Conflicts of Interest

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Chapter 5

Investment Research: How to Solve Conflicts of Interest More Efficiently

*Sandro Abegglen**

As a reaction to the conflicts of interest affecting major Wall Street investment banks in connection with financial research and the issue of securities, which received enormous publicity after the bursting of the dot-com bubble, lawmakers and financial services authorities in many jurisdictions imposed rules to ensure unbiased investment research and recommendations.

While the technical substance of the rules on investment research varies widely by jurisdiction, almost all of them are based on a combination of organizational requirements (for banks), obligations addressed to the financial analysts themselves, and rules for the proper structuring of incentive systems. However, it should not be taken for granted that the new regulations that have been rushed through are in every respect an efficient way of mitigating conflicts of interests in connection with financial analysis, as this paper is intended to show.

I shall first examine some basic facts and define the scope of the problem (section II). I shall then briefly discuss the phenomenon of banks' conflicts of interests in general, and present the main regulatory instruments used to increase the independence of financial analysts' work, using the Swiss rules as an example

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(section III). Section IV identifies the concepts underlying the relevant conflict of interest regulations. Section V provides policy proposals for achieving a more efficient regulation of conflicts of interest in connection with financial research.

I. HOW SERIOUS ARE CONFLICTS OF INTERESTS – OR: WHY DID NO ONE CRY 'FOUL' UNTIL AS RECENTLY AS 1999?

A. General

In 2002 an SEC director, reacting to press criticisms that made it sound as though the SEC had only just started examining analysts' conflicts of interest, rejected the implication, stating: 'In fact, the SEC began to examine this issue in 1999.'[1] She then went on to state that, in the summer of 1999, SEC staff had begun a review of industry practices regarding the disclosure of research analyst's conflicts of interest. This pronouncement raises the question of just how serious financial analysts' conflicts of interest really are. If they are thought to constitute an important problem, surely that must have been the case for years, if not decades, before the bursting (or, come to that, the inflation) of the dot-com bubble. If so, why was it not considered necessary to address conflicts of interest in the past, and what has changed since to produce the common opinion that financial analysts' conflicts of interest are a serious regulatory concern which needs close attention from policy makers, regulators and the industry – not to mention academics?

As a matter of fact, it is quite astonishing that a regulatory issue as large (when judged by the attention currently being given to the topic) as the conflicts of interest of research analysts should have gone unnoticed by regulators in the recent past. One rather gets the impression that the regulators' feverish activity in this area may be partly due to their desire to avoid questions such as: 'Why did you not address this problem before and avoid all this trouble?' This applies with particular force to the situation in the United States, where the New York State Attorney General, Mr. Elliot Spitzer, made the SEC look as though it had been wrong-footed by the conflicts of interest of financial analysts in investment banks. And even when the SEC did start to address these conflict of interest problems, it looked distinctly sluggish compared to Mr. Spitzer's rapid and effective intervention.

Thus the question I shall address in this paper is: Was sin really so late in coming to financial analysts, and did it come only to Wall Street, or also to other banking centres such as Zurich or London?

1. Speech by L. Richards, Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, 'Analysts Conflicts of Interest: Taking Steps to Remove Bias,' available at <www.sec.gov/news/speech/spch559.htm>.

B. DID SIN REALLY COME SO LATE?

Financial analysis and its practitioners may always have been subject to certain temptations: for example, to issue over-positive recommendations, not only to appease the managements of analyzed companies and institutional investors with participations in those companies, but also to help their own employers attract and retain investment-banking business. It is also possible that financial analysts engaged, either on their personal account or on their employer's, in securities transactions taking advantage of as-yet-unpublished investment research reports or buy or sell recommendations, to the detriment of the market.

Moreover, the obvious fact that financial analysis helps to bring in more business for the bank's brokerage/trading department may – but need not (see section V) – lead to conflicts of interest. Sell-side financial analysis always has been and still is heavily subsidized by the brokerage and trading units of banks. In fact, it was long thought that the very purpose of financial analysis was to bring more (institutional) investor business to a bank's brokerage/trading units.

