

European Office/Europabüro:
St. Michael's House
1 George Yard
London EC3V 9DH
Great Britain/Großbritannien
Tel +44.20.77 43 93 00
Fax +44.20.77 43 93 01

New York Office:
360 Madison Avenue
New York, NY 10017-7111
United States
Tel +1.646.637.9200
Fax +1.646.637.9126
www.bondmarkets.com

Washington Office:
1399 New York Avenue, NW
Washington, DC 20005-4711
United States
Tel +1.202.434.8400
Fax +1.202.434.8456



15 September 2004

Fionnuala O'Brien
Financial Services Authority
25 North Colonnade
Canary Wharf
London E14 5HS

Dear Ms O'Brien,

UK Implementation of the EU Market Abuse Directive - Research Recommendations

The Bond Market Association (the "Association")¹ welcomes this opportunity to respond to the consultation document published in June 2004 by HM Treasury and the Financial Services Authority ("FSA") on the UK implementation of the EU Market Abuse Directive ("MAD"). In this letter we focus on certain of the proposed amendments to the Conduct of Business sourcebook implementing article 6(5) MAD relating to research recommendations which are of particular relevance to fixed income research.

There are four issues which are of particular concern to participants in the fixed income markets, namely the application of the new rules to material produced by sales and trading personnel, the application of the new rules to research falling outside the minimum requirements of the directive, the requirements for the disclosure of "other significant financial interests" and the requirements for quarterly disclosures relating to "buy", "sell", "hold" or equivalent recommendations (and certain related disclosures). We discuss each of these in turn and propose possible solutions.

However, we should stress that these are clearly not the only issues of concern regarding the proposals on research recommendations. We are aware of and generally support the other comments made jointly by the British Bankers Association and the London Investment Banking Association.

1. Definition of research recommendations - application of new rules to material produced by sales and trading personnel

1.1 Background

Under the FSA's proposals, the MAD's new disclosure rules will apply to "research recommendations". The FSA's definition of this term for the most part "copies out" the

¹ 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. This letter has been prepared by the Association's European staff in coordination with members of the Association's European Fixed Income Research Task Force.

definition of "recommendation" in the Commission directive implementing MAD.² The proposed definition covers, in summary, research or other information (in written or oral form) concerning securities, derivatives or issuers which is accessible or likely to become accessible by a large number of persons or the public and which recommends or suggests investment strategy, expresses a particular investment recommendation or expresses an opinion as to the present or future value of securities or derivatives. The definition provides for a specific exception, based on a recital to the Commission directive,³ covering informal short-term investment recommendations, although this is limited to personal recommendations expressed to clients which originate from inside the sales and trading department and which are not likely to become publicly available or available to a large number of people.

The definition of "research recommendations" differs, in a number of respects, from the definition of "investment research" which applies for the purposes of other provisions of the FSA's handbook, including the provisions of the handbook requiring firms not to deal ahead of investment research.⁴ In particular, the definition of investment research explicitly limits the scope of the definition to documents that contain research or analysis or advice or recommendations based on research or analysis. The guidance issued by a number of industry associations confirms that the definition is intended to refer to substantive analysis - i.e. the critical and careful consideration and assessment of new and existing facts - and that, accordingly, in practice, much sales and trading material, such as "sales notes", execution ideas, market or trader commentary and other short term recommendations, will ordinarily fall outside the FSA's definition of "investment research".⁵ Nevertheless, that guidance indicates that some such material (e.g. some of the more considered "sales notes") could fall within the definition and that firms cannot therefore assume that there is a blanket carve-out for sales and trading material from the rules relating to dealing ahead of investment research.

1.2 *Issue*

Our members continue to have significant concerns about the inappropriate application of rules aimed at regulating research to trader commentary, trade execution ideas and other written or electronic analyses produced by sales and trading personnel which are not held out as being an impartial analysis. The Association's Guiding Principles to Promote the Integrity of Fixed Income Research (the "Guiding Principles")⁶ specifically exclude this material from the definition of fixed income research subject to the full requirements of the Guiding Principles.⁷ Although trader commentary should represent the honest opinion of the writer, counterparties generally understand that it is part of the trading desk's trade execution and/or market making function and that, because the debt markets are principal

² Directive 2003/125/EC.

³ Recital 3 to Directive 2003/125/EC.

⁴ COB 7.3.

