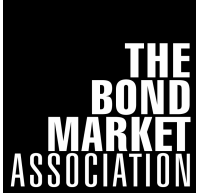


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9. January 2004



Laurence White  
Business Standards Department  
The Financial Services Authority  
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**Re: Submission of The Bond Market Association In Response To The Financial Services Authority ("FSA")'s Consultation Paper 205: Conflicts of Interest: Investment Research And Issues of Securities.**

Dear Mr White:

The Bond Market Association ("the Association")<sup>1</sup> is pleased to comment in response to FSA's Consultation Paper 205 ("CP205"). The Association's members have significant operations in the U.S., Europe, and in other countries, and the Association is committed to maintaining the highest standards of conduct in the fixed income markets as they relate to the proper management of conflicts of interest and the publication of research. We discuss some recent initiatives of the Association below.

1. **Executive Summary**

In summary:

- The Association agrees that potential conflicts between publication of research and the objective of gaining or maintaining investment banking business must be, and must be seen to be, properly managed and controlled if investors are to have confidence in investment research.
- The Association has published an exposure draft of the Association's "Guiding Principles to Promote the Integrity of Fixed Income Research"<sup>2</sup> which are intended to enhance investor protection by promoting greater awareness of how potential conflicts of interest can be managed by multi-service financial institutions that underwrite and trade debt securities and distribute to investors research about those securities.

***Comments On Proposed Draft Handbook Text: Conflicts of Interest - Investment Research***

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<sup>1</sup> The Bond Market Association is an international trade association representing securities firms and banks that underwrite, distribute and trade in fixed income securities. More information about the Association is available on its website, [www.bondmarkets.com](http://www.bondmarkets.com). This letter has been prepared in coordination with members of the [Association's European Fixed Income Research Committee.



- The Association finds much to welcome in the FSA's proposals as set out in the draft handbook text in Annex 8 to CP205. In particular, we welcome the FSA's recognition that the regulatory approach should differentiate, in some way, between the treatment of the conventional research product and other communications and should rely on firms' internal policies for the management of conflicts of interest. In this respect, the FSA's approach is broadly consistent with the Association's Guiding Principles.
- However, in a number of respects, the FSA's proposals adopt an approach which differs from that taken by the Guiding Principles. In particular:
  - The Guiding Principles focus the heightened procedures on research reports produced by persons principally engaged in the preparation of reports or which are held out as fixed income research reports, rather than whether they are held out as "objective". This label is not, in any event, helpful as a means of distinguishing to which communications heightened procedures should apply.
  - The Guiding Principles recommend specific disclosures about potential conflicts of interest, not the publication of the firm's policy, which will provide little additional useful information to clients or other users of research.

#### *Comments On Made Handbook Text*

- The Association has significant concerns in relation to the made handbook text on dealing ahead of research and personal account dealings, which take a very different approach to that set out in the Guiding Principles in a number of important respects. We will be commenting separately on these.

The attachment summarises our responses as they relate to the specific questions raised in CP205 in so far as relevant to the fixed income activities of our members.

## 2. **Regulatory Objective**

The Association continues wholeheartedly to agree with the FSA's fundamental premise that investors should be able to make their investment decisions on the basis of research that is not biased by conflicting pressures to which investment banks, or their analysts, may be subject. We also agree that potential conflicts between publication of research and the objective of gaining or maintaining investment banking business must be, and must be seen to be, properly managed and controlled if investors are to have confidence in investment research.

## 3. **The Association's Guiding Principles**

It is in this context that the Association has published an exposure draft of the Association's "Guiding Principles to Promote the Integrity of Fixed Income Research."

The exposure draft includes the guiding principles, detailed recommendations supporting those principles, and accompanying commentary regarding fixed income research practices (collectively, the "Guiding Principles"). Taken as a whole, the Guiding Principles are intended to enhance investor protection by promoting greater awareness of how potential conflicts of interest can be managed by multi-service financial institutions that underwrite and trade debt securities and distribute to investors research about those securities.

