Regulation of Securities Analysts' Conflicts of Interest in Japan

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I. Introduction

On 17 March 2004 the Board of the Japan Securities Dealers Association amended its "Resolution on the Handling of Research Reports" ("the Resolution") with effect from 1 May. The Resolution was originally adopted in January 2002 as a set of self-regulating rules designed to ensure that reports by sell-side securities analysts are written and used in a fair and proper way.

In recent years regulators and self-regulating organizations have been endeavoring to preserve the integrity of sell-side securities analysts. Regulations have been introduced to ensure that investment recommendations by sell-side analysts are independent from other departments such as the investment banking department. This is because recommendations by sell-side analysts are a big influence on individual investors and need to be unbiased to ensure that investors are protected. Regulation may take the form of either laws or self-regulating rules. In the case of Japan, the Japan Securities Dealers Association's self-regulating rules were adopted to eliminate the conflicts of interest faced by securities analysts.

The provisions of the Resolution have been updated since it was adopted in 2002 to reflect developments in other countries. The regulation of securities analysts in Japan has been strongly influenced by regulation in the United States, which has led the way in this issue (see Figure 1). Thus, this report will explain in detail the regulations governing securities analysts in Japan (including the two sets of amendments to the Resolution), while touching on developments in the United States.

Figure 1 Regulation of Securities Analysts in Japan and the United States

Year	Month	United States	Japan
2001	6	・SIA issues "Best Practices for Research" ・Congress begins hearings. ・SEC issues guidelines for investors.	
2001	7	・Congress begins second round of hearings.	
2001	8		・Financial Services Agency orders ING Baring Securities Japan Ltd., Tokyo Branch, to put its house in order.
2002	1		・Board of Japan Securities Dealers Association adopts resolution on analyst reports.
2002	4	・SEC announces that it has begun an official investigation into the role of analysts.	
2002	5	・New York state attorney general's office and Merrill Lynch announce that they have agreed a settlement of the fraud case the former had brought against the latter.	
2002	5	・SEC approves the self-regulating rules proposed by the New York Stock Exchange and the National Association of Securities Dealers and designed to ensure the neutral position of analysts.	
2002	7	・Sarbanes-Oxley Act of 2002 implemented.	
2002	8		・Financial Services Agency announces "Program for Expediting Reform of Japan's Securities Markets."
2002	12	・SEC announces a draft global settlement with 10 of the country's leading securities firms .	
2003	1		・Board of Japan Securities Dealers Association amends resolution on analyst reports.
2003	4	・Global settlement reached. ・Regulation AC comes into force.	
2003	7	・SEC accepts further amendement on NYSE and NASD regulations on the analysts' conflicts of interests.	
2003	12		・Securities and Exchange Surveillance Commission recommends to the Financial Services Agency how securities companies that use reports by outside analysts should handle such reports.
2004	3		・Board of Japan Securities Dealers Association amends resolution on analyst reports.

Source: NICMR

II. The Resolution

When the Resolution was adopted in January 2002, the Securities Industry Association (SIA) in the United States had already issued a set of "Best Practices for Research," indicating the kind of internal systems member-firms were expected to have in place to ensure the independence of research and what they were expected to disclose in their research reports.

In addition, the US Congress had held hearings dealing with the kind of conflicts of interest faced by securities analysts, while the Securities and Exchange Commission (SEC) had issued guidance to inform investors about the possibility of the conflicts of interest and to warn them not to rely solely on analysts' recommendations.

Meanwhile, in August 2001, Japan's Financial Services Agency ordered ING Baring Securities Japan Ltd., Tokyo Branch, to take action to prevent the recurrence of a report which it considered to contain erroneous figures that could mislead investors in a number of important respects.

The Resolution required member-firms to do the following:

1) Establish a system of internal supervision to ensure that reports are both appropriate and reasonable in content.
2) Ensure the security of material information when analysts are either working for other departments or passing on material information to other departments.
3) Ensure that analysts are free from interference or intervention by other departments when writing their reports and guarantee their independence of opinion by ensuring that directors of underwriting and investment banking departments do not make clients or prospective clients any promises about the contents of such reports.
4) Set up a committee to check and assess the contents of analysts' reports and try to improve their quality.
5) Forbid analysts from either dealing in or owning the securities of any of the companies they cover unless expressly permitted and ensure that executives and employees do not deal on their own account on the basis of any material information obtained as a result of an analyst's report or research.