⁵ See Industry Guidance on COB 7.3 issued by the British Bankers' Association, the International Primary Market Association, the International Securities Market Association and the London Investment Banking Association (9 February 2004), available at www.bba.org.uk.

⁶ Guiding Principles To Promote The Integrity of Fixed Income Research - A Global Approach To Managing Potential Conflicts of Interest (May 2004), available at www.bondmarkets.com.

⁷ See paragraph 3.2.1.1 of the Guiding Principles.

markets, trading desk personnel typically write about securities in which the desk has a position and in which it will trade as principal. Accordingly, counterparties understand that the trading desk may have an interest in the securities that are the subject of the trader commentary and that the commentary should not be relied upon as impartial. The Guiding Principles indicate that firms should clearly identify such material as being produced by trading desk personnel and as not being research produced by the fixed income research department, and prescribe a limited range of disclosures for such material.⁸

Our members are concerned that the MAD's broad-ranging disclosure requirements will, like the rules on dealing ahead, further limit the ability of firms' UK sales and trading personnel to provide commentary and analysis to institutional clients and counterparties. It would be difficult for firms to ensure compliance with these requirements in relation to much trader commentary, trade execution ideas and other written or electronic analyses produced by sales and trading personnel. The specific exception for short-term recommendations is, as already noted, limited to personal recommendations and therefore will be of limited assistance in relation to material directed at clients and counterparties more generally.

1.3 *Proposed solution*

We propose that the FSA's implementing measures should include guidance making it clear that, except in so far as it also covers oral recommendations, the coverage of the proposed definition of research recommendation is a subset of the coverage of the definition of investment research. This would, at least, make clear that the definition of research recommendation is limited, like the FSA definition, to recommendations including substantive analysis and that, accordingly, it does not cover sales and trading material, such as "sales notes", execution ideas, market or trader commentary and other short term recommendations which do not involve such analysis, even if they are not personal recommendations within the specific exception and irrespective of the number of recipients.

This guidance would not fully address our concerns regarding the inappropriate application of the new rules to material produced by sales and trading personnel; however, it would go some way towards ensuring that the new requirements are not significantly more extensive in their scope than the existing rules on dealing ahead of research and should enable firms at least to rely on the industry guidance relating to COB 7.3 in applying these new requirements as well.

2. **Definition of research recommendations - extension of scope of Directive requirements**

2.1 *Background*

The FSA's proposed definition of "research recommendation" covers recommendations concerning securities or derivatives or issuers of securities or derivatives, without limitation. In contrast, the Commission's implementing directive is limited to recommendations concerning financial instruments within the scope of MAD itself, i.e. those admitted to trading on an EU regulated market or the subject of an application for such admission.⁹ For

⁸ See section 4.9 of the Guiding Principles.

⁹ See article 9 MAD.

example, the directive does not require the UK to apply these disclosure rules to research relating to over-the-counter derivatives, foreign exchange or interest rates, securities that are only listed on non-EU markets or unlisted securities.

2.2 *Issue*

A number of the requirements of the directive, such as those relating to conflicts of interests relating to the issuers of those investments, are not readily applicable to other research. The FSA presents no cost-benefit analysis for its proposal to extend these disclosure requirements beyond the minimum requirements of the directive.

2.3 *Proposed solutions*

The FSA should restrict the definition of research recommendation to the requirements of the directive or at least to publicly traded securities or derivatives.

3. **Disclosure of other significant financial interests**

3.1 *Background*

The proposed handbook text would require a firm to disclose in research recommendations:

- "all of its relationships and circumstances that may reasonably be expected to impair the objectivity of the research recommendation, in particular a significant financial interest in any relevant investment which is the subject of the research recommendation";¹⁰ and
- "any other significant financial interests held by the firm or any affiliated company in relation to the relevant issuer".¹¹

3.2 *Issue*

These requirements have generated considerable concern among our members.

The Directive will impose new requirements for disclosures in fixed income and equity research of major shareholdings (exceeding 5%) in an issuer.¹² Many countries already have requirements to disclose large shareholdings to the market and some countries already have requirements to include statements of significant shareholdings in equity (and, in some cases, other) research. The systems designed to facilitate compliance with these requirements will at least be a starting point for the systems required to meet the disclosures required under the MAD, although this will still require a major effort as the percentage thresholds, methods of calculation and other precise requirements differ significantly from country to country.