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<sup>2</sup> Available at [www.bondmarkets.com/market/research\\_principles.pdf](http://www.bondmarkets.com/market/research_principles.pdf).



The Guiding Principles represent an extensive collaborative effort of Association member firms to share their thinking about recommended practices and to standardize to the greatest extent possible those practices, so that market participants have a common framework for evaluating and understanding the role and function of fixed income research and the various disclosures made by member firms. They articulate voluntary recommendations that are not intended to be a set of immutable rules or to replace the need for individual member firms to develop and implement their own tailored procedures. They are designed to serve as a helpful reference point as firms review and modify their own fixed income research policies.

The principles-based approach outlined in the Guiding Principles will help to ensure that the differing organizational structures and geographical markets of Association member firms, their multiple uses of fixed income research, as well as the unique attributes of the fixed income markets (even within and among the multiple asset classes that comprise the global bond markets), are appropriately reflected in the specific fixed income research policies and practices adopted by individual member firms. In our view, this is the best and most efficient way to ensure a behavioural framework that promotes reliable information flow to debt market participants, including investors and issuers.

Although much of the public and regulatory focus in recent years has been in the area of equity research, the Association believes it is critically important to address the issue of research integrity in the fixed income markets in a manner that takes into account their unique characteristics. Differences such as the quantitative content of fixed income research, the reference to objective benchmarks and relative values, the existence of independent research resources, the important role of the sales and trading function in producing quality and relevant information for investors, and the sophistication of market participants warrant a unique approach than that employed to manage potential conflicts of interest involving equity research, as the regulatory community has itself acknowledged. Nevertheless, it is incumbent on firms to manage potential conflicts that fixed income research analysts may face by taking steps to prevent inappropriate influences over fixed income research and to disclose to investors the existence of material potential conflicts.

#### **4. Comments On Proposed Draft Handbook Text: Conflicts of Interest - Investment Research**

Accordingly, the Association finds much to welcome in the FSA's proposals as set out in the draft handbook text in Annex 8 to CP205. In particular:

- We welcome the FSA's recognition that the regulatory approach to the management of conflicts of interest should differentiate between the treatment of the conventional research product and other communications (such as trader commentary). The Association considers that this approach is broadly consistent with the approach set out in the Guiding Principles, which draw the distinction between "research reports" and other material.<sup>3</sup> It would not be appropriate to apply the same heightened procedures to all communications issued by a firm merely because they include analyses or recommendations.
- We welcome the proposal to address the issues associated with conflicts of interest through reliance on firms' internal policies for the management of conflicts of interest. The Association considers that this approach is broadly consistent with the approach set out in

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<sup>3</sup> See Section 3.2.1 of the Guiding Principles.

the Guiding Principles, which aims to allow firms to tailor their own policies to fit differing organizational models and the differing uses for research in market segments such as fixed income markets.<sup>4</sup> The Association believes that a principles-based approach, which encourages firms to adopt and apply appropriate internal policies, is a more flexible and proportionate response to the issues relating to conflicts of interest in relation to research, and should avoid applying detailed, overly prescriptive rules that are more likely to be inappropriate to particular market segments.



- We welcome the recognition that the issues regarding the interaction between research departments and sales and trading areas are not the same as those that exist in relation to the interaction with investment banking. Again, the Association considers that this is consistent with the approach set out in the Guiding Principles.
- We welcome the decision to defer detailed consideration of the disclosure requirements in relation to research and to review the comments received in the context of the FSA's implementation of the Market Abuse Directive. A number of the requirements set out in the European Commission's proposals for implementing measures under article 6(5) of that Directive would require disclosures which go beyond those recommended in the Guiding Principles in a way that the Association considers unnecessary or inappropriate in the context of fixed income research. We would urge the FSA to adopt an approach to implementation of that Directive which takes account, so far as it is able to do so, of the critical differences between the fixed income and equities markets.
- We welcome the proposal not to proceed with prescriptive guidance on quiet periods, cessation of coverage and self-certification.