I shall now briefly describe how financial analysis fits into a bank's business setup. It will be helpful to distinguish between three types of financial analysis providers:

– Universal banks/full-service investment banks: These banks offer most, if not the full range of, investment banking, brokerage, and commercial and private banking services. They finance their sell-side research departments out of the profits from their underwriting (investment banking), institutional equity trading and (in some cases) retail brokerage. In addition, profits from the asset management business may be used to fund research (according to industry insiders, up to 50 per cent of an investment firm's research budget may be funded through institutional equity trading). Investment banking revenues are used to fund financial analysis because research may bring in new underwriting business, and institutional equity trading departments fund research because the recipients of the pertinent research reports, large institutional investors, take account of the quality of the research when choosing an investment bank. Moreover, institutional investors may, when making transaction commission payments, specify which piece of research they are paying for.
– Brokerage firms: Most brokerage firms do not engage in investment banking activities but only in brokerage/trading activities for institutional and/or retail clients. They normally depend on transaction commissions to fund sell-side research analysis.
– 'Pure' research providers: These provides are not financial intermediaries in the narrow sense of the term, i.e. they provide neither banking nor brokerage services in any form. Rather, they sell their research work as a product, in consideration of a flat fee or fee per report, to interested customers, normally institutional investors. This last category is not further dealt with in this paper, as independent research providers are less subject to conflicts of interest.

C. WHY ATTENTION NOW AND NOT THEN?

The funding of investment research, as described above, carries a risk that financial analysts' recommendations may be biased. This applies, first, when research work is funded by trading commissions: a buy recommendation, since it can be acted upon by *any* market participant, will generate more commissions than a sell recommendation, which can be acted upon by investors who already hold the security in question, put aside derivatives and short selling transactions. It also applies when research is subsidized by the underwriting business: negative recommendations are scarcely likely to increase that business. Thus there appears to be potential for conflicts of interest.

However, prior to the dot-com feeding frenzy, the addressees of research reports were mostly institutional investors and other professional market participants. As a result, conflicts of interests, if any, were mitigated or moderated by, in particular, the following circumstances:

- Institutional investors, being aware of the conflicts of financial analysts and their employers, compensated for the potential upward bias by not acting very strongly on buy recommendations, but very strongly on sell recommendations.
- In regard to knowledgeable institutional investors, financial analysts personally, as well as their employers, had a reputation to lose if the recommendations turned out to be incorrect: institutional investors had (and have) the capacity to observe and remember the quality and value of the research work provided to them, and which analyst produced it.[2]
- The very fact that large institutional investors linked their trading orders directly to pieces of research, which they would obviously not do unless they put some value on the research, was a very strong incentive for both financial analysts and their employers to provide real value to such investors. If an investor thought that a bank's financial analysts were so conflicted that they were (e.g.) making buy recommendations when they ought to be making sell recommendations, the investor would promptly transfer its trading business to another bank, or continue to trade with the original bank at a lower fee to factor out the useless 'research'. Over time, the reputation of the bank as a whole would suffer from such behaviour and would be forced to provide brokerage services at lower margins. This in turn would damage the bank's standing, as well as its eligibility for high-profile underwriting mandates, where it is essential that a bank has a good reputation in order to provide the best possible placement results. Accordingly, it is not surprising that studies appears to show that research work carried out by highly reputable banks tends to be less biased than research work by other banks.[3]

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2. See, e.g., A. Ljungqvist, F. Marston, L.T. Starks, K.D. Wei and H. Yan, Conflicts of Interest in Sell-side Research and The Moderating Role of Institutional Investors, 12 September 2005, available at <www.ssrn.com/abstract=649684>, p. 1 *et seq.*, with an extensive list of references.
3. Ibid.

During the stock exchange bubble of the late 1990s, however, these mitigating effects became far less marked, because suddenly *retail* investors became important purchasers of initial public offerings and therefore also important recipients of sell-side research. It seems that these two elements combined to form a vicious circle, as some financial analysts threw business ethics to the winds, culminating in attitudes such as the one allegedly expressed by a once very famous dot.com analyst in the US: 'I am in the flow of what's going on. What has been a conflict of interest in the past is now regarded as a synergy'.