In contrast, there are no corresponding existing requirements for disclosures of holdings of fixed income securities. In general, the rationale underlying requirements to disclose large shareholdings to the market is a desire for transparency in the market for corporate control. Similarly, the fact that bonds do not have general voting rights means that bond holdings have up to now not been regarded as presenting the same potential for conflict of interest

¹⁰ Proposed text for COB7.17.10R(1)(a), reflecting article 5(1) of Commission Directive 2003/125/EC.

¹¹ Proposed text for COB7.17.11R(1)(b), reflecting article 6(1)(b) of Commission Directive 2003/125/EC.

¹² Article 6(a) of Commission Directive 2003/125/EC.

regarding research. In any event, the multiplicity of different types, terms and circumstances of issue mean that it is much more difficult to determine a single standard of significance comparable to that used for voting equity shares. Firms have not up to now been required to have systems to produce disclosures that may be relevant to any user of fixed income (or for that matter, equity) research.

Furthermore, our members will often have many different financial relationships with issuers of securities going beyond holdings of shares or bonds. For example, they may act as underwriter of the issuer's securities, make loans or provide other commercial banking services to issuers, act as counterparty to the issuer on over-the-counter derivatives transactions or provide other services, such as custodian, trustee, etc. They may also have indirect exposures which may be affected by issuers' financial or other performance through credit derivatives or as a result of the taking of short positions.

For the most part, member firms would expect to manage the conflicts of interest relating to these relationships by the use of information barriers which restrict the extent to which research personnel know about the extent of these other relationships. It is difficult to see how the existence of positions or holdings can "reasonably be expected to impair the objectivity of the research recommendation" when, as a result of the operation of information barriers, they are not known to the persons preparing the material.

In this respect, we are concerned about FSA's suggestion (in the last sentence of paragraph 4.77 of the consultation paper) that, where research passes through a firm's control room prior to its dissemination, firms should ensure that the interests known to the control room should be added to the research before its dissemination. Such a procedure would raise serious concerns about compliance with information barriers and the dissemination of confidential information (or potentially inside information) to research recipients and to research personnel, who always have access to their own research. FSA's comment would raise similar issues in relation to interests known to firm management, legal and compliance departments and other control functions which override information barriers.

3.3 *Possible solutions*

The FSA should make clear that interests of the firm should not be regarded as significant for these purposes unless those interests are known to the research personnel involved in producing the recommendation or are known to other persons who have access to the research recommendation before its publication, excluding those persons who have access to the research recommendation by virtue of procedures relating to the operation of the firm's information barriers (or unless information about those interests is publicly available). This would give effect to the overriding principle stated in recital 7 to the Commission's implementing Directive (acknowledged by the FSA in its consultation paper) that the Directive shall not require relevant persons to breach effective information barriers.

In cases where a firm's research analysts have information about a firm's interests in fixed income securities or other interests, for example where a firm's trader informs clients, and the analysts, about his positions, or the information about the firm's interests is publicly available, a workable solution would be for firms to be allowed to choose appropriate methods to:

- determine whether those positions or interests represent a significant interest requiring disclosure. Each member firm will have to consider what tests to apply in determining their significance having regard to its own situation. That is, significance is defined in relation to the firm publishing the research. What is significant to one firm may not be significant to another.
- determine the content of the disclosures to be made when a disclosure is required. Again, it seems that a diverse range of outcomes is possible and permissible under the directive. In particular, it should be enough for firms to disclose that they have a significant interest of a particular type without being required to quantify the size of the interest.
- provide additional background in their published policies (where necessary) to explain the method(s) adopted.

4. **Requirements for quarterly disclosures relating to "buy", "sell", "hold" or equivalent recommendations**

4.1 *Background*

The proposed handbook text would require a firm to disclose, in any research recommendation, for each quarter over the previous 12 months, "the proportion of all research recommendations that have been 'buy', 'hold', 'sell' or equivalent terms" and, in addition, the "proportion of relevant investments in each of those categories" issued by issuers to which the firm supplied material investment banking services during the previous 12 months.¹³

In addition, the proposed handbook text would require firms to ensure that if "a research recommendation differs from a research recommendation concerning the same security, derivative or issuer" issued during the previous 12 months "this change and the date of the earlier research recommendation are indicated clearly and prominently".¹⁴

These provisions largely copy out the corresponding text of the implementing directive, except that the proposed handbook requirement for periodic disclosures requires disclosure "for each quarter over the previous 12 months" (taking into account investment banking services supplied "during the 12 months prior to the relevant research recommendation") differs from the directive requirement for disclosure "on a quarterly basis" taking into account investment banking services supplied in "the previous 12 months".¹⁵

¹³ Proposed text for COB 7.17.11R(4), reflecting article 6(4) of Commission Directive 2003/125/EC.

