



**SECURITIES AND
FUTURES COMMISSION**

證券及期貨事務監察委員會

Securities Firm Survey on Investment Research Activities

證券公司對於投資研究活動
的意見調查報告

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Executive summary

There has been concern in recent years that conflicts of interest faced by securities analysts or their firms may compromise their abilities to offer independent and unbiased opinions. To assess the state of the investment research industry and obtain a more comprehensive view from practitioners, the Securities and Futures Commission (SFC) conducted a survey of the securities dealing and securities advising firms' investment research activities in early 2003.

The survey questionnaire covered various areas, including the firms' investment research operations, their existing practices and their views on the issues involved in the Hong Kong investment research sector. In total, 1,069 questionnaires were issued and 365 were completed and returned, resulting in an overall response rate of 34%. Most major firms in this area participated in the survey.

The major findings of the survey are:

- 62 firms (17% of respondents) state that they have been conducting research and publishing reports on Hong Kong equities. They employ in aggregate 529 analysts.
- The investment research industry in Hong Kong is concentrated in the medium to large-sized firms, which typically have investment banking as well as securities dealing functions. Such firms tend to cover pre-Initial Public Offering (IPO) researches and service institutional investors whereas smaller firms that issue research reports generally target retail investors. The latter group's activities are normally confined to dealing in securities and providing investment advice, and analysts in these firms may engage in a wide variety of duties.
- Most analysts tend to assign more positive than negative ratings to the subject companies. A significant number of them also maintain media presence. Some, however, expressed having difficulty in accessing information on subject companies.
- Some responding firms have established certain internal controls to address conflicts of interest. The larger firms that engage in investment banking in conjunction with investment research have put in place various internal control measures to address analysts' potential and actual conflicts of interest. Similar internal control measures are less common among the smaller firms that do not engage in investment banking business.
- Most respondents hold the view that, similar to all other major markets, analysts' conflicts of interest is an issue in Hong Kong and which should be addressed. While a significant proportion of respondents think that analysts in Hong Kong produce reasonable quality research reports, many call for clearer guidelines in this area.

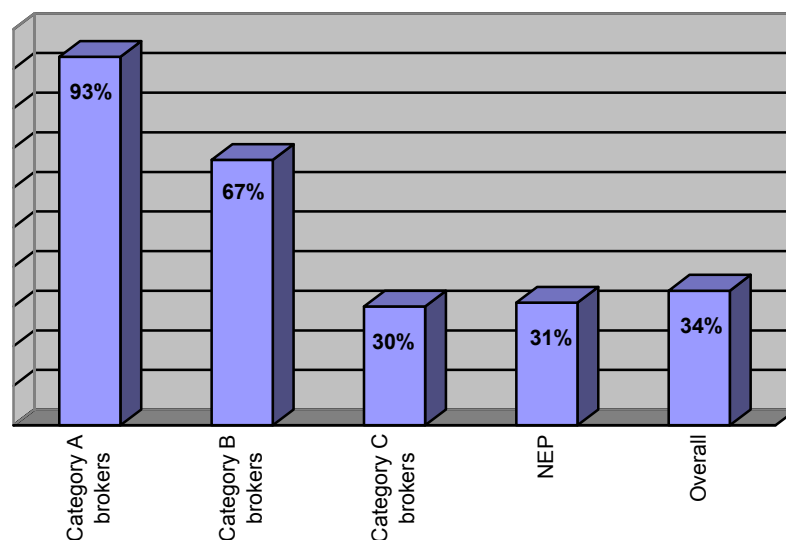
Introduction

1. Investors often make references to the information or opinions provided by securities analysts or brokerage firms during the investment process. In recent years, there has been concern that conflicts of interest faced by securities research analysts or their firms may compromise their abilities to offer independent and unbiased opinions. Conflicts may arise as a result of pressures being brought to bear upon them, such as their firms having an investment banking relationship with the companies under review or their having financial interests in the companies concerned. Such conflicts of interest may undermine the confidence of investors in financial markets.
2. The SFC has been actively monitoring the developments in this area. To assess the state of the industry and obtain a more comprehensive view from practitioners, the SFC conducted a survey of the securities dealing and securities advising firms' investment research activities in early 2003.