At the same time, some financial analysts were wallowing in unprecedented levels of remuneration. They apparently saw this as a kind of endgame and ceased to care about their long-term reputation.

However, it appears that this concatenation of events was quite unique and that the scope and gravity of the problems caused to financial research by the dot-com bubble were exceptional (which is not of course to say that no conflicts whatsoever existed at other times).[4]

II. THE APPLICABLE SWISS RULES AS AN EXAMPLE OF HOW FINANCIAL ANALYST CONFLICTS OF INTEREST CAN BE ADDRESSED

A. Preliminary Remark: Conflicts of Interest in Connection with Financial Research are Only One Example of the Numerous Conflicts of Interests Within Banks

Conflicts of interest within banks in connection with financial research are only one example of the numerous actual and potential conflicts of interest with which a bank or securities dealer is confronted when carrying out its business. Accordingly, and typically for the principle-oriented (as opposed to rule-based) Swiss approach to financial services regulation, the same principles and rules that govern banks' conflicts of interest in general are also being used as a basis for solving the conflicts of financial analysts.

Conflicts of interest are deemed to exist if a person (agent) who is *obliged* to safeguard a third party's (principal's) interests has incompatible interests of his own or is *obliged* to safeguard the conflicting interests of another principal. Swiss contract law specifically addresses conflicts of interest in connection with self-contracting and the situation in which an agent is acting for several principals in the same business. According to the relevant rules, an agent can only act in such situations if, in spite of the conflict of interest, there is no risk that a principal will be put at a disadvantage.[5]

4. See, in this volume, M. Dubois and P. Dumontier, Chapter 6, as well as L. Schrutt and S. Wieler, Chapter 8.
5. See in detail S. Abegglen, *Wissenszurechnung bei der juristischen Person und im Konzern, bei Banken und Versicherungen – Interessenkonflikte und Chinese Walls bei Banken und Wertpapierhäusern – Privatrecht und Finanzmarktrecht* (Staempfli, Bern, 2004), pp. 344–346.

Financial services providers are subject to a vast number of conflicts of interest. While studies written in continental Europe have linked this to the universal banking principle (as opposed to the regime of separation of commercial and investment banking pursuant to the repealed US Glass Steagall Act), there is no doubt that a regime that segregates the two types of banking business has not eliminated conflict of interests either. In fact, financial analysts' conflicts of interest are a good illustration of the fact that even firms active only in one type of banking business are subject to conflicts.[6]

The importance policy makers and regulators attach to conflicts of interest in financial services is shown by the extensive regulation of such conflicts (including those relating to financial analysis) within the European Union. For example, article 18 of Council Directive 2004/39/EC of 21 April 2004 on Markets in Financial Instruments (the so-called 'Markets in Financial Instruments Directive' or 'MIFID') addresses conflicts of interest in detail. Article 18 (1) MIFID requires investment firms:

> '[T]o take all reasonable steps to identify conflicts of interest between themselves, including their managers, employees and tied agent, or any person directly or indirectly linked to them by control and their clients or between one client and another that arise in the course of providing any investment and ancillary services (providing investment research is considered to be such an ancillary service) or combinations thereof.'

In contrast to MIFID, which also covers conflicts of interest in investment research, MIFID's 'predecessor', namely Council Directive 93/22/EEC of 10 May 1993 on Investment Services in the Securities Field (the so-called 'Investment Services Directive' or 'ISD'), did not apply to investment research (it was not included under either 'investment services' or 'non-core services'). The Council Directive 2003/6/EC of 28 January 2003 on Insider Dealing and Market Manipulation (the 'Market Abuse Directive' or 'MAD') also now provides for consistent EC-wide treatment of the disclosure of conflicts of interest in connection with investment research.