In addition, the Resolution required members to draw up written internal rules and procedures incorporating these requirements.

III. Amendments to the Resolution

1. The January 2003 Amendments

After the Resolution, there were several important developments in the United States which influenced Japan's regulations governing securities analysts: first, the New York state attorney general's office and Merrill Lynch agreed a settlement of the fraud case the former had brought against the latter; second, the Securities and Exchange Commission approved the self-regulating rules proposed by the New York Stock Exchange and the National Association of Securities Dealers; and third, the Sarbanes-Oxley Act, passed in July 2002, included provisions to reduce the risk of analysts facing conflicts of interest. In addition, further investigations of leading Wall Street firms were carried out by the Commission.

The main rules adopted by the New York Stock Exchange and the National Association of Securities Dealers required securities firms to do the following: (1) strengthen the Chinese walls between their research and investment banking departments; (2) overhaul their remuneration practices so that analysts' pay would not be linked to specific investment banking deals; (3) improve disclosure in research reports by, for example, revealing any conflicts of interest between either the analyst or the broker-dealer and the company covered, disclosing historical ratings and price target forecasts, and providing the percentage of ratings assigned to "buy," "hold" or "sell" categories; (4) establish a "quiet period," during which no firm acting as lead manager or co-manager for an initial public offering of a company would be allowed to issue a research report on that company; and (5) restrict personal trading by analysts or members of their households in stocks recommended in their reports.

At the same time, in August 2002, Japan's Financial Services Agency published its "Program for Expediting Reform of Japan's Securities Markets," which recognized the need to raise investor confidence in analysts' reports if the public was ever to gain confidence in the country's securities markets. In addition, the Program identified the need to re-examine the role of securities analysts along the lines recommended by the International Organization of Securities Commissions (IOSCO) and at that time under debate in the United States, and called on the Japan Association of Securities Dealers to overhaul its self-regulating rules.

As a result, in January 2003, rules requiring conflicts of interest to be disclosed and a proper analyst remuneration system to be drawn up, and forbidding securities firms from letting issuers review analysts' reports prior to distribution, except for checking factual sections, were added to the Resolution.

The new rules on disclosing conflicts of interest required members to disclose the following information in their analysts' reports:

1) Disclose that a situation could arise between them or one of their analysts and a company that is the subject of an analyst's report that might compromise the analyst's independence when the likelihood of this occurring is high.
2) Disclose that a company that is the subject of an analyst's report has been the lead manager of an initial or secondary offering of securities when not more than 12 months have passed since the day on which the registration statement of the offering was submitted.
3) Refrain from publishing in an analyst's report any investment ratings or target prices for shares when the member has been the lead manager of an initial or secondary offering of shares as part of a listing on a stock exchange or registration with the Japan Securities Dealers Association until 10 business days have passed since the listing or registration ("quiet period").

According to Resolution, the first of the above three rules would apply in the following situations: (1) where a member and a company that is the subject of a report are parent and subsidiary or affiliates, (2) where a director of a member is also a director of a company that is the subject of a report, (3) where a member owns more than 5% of the shares of a company that is the subject of a report, (4) where an analyst is an employee of or a consultant to a company that is the subject of a report, (5) where a member of an analyst's household is a director of a company that is the subject of a report, and (6) where either an analyst or a member of his household owns securities in a company that is the subject of a report.

2. The March 2004 Amendments

Since the 2003 amendments to the Resolution the controversy about the role of analysts in the United States has entered its final stage. In April 2003 the Securities and Exchange Commission and 10 of the country's leading securities firms announced that they had reached a "global settlement."

As well as agreeing to pay a total of $1.4 billion in monetary relief, 10 firms agreed to comply with some severe requirements. For example, research and investment banking departments would have to be physically separated; analysts would be forbidden from taking part in any activities (e.g., pitch meetings and roadshows) designed to promote their firm's investment banking activities, and the firms would be required to purchase analyst reports from independent research firms. The rules forbidding analysts from attending pitch meetings, etc., were later incorporated by the New York Stock Exchange and the National Association of Securities Dealers in their self-regulating rules, with the result that they now apply to all broker-dealers in the United States.

