



19 February 2009

For the attention of the de Larosière working group at the European Commission.

## Introduction

EuroIRP is the trade association representing 25+ independent research groups (IRPs, i.e. not involved in corporate advisory or proprietary trading) established in 2003. EuroIRP believes that fostering independent research is essential to enhancing the stability of the financial system.

## Background to this submission

The dot.com bubble bursting of 2001-2003 provided regulators with clear evidence of what happens when markets fail to realistically price opportunity. The 2007-2009 global financial collapse shows what happens when markets fail to realistically price risk. There was ample evidence in both bubbles of conflicts of interest among the largest and most prominent financial intermediaries. There are also real fears about the potential of collusion between large banks' proprietary trading arms and their prime brokerage hedge fund clients, to the detriment of market transparency. This promulgation of conflicted "research" in pursuit of profits and at the expense of transparent financial markets also contributed to the creation of a "shadow" banking system that further boosted systemic risks.

These developments will take years to fully understand and recover from, but their negative effects are unquestioned now, and are indeed still spawning further problems. Indeed the risk of a substantial and negative backlash against core EU principles has now come to the fore across Europe, including the free movement of both people and capital between member countries, while financial system instability imposes additional stresses.

Regulatory failure must bear part of the responsibility for what has happened and it is now imperative that gaps and weaknesses in regulation and supervision must be eliminated where possible: there is clearly such a gap in the case of the provision of non-conflicted research. EuroIRP members believe that an active response on the part of financial markets regulators is now needed to correct these conflicts of interest around the provision of research and other financial services. The unilateral US settlements in the wake of the first dot.com bubble failed to resolve these issues. Widespread institutional access to higher-quality, impartial investment research in both equity and credit markets must form a key part of any regulatory response, or we risk recurrences of the current market travails.

EuroIRP members believe that:

**(i) "there must be a clear distinction between product origination and support (i.e. syndication, market-making or trading) and product evaluation (i.e. research)".**

*The provision of research must be structurally independent of the provision of debt or equity securities to give investors a fair and clear view. If such independence is not structural, the very concept of impartial market advice loses its meaning. We believe that this has contributed to the current banking collapse in a meaningful way, rendering the so-called "Chinese walls" erected in the US in the 2002-3 timeframe ineffective. There are clear conflicts of interest between a bank's research department and its proprietary trading or prime brokerage business, just as there is a clear conflict in offering securities to the market and also providing research on those same securities or "corporate access" to issuers of those securities. Such actions contravene basic principles of fairness in debt and equity markets. Any product evaluation from product originators should therefore be labelled "marketing and promotional materials" rather than research. This distinction would at the very least alert investors to potential conflicts, for example with ratings agencies paid by the issuers of securities that they rate.*

**(ii) "payment models must distinguish between origination and evaluation, and align the incentives of the providers of services and their clients and users"**

*Investors bear a considerable cost for provision of research which obscures, rather than clarifies the underlying investment case for the securities they may be buying or selling. The issuers of securities have managed to pass on the costs of marketing those securities to investors, as a tax on their investments. The move to commission sharing arrangements (CSAs) has begun to address this issue, but there exist serious information asymmetries between independent research providers (IRPs) and CSA aggregators, many of whom compete with the IRPs in providing research. Similarly ratings agencies had a contractual "duty of care" to investors prior to the 1970s, when investors were paying them; this changed when issuers began paying for ratings. Investment banks have no such "duty of care" towards investors, only to their shareholders. Payment for research must therefore be further separated from that for trading, or at the very least, integrated providers of securities and research must be obliged to provide a transparent breakdown of the costs of those services (i.e. a market price).*

While CSAs have started the process of creating a level playing field in research, they have not removed the incentive to abuse market positions within the large integrated investment banks. EuroIRP believe the next steps would involve a tightening of the definitions attached to the 2007 Markets in Financial Instruments Directive. Under this approach, all research from banks would henceforth be categorized as "marketing materials". To comply with Article 19 of the Directive (which states that such materials should be "fair, clear and not misleading"), all potential and institutional conflicts of interest should be stated. More important, the cost of such "marketing materials" should not be borne by investors, or paid for out of client commissions, either explicitly or via implicit "access" arrangements. Such action would also enhance EU citizen consumer protections and stimulate financial services competition within the Union, both stated aims of the 2007 Directive.

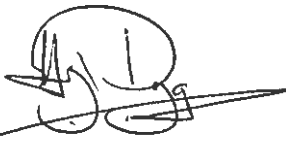
## Conclusion

EuroIRP recommends the adoption of either of the following two remedies:

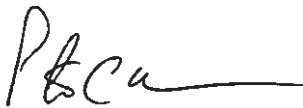
- 1) **The separation of the research and sales businesses of banks from their mainstream investment banking and trading businesses, which would allow transparent market pricing of research.**
- 2) **A far clearer regime of explicitly marking all "research" from product originators as "marketing and promotional materials" which investors must not pay for from client commissions.** This would require transparent "pricing" of research, still often "bundled" with, or cross-subsidised by other services such as banking or trading. This could create near-term difficulties for some of our EuroIRP members, but would provide a source of cost savings to fund managers, and should over time help create a more level playing field for all market participants.

The aim of these recommendations is to remove real and perceived conflicts of interest and improve market transparency. We have seen first-hand the damaging effects of the current "research" regime has had in increasing volatility in capital markets and undermining confidence in them. Doing nothing is not an option. EuroIRP believe that the longer-term effects would see the emergence of a more consistently "balanced view" in European capital markets. This would be measured in any number of ways: in the buy/sell ratios of research departments; in research on a broader range of (today, largely ignored) smaller and medium sized companies; and in research on stakeholder issues such as shareholder rights, agency costs, and corporate environmental policies. The result would be a fostering of more long-term research and greater market transparency, in both the pricing of securities and in the cost of research.

EuroIRP welcomes the opportunity to discuss these proposals and its members' views in more detail.



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