B. Basic Principles for Solving Conflicts of Interest in Swiss Law

1. Statutory Basis: Art. 11 (1) Stock Exchange Act

Art. 11(1) of the Stock Exchange Act imposes on Swiss securities dealers (most Swiss banks have a securities dealer's license that permits them to engage in brokerage business, besides them carrying out the ordinary bank business of taking

6. For a description of the various types of conflicts of interests in the financial services business see S. Abegglen (no. 5 above), p. 346 *et seq*.

deposits and lending to third parties[7]) not only duties of care and duties of information, but also a duty of loyalty (art. 11 [1] lit. c Stock Exchange Act). The securities dealer is required to 'ensure in particular that any conflicts of interest do not adversely impact its customers.' It follows from this provision that the avoidance of conflicts of interest is a top priority; in cases in which this is not possible, the securities dealer must institute organizational measures to ensure that any (potential) conflicts of interest do not adversely affect the client's interests. If this is impossible, the client must be informed; i.e. the conflict of interest situation must be appropriately disclosed. It should be noted that art. 11 (1) lit. c Stock Exchange Act does not stipulate precisely how securities dealers must ensure compliance with this rule. In principle, they are free to choose the appropriate measures in view of the relevant conflicts of interest.[8]

Both the Swiss Federal Banking Commission and the Swiss Federal Court consider compliance with art. 11 (1) lit. c Stock Exchange Act to be highly important. A substantial breach of the duty of loyalty is regarded as a breach of the securities dealer's duty to properly conduct his business (*börsengesetzliche Pflicht zur Gewähr einwandfreier Geschäftstätigkeit*), which he must comply with if he is to obtain and keep his securities dealer's licence, pursuant to art. 10 (2) lit. d Stock Exchange Act. For a securities dealer that is also licensed as a bank, this requirement also derives from art. 3 (2) lit. c of the Banking Act (*bankengesetzliche Gewähr einwandfreier Geschäftstätigkeit*). Compliance with these provisions is of paramount importance for any Swiss bank/securities dealer. Moreover, the duty to ensure the proper conduct of business operations under both the Stock Exchange Act and the Banking Act applies not only to the directors and managers, but also to the bank as an organization.

The duty of loyalty, pursuant to Art. 11 Stock Exchange Act, which comprises an obligation to ensure that clients' interests are not adversely affected by conflicts of interest, is limited to the area of securities trading and its organization and does not apply directly to other financial services.

2. Assurance of Proper Business Conduct (*Gewährspflicht*): An Important Principle in the Management of Conflicts of Interest

The limited applicability of the duty of loyalty pursuant to art. 11 (1) lit. c Stock Exchange Act does not imply that comparable duties do not exist in other areas

7. The dual licensing status (banking and securities dealer's license) is standard for any bank active in the wealth management business, because clients' assets are not only deposited with the bank but also invested in securities, which means the bank must deal in securities; banks without securities dealer status are very rare, but a number of institutions do not have a banking license, because they do not accept cash deposits from customers. In other words, any regulated institution that provides financial research services will normally have at least the status of securities dealer and will therefore be subject to the regulation described in the text.
8. For an extensive discussion of conflicts of interest and the regulatory obligations to be fulfilled in connection therewith, see S. Abegglen (n. 5 above), pp. 320 *et seq*.

of banking. The consistent practice of the Swiss Federal Banking Commission with regard to conflicts of interest makes it quite clear that it considers the same principles as described above under the duty of loyalty to be implied by art. 3 (2) lit. c Banking Act. This important provision of Swiss banking regulations requires the directors and management of a bank, as well as the bank itself, to ensure the proper conduct of business operations (the so-called *Gewährspflicht*).[9] The view that the proper management of conflicts of interest also follows from the *Gewährspflicht* is confirmed by the Swiss Federal Court. The relevant precedent is the well-known Biber case,[10] which is particularly significant in so far as the Swiss Federal Banking Commission applied very strict standards in regard to the handling of conflicts of interest, although the Stock Exchange Act did not apply (for technical reasons that are irrelevant to the present discussion). In the Biber case, the disputed transaction was a proprietary transaction by a bank that had been in possession of advantageous (but not inside) information. Both the Swiss Federal Banking Commission and the Swiss Federal Court considered this to be a breach of the good faith (*Treu und Glauben*) principle, as defined in art. 2 (1) Swiss Federal Civil Code; the bank misused an information advantage by selling shares to clients, alledgedly knowing that their value was substantially less than the current stock market price. In the circumstances of the Biber case, the Federal Court held that such a breach of art. 2 (1) Swiss Federal Civil Code was also a violation of the *Gewährspflicht*[11] laid down in art. 3 (2) lit. c Banking Act.