Also in April 2003, Regulation AC (Analyst Certification), which had been adopted by the Securities and Exchange Commission, came into force. As a result, analysts are now required to certify that the contents of a report represent their own opinions.

Meanwhile, in Japan, how securities companies handle analyst reports commissioned from third parties had become an issue. In December 2003, the Securities and Exchange Surveillance Commission (SESC) recommended to the Financial Services Agency that securities companies that used reports by outside analysts to recommend securities to their clients needed to make proper arrangements for dealing with such reports and the analysts who had written them. Two particular events lay behind this.

1) A securities analyst who had signed an agreement to write reports for a securities firm repeatedly bought the shares of the companies he was recommending in his reports before they were published and sold them afterwards when the price had risen. When the securities company asked him to transfer his trading account to them, he refused. All the securities firm did in response was to include in the agreement a clause referring to the need to comply with the law. It made no mention in the analyst's reports of the fact that he had a position in the securities he was recommending.
2) Another securities firm commissioned reports from an outside source which it made available to its clients free of charge on its Web site. Although the securities firm specified the companies covered in the reports and paid the outside source for its services in accordance with the agreement between them, it did not disclose this to its clients, who were given the impression that the authors of the reports had chosen the stocks themselves. The SESC ruled that this amounted to presenting information about an important matter in a way that was likely to mislead investors (Section 4.1 of the Cabinet Ordinance Governing the Activities of Securities Companies on the Basis of Section 42.1.9 of the Securities and Exchange Law).

The 2004 amendments to the Resolution were decided following the above-mentioned events. The amendments consisted of restrictions on the involvement of securities analysts in underwriting and investment banking activities. Specifically, the amendments forbade them from taking part in promotional activities (e.g., investor briefings) involving these two departments.

According to the Resolution, "promotional activities" refers to any activities intended to win underwriting or investment banking deals or transactions. As examples it gives (1) the case where an analyst takes part in a meeting concerning his employer's underwriting or investment banking department attended by either a member or a client of either of those departments, (2) the case where an analyst makes a recommendation to a company on behalf of his employer's underwriting or investment banking department, and (3) the case where an analyst produces written material to support the promotional activities of his employer's underwriting or investment banking department.

The amendments also include provisions for how securities firms should handle any reports they commission from outside analysts. Securities firms are now required (1) to ensure that any material conflicts of interest between outside analysts and the companies that are the subject of their reports are disclosed in those reports and (2) to inform their clients if they have paid outside analysts for their reports or instructed them to write about particular companies.

IV. Impact of the Regulations

Japan's regulations governing analysts' conflicts of interest are basically similar to those adopted by self-regulating organizations in the United States in that they require securities firms to (1) establish an internal structure that will guarantee analysts' independence, (2) disclose the possibility of any conflicts of interest in their analysts' reports, and (3) restrict personal trading by analysts.

The rule that probably has the biggest impact on analysts working for securities firms in Japan is the one that restricts analysts' involvement in investment banking activities and was included in the latest set of amendments to the Resolution.

In Japan the remuneration of analysts working for securities companies is rarely linked to specific investment banking deals. According to the Security Analysts Association of Japan, Japanese securities analysts are not as closely involved with investment banking activities as their counterparts in the United States. However, even in Japan the question how securities firms can recoup the costs of their research departments is a key issue, and relations between analysts and the investment banking activities of their employers cannot simply be ignored.

In Europe yet a different approach has been proposed from the one adopted in the United States and Japan. The European Commission's Forum Group on Financial Analysts has recommended that there is no need to forbid securities analysts from taking part in activities that promote their investment banking departments. All that would be required would be for financial institutions to ensure that none of their analysts made any investment recommendations while they were involved in investment banking activities. This reflects the impact on initial public offerings of analysts' reports and valuations.

In contrast, the rules in the United States and Japan take a more direct approach to eliminating the risk of an analyst's independence being compromised: by forbidding analysts from being involved in promotional activities, where they are most likely to be subject to pressure from their investment banking departments. However, analysts are allowed to be involved in investment banking activities to the limited extent of screening potential clients and carrying out due diligence once a securities firm has been appointed as an advisor or lead manager.

The question of how to use and fund their research departments has become one of the biggest challenges facing Japanese securities firms.