

**CONFLICTS OF INTEREST (CORPORATE FINANCE AND INVESTMENT ANALYSTS) INSTRUMENT 2003**

**Powers exercised**

- A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):
- (1) section 138 (General rule-making power);
  - (2) section 149 (Evidential provisions);
  - (3) section 156 (General supplementary powers); and
  - (4) section 157(1) (Guidance).
- B. The rule-making powers listed above are specified for the purpose of section 153(2) of the Act (Rule-making instruments).

**Commencement**

- C. This instrument comes into force on 1 February 2004.

**Amendments to the Conduct of Business sourcebook**

- D. The Conduct of Business sourcebook is amended as set out in Annex A.

**Amendments to the Glossary**

- E. The Glossary is amended as set out in Annex B.

**Citation**

- F. This instrument may be cited as the Conflicts of Interest (Corporate Finance and Investment Analysts) Instrument 2003.

15 October 2003  
By Order of the Board

## Annex A

### Amendments to the Conduct of Business sourcebook

In this Annex, underlining indicates new text and striking through indicates deleted text. Where an entire new section of text is being inserted, the place where it goes is indicated and it is not underlined.

1.3.5 G Firms are reminded that the definition of *inter-professional firm* does not include:

(3) ... ; or

(4) corporate finance business.

...

1.6.4 R Table: Corporate finance business

This table belongs to COB 1.6.3R

COB	Subject
...	
5.4	Customers' understanding of risk
<u>5.10</u>	<u>Corporate finance business issues</u>
...	

...

#### **Investment research**

2.2.4A G An offer or agreement to publish *investment research* which is, or to change a *published recommendation* so that it becomes, favourable to its subject (even if the subject is a *customer of the firm*), is an example of offering or accepting an *inducement which is likely to conflict to a material extent with the firm's duties to its other customers.* (See also COB 5.10 in relation to inducements related to *corporate finance.*)

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After COB 5.9 insert the following new section:

#### **5.10 Corporate finance business issues** **Application**

5.10.1 R This section applies to a *firm* that conducts *corporate finance business.*

## Purpose

- 5.10.2 G The purpose of this section is to provide *guidance* on the management of conflicts of interest in particular situations arising in the context of *corporate finance business*. The *FSA* expects that in most *corporate finance business* *Principle 1* (Integrity), *Principle 2* (Due skill, care and diligence), *Principle 5* (High standards of market conduct), *Principle 6* (Customers' interests) and *Principle 8* (Conflicts of interest), will be particularly relevant. The *guidance* in this section is not intended to be exhaustive, and is in addition to other provisions which apply to the *firm* (see *COB 1.6* which specifies these). It also supplements other provisions in the *Handbook* (see, in particular, *COB 2.2* (Inducements and soft commission) and *COB 7.1* (Conflict of interest and material interest)).

## Securities offerings

- 5.10.3 G The *Principles* referred to in *COB 5.10.2G* are highly relevant to the management of an offering of a *security* by a *firm*. They require a *firm* to manage conflicts of interest which may arise in a way which ensures that all its *clients* are treated fairly and which ensures that the *firm* is conducting its business with integrity and according to proper standards of business.
- 5.10.4 G The overriding responsibility of the *firm* is to have in place systems, controls and procedures to ensure that the duties which the *firm* owes to its *clients* are identified effectively and discharged appropriately. In particular, the *firm's* processes and procedures will need to take account of the following:
- (1) when carrying out a mandate to manage an offering of *securities*, the *firm's* duty for that business is to its corporate finance *client* (in many cases, the corporate issuer or seller of the relevant *securities*).
  - (2) a *firm's* responsibilities to provide services to the *firm's* investment *clients* (that is, those on the investment *client* side of the *Chinese wall* (see *COB 5.10.5G*)) are unchanged, even if they have an interest in acquiring *securities* in the offering. The *firm* will need to ensure that it complies with the relevant regulatory obligations to its investment *clients*, such as *COB 5.3* (Suitability).
- 5.10.5 G *Firms* will need to have in place systems, controls and procedures, appropriate to its structure and business, and to the sorts of offerings in which they are involved, for identifying and managing conflicts of interest (and see *SYSC 3* (Systems and controls)). Examples which the *FSA* considers that a *firm* should consider (not every example will be relevant or appropriate to every situation or *firm*) include:
- (1) at an early stage, for example before it accepts a mandate to manage the offering, discussing or agreeing with its corporate finance *client* relevant aspects of the offering process, such as:
    - (a) the process the *firm* proposes to follow in order to determine what recommendations it will make about allocations for the offering;
    - (b) details of how the target investor group, to whom it is planned to offer the *securities*, will be identified;
    - (c) the process through which recommendations on allocation and pricing are prepared, and by whom; and