Nevertheless, the Association would make the following comments on these proposals.

*Application of policies to "objective" research*

- The Association considers that it is not helpful to define the communications to which heightened procedures apply by reference to a test of whether the communication is held out as an "objective" assessment of the value or prospects of its subject matter. The Guiding Principles take a somewhat different approach to this issue which the Association considers to be an appropriate way of identifying the types of communications to which heightened procedures should apply. The definition of "fixed income research report" in the Guiding Principles covers communications produced by persons principally engaged in the preparation or publication of such reports or which are held out as fixed income research reports, as well as specifically excluding certain other categories of communication.<sup>5</sup>
- In any event, the Association does not consider it helpful to focus on whether the research is held out as being "objective", when research necessarily involves the expression of subjective opinions. Rather, the Association's aim in developing the Guiding Principles has been to establish a behavioral and organizational framework for fixed income that promotes an "independent" information flow to debt market participants.<sup>6</sup>

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<sup>4</sup> See Section 1.2 of the Guiding Principles for a discussion of some of the differences between fixed income and equity research.

<sup>5</sup> See Section 3.2.1 of the Guiding Principles.

<sup>6</sup> See Section 2 of the Guiding Principles.



- In particular, a firm should not be regarded as publishing objective (or independent) research, merely because "it is reasonable for [recipients of the research] to rely on it" as such, regardless whether that is because of anything said or done by the firm and regardless of whether the firm could reasonably foresee that this was likely to be the case.<sup>7</sup> We do not consider it necessary for there to be "anti-avoidance measures" in this context. The definition should at least be limited to cases where things said or done by the firm may reasonably be regarded as inviting recipients to rely on the research as independent.
- In any event, we do not consider that the fact that research may be held out (or regarded) as objective or independent should be the unique factor that triggers the application of heightened procedures. Some or all of the communications specifically excluded from the definition of "fixed income research report" in the Guiding Principles (such as reports discussing broad based indices but not discussing specific issuers) might be held out or regarded as independent. However, it would not be necessary or appropriate to apply the same rules to them as apply to other types of communication, especially having regard to the very limited possibility of conflicts arising from investment banking activity.
- In addition, the FSA's proposed rules and guidance that follow the initial general rule<sup>8</sup> appear to apply to all types of "investment research" published by the firm, without distinction, regardless of whether it is held out as objective (or independent). Thus, for example, on its face, all the proposed guidance would apply to communications such as trading desk commentary and sales notes (which may be "investment research" within the broad definition inserted into the handbook). This approach differs from the approach taken in the Guiding Principles, which distinguish between fixed income research reports and other communications. Although the recommendations in the Guiding Principles mainly focus on the appropriate procedures and disclosures for fixed income research reports as such, the Guiding Principles also contain recommendations which address those other categories of communications in an appropriate way.<sup>9</sup>

#### ***Requirement to publish research policies***

- The Association agrees that it is important that firms develop appropriate policies for managing potential conflicts of interest and that firms should disclose relevant information about potential conflicts of interest.<sup>10</sup> However, the Guiding Principles do not include a recommendation that firms publish their conflict management policies. The Association does not believe that disclosures of this kind would provide useful information to clients and other users of research. The proposed requirement on firms to publish their policy also goes beyond the proposed requirements under the Market Abuse Directive, which would only require disclosure of, in general terms, the effective organisational and administrative arrangements for the prevention and management of conflicts of interest.<sup>11</sup>
- If there is to be any requirement to disclose a firm's policy, the requirement should only be to disclose a summary of the main features of that policy. It should not require disclosure of

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<sup>7</sup> See proposed COB7.16.7R(1)(b).

<sup>8</sup> See proposed COB7.16.7R(2) through to COB7.16.16G.

<sup>9</sup> See Section 4.9 of the Guiding Principles.

<sup>10</sup> See Section 4.6 of the Guiding Principles.