In a later, equally well-known decision,[12] the Swiss Federal Banking Commission confirmed the requirements as developed in the Biber case. In particular, the Commission held that it is a breach of art. 3 (2) lit. c Banking Act if a bank's conduct is fundamentally opposed to the behaviour to be expected of an honest banker. In addition, the Commission imposed on banks an obligation not to compromise themselves, i.e. damage their reputations and undermine public confidence. Finally, the Commission stated that banks must pay special attention to the principle of art. 2(1) Swiss Federal Civil Code and that conflicts of interest must be resolved in a way that does not put clients or third parties at a disadvantage.

C. Implementation of these Principles

1. Code of Conduct for Securities Dealers

A first general application of art. 11 (1) lit. c Stock Exchange Act is provided in section D (Duty of loyalty) of the Code of Conduct for Securities Dealers dated

9. See e.g. M.L. Aellen, *Die Gewähr für eine einwandfreie Geschäftstätigkeit*, (Berne, Staempfli, 1990); the book is still of fundamental importance.
10. ATF 2A.230/1999/bol of 2 February 2000, Bulletin CFB 40/2000, p. 37 *et seq.*
11. For a detailed discussion of the Biber case, see S. Abegglen (footnote 4), p. 369 *et seq.*
12. Decision of the Federal Banking Commission of 19 March 2003 in regard to the allocation of shares in the initial public offering (IPO) of Think Tools AG, Bulletin CFB 45/2003, 164 *et seq.*

22 January 1997, and issued by the Swiss Bankers Association. The FBC considers the Code of Conduct to be a minimum standard, compliance with which must be monitored by the banking law auditors of all Swiss securities dealers (and any bank holding a securities dealer's license). The Code of Conduct does not contain any specific requirements that are not also covered by the instruments discussed below, and is therefore not further addressed here.

However, it is noteworthy that the principle-based Code of Conduct leaves it in the discretion of the banks which organizational measures be implemented as long as they ensure compliance with the duty of loyalty and appropriate management of conflicts of interest.

2. Directives on the Independence of Financial Research

In contrast to the above-mentioned Code of Conduct, this piece of regulation is rule-based in the sense that banks have less discretion on how to implement the required measures taking into consideration their type of business. The Swiss Bankers Association's Directives on the Independence of Financial Research[13] provide a number of very specific rules for *internal organization* regarding the relationship between financial research on the one hand, and securities trading (including proprietary trading) and sales (N 13–16), the new issues department and investment banking, the loans department and equity participations held by a bank on the other. From an organizational, hierarchical and functional perspective, financial analysis must be separate from all the other specified units. And those units, as well as the financial research department, must be so structured as to ensure that no privileged ('material, non-public') information flows between them that is not simultaneously available to clients of the bank ('Chinese walls'). In the rare cases in which such information is exchanged despite these precautions, the bank's Compliance Unit must be called in to ensure, in particular, that the exchange of information occurs within a regulated framework which will prevent the conflict of interest from having any negative consequences (N 16).

In addition, these directives set forth rules governing *external relationships* (i.e. the relationship of the financial research department and the individual analysts with bank clients and companies being analyzed), and proprietary trading by financial analysts.

Finally, the introduction to the Directives (page 2) states that banks are free to implement the content of the Directives as they see fit; provided, of course, that the minimum requirements are met.

These Directives (dated 24 January 2003) are not part of statutory law but *de facto* have the force of law: this piece of self-regulation has been recognized by the Swiss Federal Banking Commission as a minimum standard with which any Swiss bank or securities dealer engaged in producing and publishing financial

13. Available at <www.swissbanking.org/en/3566_e.pdf>.

research must comply, and as an ongoing requirement for proper business conduct under the relevant Swiss banking and brokerage regulations. Compliance with the Directive is subject to regular audits by external banking and broker/dealer auditors.

