

The Security Analysts Association of Japan

5 F, Tokyo Stock Exchange Building, 2-1 Nihonbashi-Kabutocho, Chuo-ku, Tokyo 103-0026, Japan
Tel: 81-3-3666-1515 Fax: 81-3-3666-5845

English Summary of Position Paper Entitled *Promoting Professional Ethics for Securities Analysts*¹

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The Security Analysts Association of Japan

The Professional Ethics Committee of the Security Analysts Association of Japan (SAAJ) developed a paper entitled *Promoting Professional Ethics for Securities Analysts* based on recent circumstances surrounding securities analysts, and in January 2002 published it for the comment of members and other interested parties. In April 2002, the paper was approved by the SAAJ Board of Directors and distributed to all SAAJ corporate and individual members.

This paper addresses issues which members should take into account in contemplating professional ethics for securities analysts, proposes revisions to the current SAAJ Standards of Professional Conduct, and suggests measures to be taken by SAAJ to enhance professional ethics.

The paper consists of five parts, a summary of each of which is as follows:

I. Introduction

Financial markets in Japan have come to recognize the importance of the role of securities analysts as investment professionals. At the same time, criticism of securities analysts, which has intensified parallel with increasing criticism of the profession in the U.S since last year, has led to the discussion of various issues regarding securities analysts. Hence, at this juncture, securities analysts should contemplate their ethical responsibility as investment professionals.

II. Message to Individual Members

1. Preservation of accuracy, objectivity, and fairness of research reports

The fundamental premise in preparing research reports is that the data based on which analysis is made must be accurate and the source identifiable. Additionally, analytical methods must be rational and the process leading to a conclusion clear. Research reports must not only be logically structured without any misrepresentations but also unbiased and objective. Securities analysts should aim at high quality reports by adding profound analysis to information on the issuing companies.

¹ This is the English translation of a summary of the paper entitled *Promoting Professional Ethics for Securities Analysts* published in Japanese in April 2002 by the Security Analysts Association of Japan (SAAJ). SAAJ is a not-for-profit organization for investment professionals with 550 corporate members and 16,000 individual members from the investment community in Japan.

2. Issues on stock price ratings

There are several factors that could cause a preponderance of “buy” over “sell” recommendations. However, if circumstances resulted in an extreme paucity of sell recommendations, the credibility of stock price ratings would be affected. While members are encouraged to endeavor to provide sell recommendations when necessary, it is also deemed critical that once rated a stock should continuously be followed, and that due diligence be paid from the viewpoint of the fair treatment of clients in communicating information on rating changes.

3. Investment-banking relationships

If research department staff work with their investment banking colleagues, it is critical they recognize the possibility of conflict of interest between issuers and investors and exert due diligence not to prepare research reports which are unjustifiably favorable to issuers.

If securities analysts are seen to favor issuers, it would very likely be regarded as contrary to the rationale for their very existence. The understanding and support of management and supervisors is indispensable to maintain the independence and objectivity of securities analysts vis-à-vis investment banking relationships.

In communications with issuing company management, there should be an arm’s length relationship with issuers, and securities analysts should be very cautious to avoid any appearance of symbiotic relationships.

4. Analysts’ Personal Investments

There are pros and cons to personal investments by securities analysts, who provide investment recommendations/information, in the securities which they follow. In the US, many argue that personal investments should be allowed because such investment provides public evidence of an analyst’s confidence in the securities recommended and because it is unfair to restrict the right of securities analysts to seek wealth. In Japan, some are sympathetic to such arguments. However, the SAAJ’s view is that personal investments by securities analysts in the securities which they follow should, in principle, be prohibited, from the viewpoint of enhancing the objectivity and integrity of securities analysts, and has thus proposed the following revisions to the current SAAJ Standards of Professional Conduct:

- (1) In principle, securities analysts providing investment recommendations to clients and prospective clients shall not make personal investments in the securities they follow.
- (2) However, (1) above will not be applied provided such investment is reasonably determined not to impair objective and unbiased securities analysis.
- (3) If members make personal investments according to provision (2), they must disclose beneficial ownership of the securities concerned.

In other words, while provision (1) clearly states that, in principle, securities analysts engaging in investment recommendations are prohibited from personal investments in the securities which they follow, considering various arguments on the subject, securities analysts need not be immediately prohibited from making personal investments in such securities provided certain

disclosure is made. Nevertheless, SAAJ hopes that not only will members voluntarily refrain from making personal investments but that their employers will also increasingly prohibit them from making such investments.

