUES

The main outstanding issues arising from the Forum Group's report and the IOSCO Principles are:

- the possibility of mandatory analyst **registration**, possibly linked to **qualifications**;
- the regulatory and competitive position of **independent** research firms vis-à-vis the provision of research by investment banks;
- the desirability for best practice codes or corporate governance rules covering **issuer relations with analysts**; and
- the important role of investor **education** in addressing the problem of conflicts of interest in investment research.

##### 4.1. Analyst registration

The Commission has decided not to propose at this stage mandatory registration of analysts linked to qualifications. The Forum Group was divided on the need to subject analysts to mandatory minimum qualification requirements.<sup>39</sup> There is insufficient evidence that problems of analyst bias derive from a lack of qualifications. Rather, it seems evident that they derive from failures by firms properly to manage the conflicts of interest arising in their production of investment research. These issues are addressed by the MiFID.<sup>40</sup> Moreover, mandatory registration of analysts is not one of the IOSCO core measures.

##### 4.2. Independent research

The Commission does not consider that there are necessarily inherent quality differences between research produced by independent research firms and that produced by investment firms. Nevertheless, whereas independent firms need to cover their costs by charging clients, much research produced by investment banks is paid for by institutional investors (and, through them, by their underlying clients) only indirectly. This process can often be somewhat opaque and accountability is not always clear.

To a large extent, these issues are addressed in the MiFID and its implementing measures. In particular, implementing measures relating to inducements permit inducements to be accepted by investment firms (such as portfolio managers) from third parties (such as their brokers) only if they are fully disclosed to their clients and only if they are designed to improve the quality of the provision of the investment or ancillary service concerned to the client, and do not impair compliance with the firm's duty to act in the best interests of the client.<sup>41</sup> These

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<sup>39</sup> at p. 50 of the Forum Group's report (cited at footnote 1)

<sup>40</sup> See the provisions mentioned in section 3.2 above.

<sup>41</sup> Article 26 of the Implementing Directive.

measures are particularly relevant to ‘bundled’ or ‘softed’ services<sup>42</sup> that are received by portfolio managers from or on behalf of brokerage houses<sup>43</sup>. The receipt and provision of ‘softed’ and ‘bundled’ research can continue beyond implementation of the MiFID, only if it can be duly justified and shown to pass the strict tests in the legislation. This ensures that research produced in-house by banks, and research produced by independent investment houses under so-called commission-sharing arrangements, remains on an equal competitive footing.<sup>44</sup>

### 4.3. Issuer relations with analysts

The Commission notes that the consultation on the Forum Group’s report demonstrated support for some form of best practice code or corporate governance rules covering **issuer relations with analysts**.

The MiFID and the Market Abuse Directive, with their strict rules on conflicts management and disclosure and presentation of research, will prevent issuers from having undue editorial influence over research prepared by investment firms. They will also prohibit issuers from disclosing price-sensitive information to analysts ahead of its release to the rest of the marketplace, except where they are made insiders and subjected to confidentiality obligations.

The Commission believes that best practice codes of professional or trade associations can help to promote more professional relations between issuers and analysts.<sup>45</sup> Such codes address issues such as retaliation by issuers against analysts that produce negative or ‘sell’ recommendations.

Against this background, the Commission does not propose to bring forward a legislative proposal in this area at this stage.

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<sup>42</sup> Bundled services’ refers to those services provided by investment firms to their clients (for example, institutional investors) as part of a total package of services for which a single fee, usually a commission, is paid. ‘Softed services’ refers to those services which are provided to the client as part of a package for which a single fee is payable, but which are not provided by the investment firm in question but by another party under an arrangement with it.

<sup>43</sup> This applies to providers authorised under MiFID who provide individual portfolio management, and also to UCITS managers by virtue of Article 5.3 of Directive UCITS Directive (Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), O.J. L 375, 31.12.1985 p. 3.

<sup>44</sup> See also Recital 37 of the implementing Directive, which recommends independent research houses adopt MiFID-like standards of conflicts management and disclosure.

<sup>45</sup> Examples of such codes include the Charter for Financial Communications (drawn up jointly by the Cercle de Liaison des Informateurs Financiers en France (CLIFF) and the Société Française des Analystes Financiers (SFAF)) at [http://www.cliff.asso.fr/en-GB/iso\\_album/charter.pdf](http://www.cliff.asso.fr/en-GB/iso_album/charter.pdf). See also the best practice guidelines drawn up by the Association of Investment Management and Research and the National Investor Relations Institute at <http://www.cfainstitute.org/standards/ethics/aimnrircomment.html>. See also the Principles of Ethical Conduct of the Association of Certified International Analysts at <http://tinyurl.com/lxsq2>.

#### **4.4. Investor education**

The IOSCO Technical Committee stated that investor education should play an important role in managing analyst conflicts of interest.

The Commission agrees that investors should be aware of the potential for conflicts of interest to affect investment research, and about the meaning of disclosures as to conflicts. This is an area that we consider especially well suited for action by Member States, by trade associations, and of course by investment firms themselves.

The Commission for its part is committed, as part of its health and consumer protection strategy, to ensure better informed and educated consumers.<sup>46</sup> In this context, the Commission plans a conference for Spring 2007 to bring together examples of best practice in consumer education and improving consumer financial literacy. The outcome of this conference will drive further reflection by the Commission on what further role, if any, it should play in the field of consumer financial education.

#### **4.5. Other material contained in the Forum Group's recommendations and the IOSCO principles**

To the extent that the Forum Group recommendations or the IOSCO principles for independence of analysts are not specifically addressed in the legislative measures mentioned, they will nevertheless be useful to assist:

- investment firms in framing their conflicts of interest policies under the MiFID and the text of their required disclosures under the Market Abuse Directive;
- analysts, issuers and investment firms in drawing up codes of conduct and other self-regulatory measures to ensure adequate management and disclosure of conflicts of interest and other issues affecting research quality and integrity.

### **5. CONCLUSION**

Taken together, the MiFID and the Market Abuse Directive and their implementing measures will represent a significant step forward in creating a European-level regulatory framework for avoiding, managing and disclosing conflicts of interest in all investment and ancillary services, including investment research. All such measures need to be implemented by Member States within agreed timetables to be fully effective. Where appropriate, regulators should also consider issuing guidance to ensure convergent, common-sense application of the legislative measures.

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See Healthier, Safer, More Confident Citizens: a Health and Consumer Protection Strategy, COM(2005) 115 final; 2005/0042 (COD), at paragraph 4.2.4.

At this point, the Commission does not consider that it is needed to adopt further specific legislation in this field. Nevertheless, the Commission will continue to carefully monitor the application of these measures, including their effect on the market for investment research. This experience will be valuable in reviewing the legislative measures for their continued appropriateness. In line with the principle of Better Regulation, should existing measures prove insufficient, then the Commission will consider bringing forward further proposals (legislative or other). Any such proposals would be subject to consultation and regulatory impact assessment.