III. REGULATORS' TYPICAL APPROACH TO SOLVING CONFLICTS OF INTEREST

A. Overview

The following sections provide a brief overview of the concepts that underlie the general rules intended to prevent or mitigate conflicts of interest.

B. Instruments Most Often Used to Regulate Research Analysts' Conflicts of Interest

Legislation and regulation that addresses conflicts of interest connected to financial research typically use the following instruments:

- Organizational measures: The organizational, functional and hierarchical separation of financial research from all other units and departments within a bank ought to ensure the independence of financial analysts. Banks also must ensure that other departments are not engaged in front running etc., based on knowledge of the contents of as-yet-unpublished recommendations etc. These separations include limitations on relationships and communication between investment banking, trading and asset management on the one hand, and research analysts on the other (Chinese walls). The separations should not only provide information barriers, but also exclude undue influence on analysts from within a bank (e.g. analysts must not be directly supervised by, or report to, a person who is responsible for another business unit in the bank, e.g. proprietary trading). In exceptional circumstances, e.g. in connection with pre-IPO investment research work, financial analysts can be taken 'across' the Chinese Wall, but usually only with the approval of a high-level compliance officer.
- Appropriate compensation structure: Detailed stipulations on the compensation of banks' financial analysts are intended to provide incentives to improve the independence of financial analysts' work, or at least to avoid providing incentives which might bias financial analysts' judgments. In particular, an analyst's compensation must not be tied to a specific investment banking or equity trading transaction, and if it is generally linked to the bank's underwriting and/or equity trading returns, this must be disclosed in the research reports. In addition, it goes without saying that financial analysts may not accept any incentives in whatever form from companies on which they conduct research work.

- Ban on analysts' proprietary trading: Proprietary trading by financial analysts is heavily restricted: In contrast to the popular concept of 'put your money where your mouth is', financial analysts are generally prohibited from investing in securities on which they carry out research work, or even (with certain exemptions) in the sector in which they conduct research work. Front running is strictly prohibited, as are, of course, the execution of transactions that are contrary to analyst recommendations.
- Transparency, disclosure of potential and actual conflict of interests: Banks are usually required to include disclosure statements in their recommendations. An investment bank must disclose if it is engaged in underwriting or other investment banking business with the companies being analyzed. For example, according to the Swiss rules, in every published research report, banks must disclose whether they participated in any issue of securities on behalf of the company being researched within the last three years.
- Relationships with companies being analyzed are governed in detail: A helpful illustration is available in sections 25–32 of the Swiss Bankers Association Directives on the Independence of Financial Research (see the annex to this paper). These rules oblige companies being researched to treat all analysts equally (to prevent them from punishing analysts for unfavourable recommendations),[14] and stipulate quiet periods that a bank that is involved in an initial public offering as a manager or co-manager must observe, during which no new research reports on the company in question, or new recommendations, may be published. Similar rules, usually with shorter quiet periods, apply to secondary public offerings.

C. Conclusion: Three-pillar Approach

A brief analysis of the above commonly applied rules and regulations shows that the underlying regulatory concept has the following three pillars:

- First pillar: Measures, notably Chinese Walls of every type, are taken to ensure that conflicts of interests are not detrimental to clients' interests.
- Second pillar: In situations that generate strong conflicts of interest, these conflicts must be disclosed (e.g. the bank's investment banking mandates; any compensation of financial analysts that is tied to investment banking; the bank's equity holdings in analyzed companies, etc.).
- Third pillar: In situations that constitute a particularly strong incentive for financial analysts to come up with positively biased recommendations, the bank must, under Swiss law, abstain from publishing research reports and

14. For an excellent discussion of the connection between an accounting topic, namely fair value reporting by analyzed companies, and regulation of financial analysts' conflicts of interest see R. Volkart, P. Labhart and E. Schön, 'Fair-Value-Bewertung und Value Reporting' in H. Bieg and R. Heyd (eds), *Fair Value: Bewertung in Rechnungswesen, Controlling und Finanzwirtschaft*, (Munich,Vahlen, 2005), p. 517 *et seq*.

recommendations. Examples include situations in which a bank holds 50 per cent or more of an analyzed company; when a bank performs financial research on the bank's own securities; or when a financial analyst is involved in a commercial relationship with the analyzed company.