- (d) (if relevant) that it may recommend placing *securities* with an investment *client* of the *firm* for whom the *firm* provides other services, with the *firm's* own proprietary book, or with an *associate*, and that this represents a potential conflict of interest;
- (2) having internal arrangements designed to ensure that the *firm* will give unbiased and full advice to the corporate finance *client* about the valuation and pricing for an offering (the *FSA* accepts that valuation is a complex process and great precision may not always be possible in a *security* offering);
- (3) having internal arrangements under which individuals or business units in the *firm*, whose responsibilities are ordinarily to provide services to the *firm's* investment *clients* (that is, those on the investment *client* side of the *Chinese wall*), are not involved directly in decisions about recommendations to a corporate finance *client* on pricing (although they might, for example, be permitted to provide information about likely investor interest to those advising the corporate finance *client*);
- (4) ensuring that its systems, controls and procedures to identify and manage conflicts of interest also cover the allocation process for an offering of *securities*; for example:
  - (a) having internal arrangements under which the allocation process and the development of recommendations on allocation (names and amounts proposed to be allocated) are made to the corporate finance *client* only by staff who do not have any responsibilities for servicing investment *clients*;
  - (b) inviting the corporate finance *client* to participate actively in the allocation process so that its proper interests can be taken into account effectively, including making available to the corporate finance *client* appropriate information to support the proposed recommendations on allocation;
  - (c) basing recommendations about allocation and pricing on objectives agreed with the corporate finance *client*;
  - (d) making the initial recommendation for allocation to *private customers* of the *firm* as a single block and not on a named basis;
  - (e) having internal arrangements under which senior personnel in the department (or equivalent business unit), who are responsible for providing services to *private customers*, make the individual allocation recommendations for allocation to *private customers* of the *firm*; and
  - (f) disclosing to the *issuer*, after completion of the transaction, details of the allocations which were actually made; and
- (5) having internal arrangements under which allocation recommendations are not determined by the level of business which a *firm* does or hopes to do with any other *client* (see also *COB 2.2* (Inducements and soft commissions)); for example:
  - (a) any allocation to a *private customer* of the *firm* should be justifiable in terms of the process for developing allocation recommendations which

was disclosed to the corporate finance *client* at the outset (as well as in terms of any other obligations which the *firm* may have - for example under *COB* 5.3 (Suitability) or *COB* 7.7 (Aggregation and allocation)); and

- (b) any recommendation for allocation to the proprietary trading desk of the *firm* or to an *associate* or *affiliate* of the *firm* should be justifiable in terms of the objectives of the allocation policy and should be consistent with the process for developing allocation recommendations disclosed by the *firm* at the outset.

- 5.10.6 G One control which a *firm* might use is a review by the compliance function after the event of how well the *firm's* conflicts of interest management processes worked in relation to an issue. This might be of particular use if there are significant differences between the recommendation on price and subsequent market behaviour. The review might examine how the recommendations of the *firm* on pricing were reflected in market dealings after the issue. If significant differences are observed, it may be appropriate to identify why, and what that discloses about the way in which the *firm's* systems and controls operated in relation to that offering. The frequency of any review is a matter for the *firm*, in the light of its business and structure.

**Securities offerings: behaviour in breach of the Principles**

- 5.10.7 G (1) For the avoidance of doubt, the *FSA* considers that the following would each be a breach of the *Principles* referred to in *COB* 5.10.2G, and a breach of *COB* 2.2.3R:
- (a) an allocation made as an inducement for the payment of excessive compensation in respect of unrelated services provided by the *firm*; for example, very high rates of commissions paid to the *firm* by an investment *client*, or an investment *client* providing very high volumes of business at normal levels of commission (which may also be a breach of *COB* 7.2 (Churning and switching));
  - (b) an allocation made to a senior executive or a corporate officer of an existing or potential corporate finance *client*, or of a *listed* company, in consideration for the future or past award of *corporate finance business*; and
  - (c) an allocation which is expressly or implicitly conditional upon the receipt of orders or the purchase of any other service from the *firm* by the investor, or any *body corporate* of which the investor is a corporate officer.
- (2) A *firm's* systems, controls and procedures should, therefore, be designed to prevent these sorts of behaviour.

- 7.1.1 ... R (1) ...
- (2) *COB* 7.1.4 E (1) and (2) do not apply in relation to investment research (see *COB* 7.3 (Dealing ahead of investment research)).

...

### 7.3 **Dealing ahead of investment research**

#### **Application**

- 7.3.1 R This section applies to a *firm* ~~when if it~~, or any of its *associates*, prepares *investment research* for publication or distribution to its *clients*, or intends to publish or distribute *investment research* to its *clients* ~~a written recommendation, or a piece of research or analysis, to *customers* that relates to a *designated investment*.~~

#### **Purpose**

- 7.3.2 G *Principle 6* (Customers' interests) requires a *firm* to pay due regard to the interests of its *customers* and treat them fairly. *Principle 8* (Conflicts of interest) requires a *firm* to manage conflicts of interests fairly, both between itself and its *customers* and between a *customer* and another *client*. In conjunction with *Principle 1* (Integrity), *Principle 2* (Due skill, care and diligence) and *Principle 5* (High standards of market conduct), they require a *firm* to manage conflicts of interest which may arise in a way which ensures that all its *clients* are treated fairly and which ensures that the *firm* is conducting its business with integrity and according to proper standards of business. This section aims to ensure that ~~either~~ a *firm* pays due regard to the interests of its ~~*customers*~~*clients* by ~~postponing~~ not undertaking an *own account* transaction when the *firm* or its *associate* publishes *investment research* ~~a written recommendation, except in very limited circumstances or, when this is not practicable or desirable generally in the interests of the *firm's* *customer*, that any dealing does not unfairly disadvantage the *customer*.~~

- 7.3.2A G The *FSA* regards circumstances in which a *firm* deals in *designated investments* that are the subject of *investment research* which it publishes to *clients* as a significant potential source of conflicts of interest. The conflicts involved are such that the *FSA* does not consider that they can be managed adequately by disclosure of their existence.