¹⁴ Proposed text for COB 7.17.8R(1)(f), corresponding to article 4(1)(f) of Commission Directive 2003/125/EC.

¹⁵ Article 6(4) of Commission Directive 2003/125/EC. However, COB 7.17.8R(1)(f) appears incorrectly to transpose the implementing directive by using the glossary term "research recommendation" rather than simply "recommendation". It is reasonably clear that Commission Directive 2003/125/EEC uses the term "recommendation" in a number of places not in the defined sense set out in article 1(3), but in the sense of referring to the investment recommendation itself. Compare article 4(1)(c) where the term "recommendation" is also used, which the proposed text for COB 7.17.8R(1)(c) correctly transposes using the same word, rather than the glossary term "research recommendation". It is obvious that any new research recommendation will in fact differ from earlier research recommendations (otherwise there would be little point in issuing a new report). The key issue is whether the investment recommendation differs from prior recommendations.

¹⁵ Proposed text for COB 7.17.8R(1)(f), corresponding to article 4(1)(f) of Commission Directive 2003/125/EC.

4.2 *Issue*



Our particular concerns arise because a large part of fixed income research significantly differs from equity research. As more fully explained in previous correspondence with you, a large part of fixed income research involves an analysis of markets with a view to identifying particular trading strategies and developing short term trading recommendations in the light of particular market circumstances, rather than fundamental analysis of a particular issuer and its individual prospects. For example, these recommendations may involve an analysis focused on the relative value of two or more particular instruments or classes of instruments, or trading strategies involving cash instruments and futures, swaps or other derivatives and may recommend the purchase of one instrument or class of instruments or, sometimes the purchase of one instrument or class and sale of another (in each case either alone or in combination with other transactions).

While this research may use the terms "buy" or "sell" (or "hold") these are not used in the same way as in the context of equity research, which appears to be the sense in which these terms are used in the Directive, in that they are based on transitory market circumstances rather than fundamental credit analysis. However, it seems that, in some cases, this material taken as a whole could constitute a research recommendation within the definition, at least if it involves substantive analysis (see above) and is made available to a large number of people.

The issues this raises are made more complex by the nature of fixed income markets. For example, one recommendation may be for one issuer that applies to literally hundreds of bonds outstanding although each bond is not specifically identified. It would be extremely difficult to identify how many ratings this would be. In particular, it would be confusing if it were counted as one rating when a corresponding rating of another issuer counted as separate ratings just because the analyst specifically identified the ratings for each bond. In other cases, an analyst may have a "buy" recommendation on an issuer's long-dated paper and a "hold" recommendation on its short-dated paper where each category may encompass 20 bonds or more or even a "buy" and "sell" recommendation at the same time on the same bond in the context of different trading strategies.

We believe that it would defeat the purpose of the quarterly disclosure requirements if firms were required to include all their short-term trading recommendations in their calculations. It would distort the intended calculations, and obscure the intended information, if a firm had to count recommendations of this kind for these purposes. This is particularly important if the firm is aggregating both equity and fixed income research recommendations in producing the required quarterly disclosures.

Similar issues arise in relation to the requirement to disclose changes in recommendations. A single piece of fixed income research might include several individual trading recommendations, some involving the same instruments. These will inevitably differ from other trading recommendations included in other fixed income research issued by the same firm, sometimes contemporaneously, involving similar instruments. For example, a firm

¹⁵ Article 6(4) of Commission Directive 2003/125/EC.

