Paper No. 4B/01

Bills Committee on
Securities and Futures Bill and Banking (Amendment) Bill 2000

US regulatory requirements on disclosure of interests in investments by analysts

At the Bills Committee meeting on 9 February 2001, Members asked for more information on the regulatory requirements in the United States on disclosure of interests in investments by analysts. We have consulted the US Securities and Exchange Commission ("SEC") on this matter and our understanding of the position is set out below.

Federal Securities Laws

2. US federal securities laws do not contain any provisions specifically targeted towards conflicts of interest that securities analysts may have. However, certain activities by securities analysts could fall within the general fraud provisions of federal securities laws. By virtue of section 10(b) of and rule 10b-5 under the US Securities Exchange Act of 1934, it is unlawful for any person, in connection with the sale or purchase of a security, to make untrue statements of material fact or omit to state a material fact that is necessary in order for a statement not to be misleading.

3. US courts have found that the failure of broker-dealers and analysts to disclose material conflicts of interest when recommending a security violates rule 10b-5. For example, in *Chasin v. Smith Barney & Co., Inc.*[1] the court found that Smith Barney violated Rule 10b-5 by not disclosing to a customer that it was making a market in securities that it recommended and sold to that customer. Likewise, in *SEC v. Butler*[2] a US district court found a securities analyst to have violated section 10(b) and Rule 10b-5 by making misleading and false statements concerning a stock and failing to disclose he was selling some of his own holdings in this company while recommending others to buy.

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[1] 438 F.2d 1167 (2d Cir. 1971)

[2] Litigation Release No. 13264 (June 8, 1992)

4. Section 17(b) of the Securities Act of 1933 governs fraud in connection with a securities offering and requires anyone receiving compensation from an issuer or underwriter of a security to disclose this fact and the amount of compensation. Newsletters and their publishers have been enjoined from violations of Section 17(b) for recommending the purchase of specific securities without disclosing the fact that they were paid for making such recommendations. Likewise, the SEC has brought several actions against Internet stock "touters" for promoting certain stocks over the Internet without disclosing their contractual arrangements with the issuers.

Self-Regulatory Organizations

5. In addition to the federal securities laws outlined above, both the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers ("NASD") regulate their members' communications with the public. NYSE Rule 472 and NASD Rule 2210 both require all public communications (including research reports) to be based on principles of fair dealing and good faith and strictly prohibit the omission of material facts.

6. Furthermore, whenever a member recommends the purchase or sale of a specific security, the member firm must specifically disclose the following -

(a) whether the firm usually makes a market in the recommended security;

(b) whether the firm was manager or co-manager of a public offering of any securities of the recommended issuer within the last three years;

(c) (for the NYSE) whether the firm or its employees involved in the preparation of the communication may have positions in any securities or options of the recommended issuer; and

(d) (if done over-the-counter (OTC)) whether the firm or its officers and partners own options, rights or warrants to purchase any of the securities of the recommended issuer.

Industry Association Standards

7. Many securities analysts are members of the Association for Investment Management and Research ("AIMR"), a certifying body for financial analysts. AIMR has its own "Standards of Professional Conduct" and may revoke its "chartered financial analyst" designation if a member of the organization violates these standards. With regard to conflicts of interest, AIMR Standard IV.B.7 requires members to disclose to their clients "all matters, including beneficial ownership of securities or other investments, that could reasonably be expected to impair the members' ability to make unbiased and objective recommendations." Likewise, AIMR Standard IV.B.1 calls on its members to use particular care in determining the fiduciary duty that applies in relationships with clients and to comply with such duty as to those persons and interests to whom the duty is owed.

Securities and Futures Commission
31 May 2001