Methodology and responses

- The SFC requested all regulated securities dealing and securities advising firms (which would include all firms engaging in securities research) to complete and return a survey questionnaire in January 2003. The questionnaire covered various areas, including the firms' investment research operation, their existing practices and their views on the various issues in the Hong Kong investment research sector.
- A total of 1,069 questionnaires were sent out, of which 365 were completed and returned. This gives an overall response rate of 34%. The response rates of Categories¹ A and B brokers are substantially higher (93% and 67% respectively) than those of Category C and non-Exchange Participants (NEP) (30% and 31% respectively). Please see Chart 1.

Chart 1: Response rates of different categories of brokers



¹ To aid analysis, we have in this paper treated a Category A broker to mean a Stock Exchange of Hong Kong (SEHK) "Category A" Exchange Participant **or its group companies**; a Category B broker to mean a SEHK "Category B" Exchange Participant **or its group companies**, and a Category C broker to mean a SEHK "Category C" Exchange Participant **or its group companies**.

Profile of respondents

- 62 respondents state that they have been conducting and publishing investment research reports on Hong Kong equities. In aggregate, they employ 529 analysts.
- For ease of analysis, we have classified these 62 respondents into two groups (Groups 1 and 2) in terms of their business model and client base.

Chart 2: Composition of Group 1 and Group 2 firms

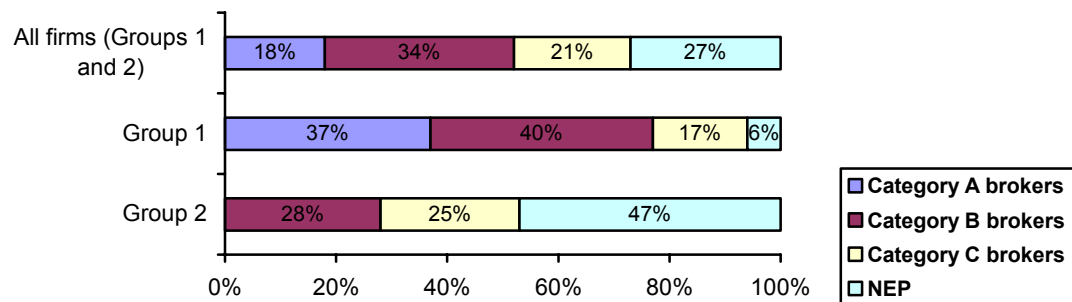


Table 1: Employment distribution of analysts by group

	Group 1	Group 2
Number of analysts employed by each group	442	87
Number of analysts employed by each group as a % of the total number of analysts in the market	84%	16%
Average number of analysts employed by each firm	14.7	2.7
Range of number of analysts employed in each group	2-50	1-11

Group 1 firms

- Group 1 is composed of 30 medium to large-sized firms, including 11 Category A, 12 Category B and five Category C brokers, and two NEPs (displayed in Chart 2). They are mainly “full service investment firms” that have investment banking, asset management and securities dealing and advising functions in addition to investment research.

8. These firms collectively employ 442 analysts, which constitute 84% of the total number of analysts employed by all the respondents. Please see Table 1. A firm in this group typically employs no less than 15 analysts. They generally produce more comprehensive research reports (over two pages).
9. The majority of Group 1 firms (80%) produce and publish research reports primarily for institutional clients, and in-house sales and marketing staff to support their securities dealing activities. 40% of the firms state that publishing research reports also serve to support their investment banking activities. Chart 3 shows the target readers of their research reports.