The reason for enjoining such restraint on banks is, fundamentally, the belief that the Chinese Walls and other instruments which should be sufficient to ensure the *de facto* independence of financial analysts are viewed with suspicion by the public, who will assume that financial analysts and banks are biased in their judgments whether the financial analysts actually act independently or not. The same anxiety is reflected in the question (whose relevance goes well beyond the conflicts of interest of financial analysts) of whether regulatory Chinese Walls do, in fact, prevent knowledge transfer within a bank, which is a prerequisite e.g. of the due diligence defence in cases in which an underwriting bank argues that the specific knowledge available about a company (in e.g. the loans department) did not have to be taken into consideration when drafting the company's issue prospectus.[15]

An (admittedly extreme and somewhat theoretical) example may serve as an illustration. The Chinese Wall requirements do not (e.g.) allow the loans department to pass material non-public information to the financial analysts. Suppose the loans department is aware that a borrower is about to go bankrupt and the same borrower is being analyzed by the same bank's analysts: in the worst case, this may mean that the bank's analysts are making a buy recommendation on a company the bank knows to have very severe financial problems. In this case – or in a similar situation – the reputation of the bank as a whole is at stake, since it may appear as if the financial analyst has issued a buy recommendation on purpose in order to protect the loan position and to help the bank terminate its exposure to the analyzed company.

IV. POLICY THOUGHTS AND PROPOSALS

A. HIGH COSTS OF CURRENT REGULATION

As the above discussion shows – and as is also plainly obvious from a glance at e.g. the Swiss Bankers Association's Directives on the Independence of Financial Research,[16] or the even more complex art. 18 MIFID, and in particular its implementation measures as advised by the Committee of European Securities Regulators (CESR)[17] – regulations in the area of conflicts of interests place substantial burdens on banks and securities firms that conduct research work and publish research reports and recommendations. The implementation and monitoring of these highly detailed rules are extremely costly and complex. Moreover, because this piece of regulation is rule-based rather than principle-based, it significantly limits the organizational freedom of banks. In addition, it should be noted that internationally

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15. See S. Abegglen (n. 5 above), pp. 384–391.
16. Available at <www.swissbanking.org/en/3566_e.pdf>.
17. <www.europa.eu.int/comm/internal_market/securities/isd/index_en.htm>

active financial service providers are not only required to comply with the rules and regulations of their home country. Whenever research reports are 'exported' or 'imported', the various rules of the foreign jurisdictions must be observed. While MIFID and MAD have introduced some consistency to the general rules across the EC, substantial differences exist in non-EC jurisdictions. For example, the rules differ on the thresholds that define when an investment bank must disclose that it holds a participation in a company being analyzed – minimum participation for disclosure in Switzerland, for example, is five percent; and, depending on the jurisdiction, different definitions apply as to what constitutes an investment banking mandate that must be disclosed.

Reactions to the costs that go along with such pieces of legislation vary between equanimity (i.e. full compliance), avoidance of certain research and/or business segments and outsourcing of research work to independent firms and disposal of in-house research units, e.g. to ratings agencies. This shows that the burden of the rules and regulations is substantial. In fact, as Jean-Baptiste Zufferey stated, one can speak of a 'regulatory shower' to which the financial analyst regulation has made its contribution.[18] The question therefore arises of whether it might not be possible to increase the efficiency of the anti-conflicts regulation. In the following section, I will offer an answer to that question in the form of a number of policy proposals.

B. FOUR POLICY PROPOSALS

1. First Proposal: Replace Excessive Rule-based Separation Requirements by Escalating Measures

In general, the extensive, highly technical and detailed requirements regarding organizational, hierarchical and functional *separation* of research units from other departments in banks appear to go too far and may not be necessary to ensure high-quality financial analysis. This is not to question the importance of Chinese Walls, which – independent of the present regulation of financial research – must be in place in banks and security firms to prevent misuse of material non-public (insider) information. However, rather than promulgate highly technical separation requirements that substantially affect a bank's organizational freedom, why not consider less extensive, but still extremely effective, and therefore more efficient, means to ban the management of a bank from exerting pressure on individual analysts to arrive a particular research results? The necessary prohibition could be effectively enforced by placing a range of escalating measures at the disposal of the compliance officer and enabling analysts to lodge formal complaints in response to undue pressure. This means, of course, that the compliance officer must have a position in the hierarchy within the firm, allowing him to effectively fight and sanction abuses, even if committed by higher management.