<sup>11</sup> See article 6(2) of the proposed Commission Directive implementing Article 6 paragraph 5 of the European Parliament and Council Directive 2003/6/EC on Insider Dealing and Market Manipulation (Market Abuse).

the detailed requirements of that policy or the systems, controls and procedures supporting that policy. For example, if a firm has adopted a policy based on the Guiding Principles, it should be enough to publish the ten high level principles, rather than any detailed material spelling out their application to particular situations.

- In addition, it should be sufficient to make available the required disclosure to the firm's clients to whom it distributes its research (e.g. through the firm's research website or in writing to a client on request).

#### *Other issues*

- The FSA's commentary appears to suggest that it would be inappropriate for an investment analyst to attend roadshows even in a passive capacity.<sup>12</sup> The Guiding Principles recognise that it is appropriate to restrict the extent to which analysts can actively participate in roadshows (e.g. as presenters) but do not recommend restrictions on mere passive attendance.<sup>13</sup> The Association believes that it is important that analysts can attend roadshows in a passive capacity.
- The FSA's proposed guidance would restrict reporting structures which give day-to-day supervision or control of analysts to anyone whose "responsibilities ... might reasonably be considered to conflict with the interests of the clients to whom the investment research is published or distributed".<sup>14</sup> The Guiding Principles focus on supervisory and management structures that insulate research analysts from review, pressure and direct oversight by investment banking personnel.<sup>15</sup> The Association believes that this is a more appropriate approach.
- The FSA's proposed guidance recognises that an analyst's remuneration can be linked to the general profits of the firm. The Guiding Principles recognise that the remuneration of an analyst can be linked to a broad range of permissible factors, including factors such as the profitability or revenues of the firm's fixed income division.<sup>16</sup>
- The FSA's proposed definition of "relevant issuer" would cover covers issuers of investments, which have only a very limited connection with the covered investments. It is not at all clear that it is appropriate to the context or indeed necessary at all.<sup>17</sup> It would be sufficient to refer to the "issuer of the relevant investment" in all cases in the text of COB7.16.

#### *Territorial application*

- The FSA's guidance should make clear how it applies where the UK firm is distributing (or approving for distribution) material produced in other locations (or legal entities). It may be impractical to impose UK standards on the production of such material, especially if those standards are not in line with globally accepted standards. On the other hand, it will often

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<sup>12</sup> See paragraph 3.46 of CP205 and contrast proposed COB7.16.12G(2)(b).

<sup>13</sup> See Section 4.7.2 of the Guiding Principles.

<sup>14</sup> See proposed COB7.16.10G.

<sup>15</sup> See Section 4.2 of the Guiding Principles. *But see* Section 4.1.3 of the Guiding Principles which recommends that decisions regarding research coverage and timing should be made by research department personnel.

<sup>16</sup> See Section 4.4 of the Guiding Principles.

<sup>17</sup> The definition of "relevant issuer" only now appears to be used in COB7.16.13G, where it seems inappropriate.

be impractical to disclose the policies of each and every contributor to the research process. The FSA's guidance should recognise the limited role that UK policies play in relation to such activities.

5. **Made Handbook Text: Dealing Ahead Of Research and Personal Account Dealing**

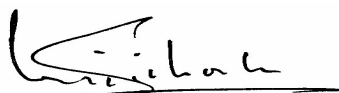
The Association has significant concerns in relation to the rule changes adopted by the FSA relating to dealings ahead of research and personal account dealing. These restrictions take a very different approach from that set out in the Guiding Principles, in particular as regards dealings ahead of research. The Guiding Principles recommend that firms prohibit traders and other firm personnel from using knowledge of the timing or material investment conclusions in a pending research to trade in covered securities or related derivatives.<sup>18</sup> However, these recommendations only apply in relation to communications which amount to a fixed income research report (and not trader commentary or sales notes or reports which do not include analysis or recommendations of a specific debt security or issuer<sup>19</sup>), where the report can be expected to have an immediate impact on the price of the debt securities (or their derivatives) and then only when the traders use privileged access to information about the timing or content of the forthcoming report. The Association will be commenting separately to FSA about these issues.