If securities analysts invest in the securities they follow, they are required not to trade in such securities before making investment recommendations regarding the securities or before sufficient time has passed for investors to consider analyst recommendations on such securities (preventing so-called "research front running"). Although such transactions are interpreted as prohibited under the current SAAJ Standards of Professional Conduct, in order to make things clear SAAJ proposes establishing a specific provision on the subject in the standards. SAAJ also proposes to establish a similar provision for securities analysts on the buy-side.

5. Additional guidance when acquiring material non-public information from an issuer

The current SAAJ Standards of Professional Conduct provide that if securities analysts acquire material non-public information in the process of communicating with the management of an issuing company they are prohibited from using such information for themselves or communicating it to others. In addition, SAAJ proposes establishing a provision to the effect that if securities analysts acquire material non-public information directly from an issuer, they should strive to encourage the issuer to make it public if they determine such public disclosure appropriate.

III. Requests to Corporate Members

In order to ensure that securities analysts conduct objective and fair analysis, it is crucial that individual members adhere to the SAAJ Standards of Professional Conduct, and at the same time it is indispensable that firms to which securities analysts belong provide an environment in which such objective and fair analysis can be conducted. From this viewpoint, SAAJ makes the following proposals and requests to corporate members:

- The current SAAJ Standards of Professional Conduct will be revised to include a provision that corporate members should strive to ensure that the independence and objectivity of their securities analysts is preserved.
- Individual firms should develop an environment in accordance with the 25 January 2002 Resolution of the Board of Directors of the Japan Securities Dealers Association ("Treatment of Analyst Reports") which provides items firms should comply with regarding the internal review of research reports and the preservation of the independence of securities analysts, and which SAAJ highly evaluates.
- Firm management should understand and support the preservation of the independence and objectivity of securities analysts vis-à-vis other departments and issuing companies, and should also have in place an appraisal and compensation system that does not affect analyst independence and objectivity.
- Firms should give full consideration to the maintenance and improvement of the professional competence of securities analysts in response to a changing business environment.

IV. Providing Information to the Investing Public and Analyst Responsibility

In both Japan and the US, while the major clients of securities analysts have been institutional investors, individual investors are getting more opportunities to have access to information issued by securities analysts. While it is desirable that securities analysts contribute to providing information to individual investors, analysts should be aware of the differences between institutional and individual investors in their use of information provided.

Institutional investors utilize analyst reports as a source of information, and are interested in not only the conclusions but also the process leading to them. While they undertake critical review as investment professionals, they implicitly share a common understanding of professional knowledge with securities analysts. On the other hand, individual investors do not usually have much technical knowledge and tend to merely read the conclusions.

Accordingly, SAAJ is of the view that:

- When preparing reports for institutional investors, considering that such reports are increasingly accessible to individual investors, securities analysts should avoid using expressions which are only understandable to experts, exert more diligence in distinguishing between facts and opinions, and make efforts to provide stock price ratings with enhanced accuracy.
- Summaries of reports for individual investors should accurately represent the points in the main body of the report. Also, when analysts prepare materials for individual investors, they should fully explain the characteristics of investments including risk (especially for new financial instruments) and provide an understandable outline of issuing companies like “basic reports” issued in the US. Additionally, stock price rating categories should be easy to understand.

V. Measures to Enhance Members’ Professional Ethics

SAAJ has decided to take the following measures to promote professional ethics and enhance members’ compliance with the SAAJ Standards of Professional Conduct:

- Gather comments from the public including SAAJ members, investors, and issuing companies via the SAAJ website regarding relevant SAAJ’s services/activities including those related to the responsibilities of securities analysts, and utilize them in planning projects and assessing the situation with respect to members’ compliance with the Standards of Professional Conduct.
- Establish preliminary procedures to assist the Professional Ethics Committee in more promptly and effectively responding to any suspicious occurrence involving violation of the Standards of Professional Conduct. In addition, SAAJ will provide procedures for issuing a warning in the name of the Chairman of the Professional Ethics Committee to any member whose conduct, while not falling under sanctions as provided in the SAAJ Articles of Association, nevertheless brings into question his/her professional ethics.
- Introduce a regular column on the subject of professional ethics in SAAJ’s monthly *Security Analysts Journal*.