Chart 3: Target readers of Group 1 firms' research reports

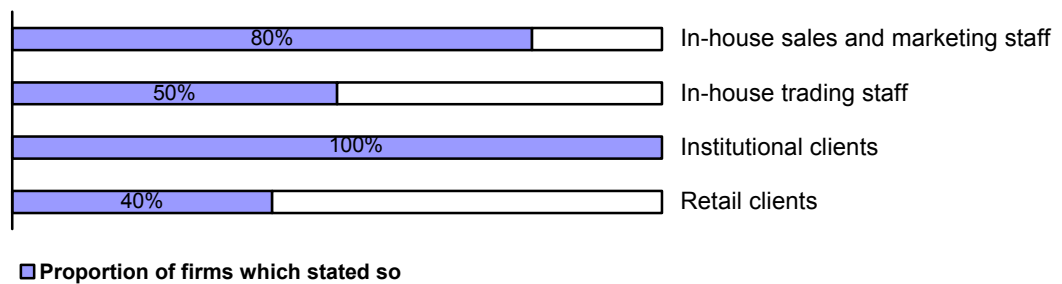
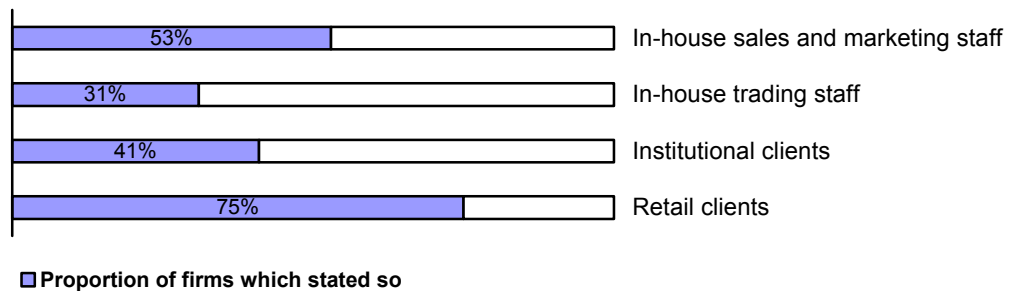


Chart 4: Target readers of Group 2 firms' research reports



Group 2 firms

10. Group 2 composes of 32 small to medium-sized firms, including nine Category B and eight Category C brokers, and 15 NEPs. They do not have an investment banking function and their core business is securities dealing and advising. Noticeably, 47% of them are non-SEHK Participants. Please see Chart 2.
11. In aggregate, they employ 87 analysts (16% of the total number of analysts in the market). Please see Table 1. Typically, a firm in this group employs less than five analysts. These firms undertake investment research as a value-added service to clients, and their reports normally consist of brief summaries (less than two pages) on specific stocks.
12. 75% of them state retail clients as the target readers of their research reports. More than half of the firms (53%) also indicate in-house sales and marketing staff as target reader. Please see Chart 4.

Responses of Group 1 firms

Rating or recommendation

13. As Charts 5 and 6 indicate, Group 1 firms' analysts tend to assign more positive than negative ratings to their subject companies. In both 2001 and 2002, more than half of the ratings assigned to the subject companies were positive, whereas only 17% were negative.