¹⁵ Compare article 4(2) of Commission Directive 2003/125/EC.

may, over a period of 12 months, issue research containing a large number of differing trading recommendations involving particular classes of government bonds. To describe these as changes in recommendations would not be accurate when the different recommendations result not from a change in a fundamental view on the issuer but changing market conditions or the analysis of particular instruments in the context of differing trading strategies. It would not provide any meaningful information to investors if firms were required to track and tabulate information on the differences between and timing of these various different trading recommendations. The complex disclosures required could also be disproportionate in relation to the length of the research report, yet the directive would not allow the information to be presented by using a link to a website.¹⁶

This would also tend to obscure the information which the Directive was intended to ensure is disclosed to investors. The aim appears to have been to require firms to highlight to users of their research those changes in their evaluations of an issuer or its prospects that might be linked to conflicts of interest rather than fundamental changes in the actual position. Changes in trading recommendations of this kind do not provide useful information on these issues.

Finally, the proposed handbook requirement for disclosure of information "for each quarter over the previous 12 months" - requiring the disclosure to take into account investment banking services supplied "during the 12 months prior to the relevant research recommendation" - creates a super-equivalent and very demanding requirement to produce disclosures on a rolling basis. For example, when a firm publishes research on a particular date, the proposed handbook text appears to require the research to include an analysis as of four end dates during the previous 12 months, although it is not entirely clear whether the firm can select these at its discretion (whatever the dates selected, there will be difficulties if the firm is publishing the research very soon after one of the selected dates and the information about the recommendations published in the quarter ending on that date is not yet available). More importantly, the handbook text would seem to require the firm to make the analysis by reference to the identity of the companies to which investment banking services had been supplied in the 12 months prior to the issue of the research itself. In effect the firm would need to recalculate the analyses for each relevant quarter on every day that it actually issues research.

The directive requirement is much simpler and less burdensome. It requires disclosure "on a quarterly basis" taking into account investment banking services supplied in "the previous 12 months". A firm should be able to comply with the requirement by publishing the required analysis following the end of each calendar quarter (or other three month period selected by it) by reference to investment banking services provided during the 12 months prior to the end of that quarter (or other three month period) and including the latest such publication or a link to the latest such publication in the research recommendation.

4.3 *Possible solutions*

We believe that the objective of the quarterly disclosure requirements would be met by a calculation which is based on the disclosure of comparable investment recommendations. Thus, a workable solution would for firms to be allowed to:

¹⁶ Compare article 4(2) of Commission Directive 2003/125/EC.



- use for the purposes of the quarterly disclosure fixed income research recommendations which involve a fundamental credit analysis of a particular issuer and include an investment conclusions such as "underweight" or "overweight" or a similar opinion comparable to that contained in equity research (firms should be able to show the results on an aggregated basis for both equity and fixed income research or separately for the type of research - equity or fixed income - in respect of which the data is prepared);
- disclose the basis of the calculation to users of the research.

This form of calculation should be capable of indicating whether there is an unusual relationship between the firm's investment banking services and its investment conclusions in the manner which the Directive had in mind.

Similarly, we consider that the objective of the requirement to disclose changes in recommendations would be met by disclosures in cases where the changed recommendation relates to a change in the fundamental analysis of the issuer, rather than in every case where there is a previous, differing trading recommendation of the kind referred to above. However, again, firms should disclose the basis on which they comply with these requirements.

Finally, we consider that the handbook text should copy out the directive requirements for firms that are investment firms or credit institutions and that publish research recommendations to disclose the specified analysis "on a quarterly basis" and to include the latest such analysis or a link to that analysis in the research recommendations themselves.

5. Conclusion

Having considered the issues at length with our member firms and looked at constructive ways of meeting the requirements in the new handbook text, it is essential for our member firms to reach a common understanding with the FSA on the acceptability of our proposed solutions. Accordingly, we would welcome an opportunity to discuss these issues further with the FSA.

As can be seen, we are not seeking to exempt fixed income research from the scope of the directive. However, we believe that firms should be permitted to apply the directive's requirements in a way that is consistent with its intended objectives, rather than following a literal interpretation which prevents their achievement and causes, as things currently stand, some firms to produce less research. Please let us know if you have any questions on this letter. We have copied this letter to your colleague, Samantha Barrass, with whom we have had previous discussions on this and other research related issues.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Bertrand Huet", written over a horizontal line.

Bertrand Huet
Vice President
European Legal and Regulatory Counsel
On behalf of



Bunt Gosh
(Credit Suisse First Boston)

Stuart Parkinson
(Deutsche Bank)

Co-Chairs, BMA European Fixed-Income Research Task Force

Cc: Samantha Barrass, FSA