- 7.3.2B G The *FSA* considers that these conflicts of interest do not arise if equity analysts or others prepare research papers or analyses relating to *designated investments* solely for a *firm's* own internal use, for example, in order to inform its decisions about managing its proprietary trading or its strategic direction. The *FSA* considers that it is inappropriate for an analyst to prepare research papers or analyses which are intended, first for internal use by the *firm*, and then for later publication to *clients*.

#### **Requirement not to undertake to postpone own account transactions**

- 7.3.3 R If a *firm* or its *associate* intends to publish or distribute *investment research* to *customers*~~*clients* or prepares *investment research* for publication or distribution to its *clients*~~ ~~a written recommendation, or a piece of research or analysis, that relates to a *designated investment*,~~ unless COB 7.3.4R applies, the *firm* must:

- (1) ...
- (2) ...

until the *customers/clients* for whom the publication was principally intended have had (or are likely to have had) a reasonable opportunity to act upon it.

...

### Exceptions

7.3.4 R COB 7.3.3 R does not apply if:

- (1) ~~the publication could not reasonably be expected to affect significantly the price of the designated investment concerned or any related designated investment; or [deleted]~~
- (2) ...
- (3) ... ~~or~~
- (4) ~~the firm has taken reasonable steps to ensure that it or its associate needs to deal to fulfil a customer order that is likely to result from the publication, and that doing so will not cause the price of the designated investment or related designated investment that is the subject of the written recommendation, or piece of research or analysis, to move against a customer's interest by a material amount; or [deleted]~~
- (5) ~~the firm or its associate discloses in the publication that the firm or its associate has undertaken or may undertake an own account transaction in the designated investment concerned or any related designated investment. [deleted]~~

7.3.5 G The exceptions in COB 7.3.4R (2) and (3) allow a firm to continue to provide key services to the market and to its customers even if the firm would be considered to have knowledge of the timing and content of the investment research which is intended for publication to clients when, for example, it is impracticable for the firm to put in place a Chinese wall because the firm has few employees or cannot otherwise separate its functions.

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7.13.6A G For the purposes of COB 7.13.6 R(2), the FSA considers that an investment analyst is likely to be involved to a material extent in the firm's designated investment business.

### Reasonable steps

7.13.7 E (1) For the purposes of COB 7.13.4R, a firm's "reasonable steps" should ensure that:

(a) ...

(aa) an investment analyst may not undertake a personal account transaction in a designated investment if the investment analyst prepares investment research which is published or distributed to clients:

(i) on that designated investment or its issuer; or

(ii) on a related investment, or its issuer;

unless the *personal account transaction* is:

- (iii) not contrary to any published or distributed recommendation for which he is responsible as an *employee* of the *firm*, which has not been withdrawn; or
- (iv) to realise the cash value of a holding or position, is undertaken in order to meet an obligation of the *investment analyst* which is not related to any *designated investment* within (i) or (ii), and is one to which the *firm* has given its permission in writing;

(b) ...

(c) ...

...

7.13.10A G (1) Because of the nature of the conflicts of interest that arise, a *firm* may decide:

(a) that an *investment analyst* should be prohibited from carrying out any *personal account transactions* at all; or

(b) that an *investment analyst* should be prohibited from undertaking a *personal account transaction* in a *designated investment* if the *investment analyst* prepares *investment research*:

(i) on that *designated investment* or its *issuer*; or

(ii) on a related *investment*, or its *issuer*; or

(iii) on a *designated investment* or an *issuer* which belongs to the same industry or business sector as that *designated investment*;  
or

(c) that there should be a prohibition on *personal account transactions* by *investment analysts* for a limited time covering a period before and after the intended publication date for *investment research*.

(2) If a *firm* does impose a prohibition, it may wish to make clear to the *employee* whether or not the prohibition extends to the sorts of transaction which the *Glossary* excludes from the definition of *personal account transaction* (for example, transactions in *units* in *regulated collective investment schemes*, and certain discretionary transactions).

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## Annex B

### Amendments to the Glossary

Insert the following new definitions in the Glossary in the appropriate alphabetical position:

- investment analyst* an *employee* of a *firm* who prepares *investment research* or the substance of *investment research*.
- investment research* a *document* (other than a *personal recommendation*), or material the substance of which is common to a number of documents although worded as if they are *personal recommendations*, which contains one or more of the following:
- (a) the results of research into a *designated investment* or its *issuer*;
  - (b) analysis of factors likely to influence the future performance of a *designated investment* or its *issuer*; and
  - (c) advice or recommendations based on those results or that analysis.