6. **Need for Evidence-Based And Proportionate Rulemaking**

While the Association welcomes many of the steps that the FSA has taken to improve on the proposals in CP171, we continue to believe that new regulation should be promulgated only to the extent that existing rules are found to be inadequate and should focus on areas where there is evidence of practical issues arising. We do not consider that the cost-benefit analysis in CP171 or CP205 justifies the changes made or proposed in relation to fixed income research. In particular, we do not consider that there has been an adequate cost benefit analysis in relation to the deletion of the exemptions from the dealing ahead restrictions, especially as they relate to trader commentary and other material produced in the sales and trading area and material produced which is not likely to have any price impact. We consider it vital that the FSA upholds the principle of justifying new regulation by reference to rigorous standards.

We would be pleased to discuss in greater detail any of the issues raised in this letter. Please do not hesitate to contact Scott-Christopher Rankin, Executive Director of BMA, at +44.20.77 43 93 33.

Yours sincerely,



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<sup>18</sup> See Section 4.8.1 of the Guiding Principles.

<sup>19</sup> See Section 3.2.1 of the Guiding Principles.



## Responses to FSA's specific questions

*Q1: Do you agree with our narrowing the scope of our proposals to investment research held out, or reasonably relied on, as objective?*

We welcome the FSA's recognition that the regulatory approach should differentiate, in some way, between the treatment of the conventional research product and other communications and should rely on firms' internal policies for the management of conflicts of interest. However, we discuss in our response the concerns we have as to the proposed method for distinguishing research to which heightened procedures apply, in as much as it differs from the approach proposed in the Guiding Principles.

*Q2: Is the concept of investment research held out, or reasonably relied on, as objective clear enough?*

As indicated, we have concerns as to the proposed concept, which we believe is likely to be over-inclusive. The FSA should at least recognise that heightened procedures may not be appropriate in relation to all categories of research that may be held out as produced independently of other activities, for example because they do not raise the same issues with respect to conflicts of interest. The Guiding Principles recognise this by excluding certain categories of communication from their definition of fixed income research report.

*Q3: Do you agree with our decision not to specify what kinds of investment research must be held out as objective and what need not be?*

We agree that the FSA should not seek to prescribe which types of research should be subject to heightened procedures.

*Q4: What kinds of research do you anticipate or intend: a) would be produced under the controls we propose? b) would be produced outside the controls?*

In the fixed income area, we would expect that firms which use the Guiding Principles as the reference point for their own policies would apply the heightened procedures they recommend to the categories of communication falling within their definition of fixed income research report.

*Q5: How do you think consumers of research or their clients might use the regulatory distinction we are seeking to draw?*

We do not consider that users of research or their clients will find the regulatory distinction between "objective" and other research helpful.



*Q6: Do you agree that investment research can and should be clear, fair and not misleading even if not produced in line with our guidance for objective investment research?*

Yes.

*Q7: Do you agree with our proposal requiring firms providing objective investment research to have and enforce a conflicts management policy, and to make that policy publicly available?*

We agree that firms should have an appropriate conflicts management policy in relation to their fixed income investment research activities and should make appropriate disclosures with respect to actual or potential conflicts of interest in relation to those activities. However, we do not consider that the publication of firms' policies would provide clients or other users of research with useful information. In any event, any requirement to publish conflict management policies should be limited in an appropriate way to ensure that it is practical and not unduly burdensome.

*Q8: Do you believe that our proposed policy requiring firms to have a conflicts management policy for investment research they hold out as objective can appropriately be applied to investments other than equities?*

We agree that firms should have an appropriate conflicts management policy for their fixed income investment research activities, as well as for their equities business.

*Q9: Do you agree that our proposals should cover conflicts of interest in small firms and non-sell-side firms?*

We have no comment on this aspect of the FSA's proposals.

*Q10: Are there any particular difficulties which small firms and non-sell-side firms will have in complying with our revised conflict management standards?*

We have no comment on this aspect of the FSA's proposals.