18. See Chapter 7 by J.B. Zufferey, who is inter alia Vice-Chairman of the Swiss Federal Banking Commission (which is the Swiss financial services authority).

2. Second Proposal: Differentiate Between Institutional (Sophisticated) and Retail Investors

Generally, the rules designed to prevent or limit potential conflicts of interest associated with the preparation of financial research reports do not differentiate between institutional investors (or other professional financial intermediaries) and retail investors as recipients of recommendations. This practice is inefficient, because institutional investors should be in a position to protect themselves, as long as market mechanisms work as required.[19] In particular, it is inefficient to subject banks that provide research work and recommendations only to institutional investors to the very same set of rules that applies to banks that provide recommendations in part or only to retail investors.

3. Third Proposal: Allow Reputation Cost to Work

The effectiveness of reputation as one means of regulation of corporate governance for public companies has been shown in Switzerland most prominently by Hans Caspar von der Crone.[20] Reputation as a regulatory instrument can also be put to work in the context at hand. As described in Sections II.B and II.C, among the most important objectives of investment research are to attract more institutional investor trading business and to increase a bank's reputation, enabling it to charge higher fees for trading and investment banking services. This objective can only be reached because institutional investors do actually observe and remember the quality of research work and investment recommendations, and reward good work by taking trading business to the relevant institution. Hence it is most efficient if a financial analyst's remuneration is geared to the trading commissions generated by institutional investors who appreciated his work (see the fourth proposal below). However, current regulations generally prohibit this type of link, on the assumption that it will encourage the analyst to issue false trading signals. That is incorrect: as long as the analyst's performance and his bank's investment research performance can be monitored (and remembered) by relevant investors (not only institutional but also retail investors), analysts and banks will, in order to keep or increase their reputations (and, accordingly, keep or increase their ability to charge premium fees and command premium salaries), make great efforts to produce high-quality, that is unbiased, investment research. Recently published rankings of banks' and analysts' investment research seem to indicate the usefulness of this reputation concept.[21]

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19. For the differentiation between institutional investors and retail investors see generally e.g. D.R. Fischel, 'Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities' (1982) *Bus. Law* 38, 2 *et seq*.
20. Hans Caspar von der Crone, Verantwortlichkeit, Anreize und Reputation in der Corporate Governance der Publikumsgesellschaft, *Zeitschrift für Schweizerisches Recht* (ZSR) 119 (2000) II 235 *et seq*.
21. A large number of rankings are made available in special-interest publications. Interestingly, even general newspapers such as Neue Zürcher Zeitung (NZZ) have begun to publish rankings

It could be made to work for retail investors, as well, by introducing standardized reporting of a bank research unit's track record with respect to specific securities; all banks could be required to publish such a track record in connection with each piece of research work.[22]

4. Fourth Proposal: Reward Analysts for High Quality Work

This proposal is to be set alongside the third proposal: The general requirement that the remuneration paid to financial analysts may not be dependent upon the performance of one or more specific securities trading or sales transactions and/or commissions generated thereby seems to be contrary to the very purpose of ensuring more high-quality investment research when the recipients of the research are institutional investors. Where there is transparency on the remuneration structure, institutional investors will decide whether to perform their transactions with a specific bank on the basis of the value they put on the research report's conclusions. In the event the research reports of a bank's analysts are biased for the purpose of generating transaction commissions based on unjustified buy or sell recommendations, careful institutional investors will take their business from that bank and give it to a better one.

of the best research units, e.g., 'Die besten Analytiker für Schweizer Aktien', NZZ, 18 October 2003, No. 243, p. 27.

22. Making the provision of this type of information mandatory would be unnecessary; it could be left to investors to decide whether or not to base investment decisions on research recommendations from firms which withhold their ranking.

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