Chart 5: Proportion of ratings assigned by Group 1 firms' analysts in 2002

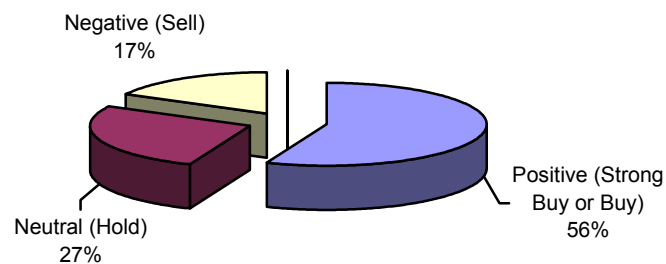
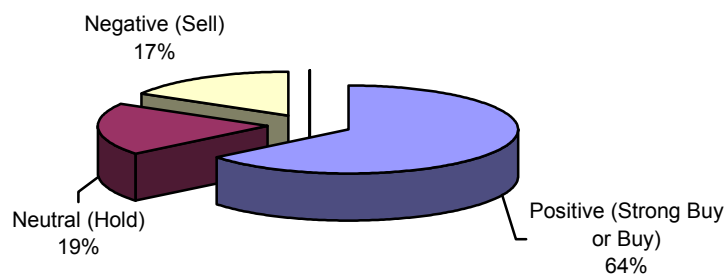


Chart 6: Proportion of ratings assigned by Group 1 firms' analysts in 2001



Firms' business activities

14. Firms in Group 1 operate a more complex business model. All of them have business functions in investment banking, asset management, securities dealing and advising as well as investment research. The analysts often perform multiple roles within the firms and many of them are involved in investment banking activities. They may review companies with which their firms have an investment banking relationship. From time to time, they also publish pre-IPO research reports on companies in which their firms have involvement. Table 2 provides the percentages of firms having the various business activities.

Table 2: Group 1 firms' business activities

Business activity	Proportion of respondents having the business activity
Securities dealing	100%
Corporate finance / investment banking	100%
Securities advising	70%
Asset management	17%

Analysts' business functions

15. 63% of Group 1 firms state that their analysts assist their corporate finance/ investment banking department. This practice is common among smaller firms in this group. 57% also state that their analysts provide commentaries or contribute articles to the print or broadcast media. A substantial majority of the analysts also provide investment advise to clients. Please see Table 3.

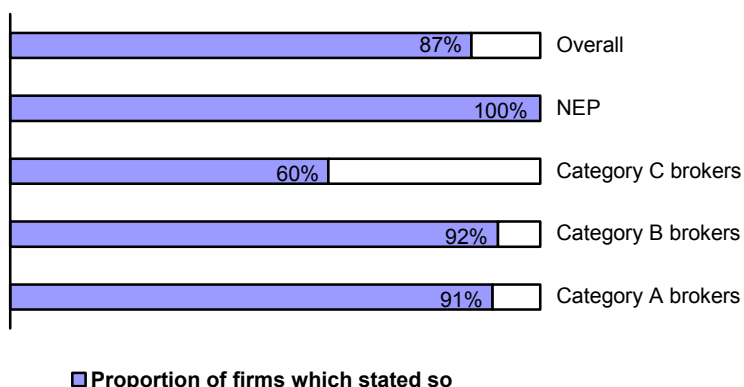
Table 3: Business functions of Group 1 firms' analysts

Business function	Proportion of respondents' analysts engaging in the function
Undertake investment research for publication	93%
Advise clients	80%
Assist in corporate finance / investment banking	63%
Provide commentaries or articles to the media	57%
Execute orders for clients	3%
Others	0%

Firms' business relationships

16. 87% of Group 1 firms state that their analysts reviewed companies which their firms or groups had corporate investment banking relationships in the previous two years. However, this practice is less common among the smaller firms, as indicated in Chart 7.

Chart 7: Proportion of Group 1 firms whose analysts reviewed companies with which their firm or group had investment banking relationships in the previous two years



17. 60% of the firms publish pre-IPO research reports on companies in which IPOs they or their groups' investment banking departments are involved. The most commonly cited reason for publishing such research reports is that it is a part of their normal course of business. Many larger firms produce the reports to meet investment banking clients' expectation. 37% of the respondents declare that their work will first be reviewed by their investment banking clients.

Reporting lines of analysts

18. 97% of Group 1 firms' research departments do not report to heads of other departments.
19. In terms of work review, 60% state that their compliance departments, and 30% state that their investment banking department, would review or endorse their research reports before publication. The main purposes of this practice are to ensure consistency with internal policy (76%), compliance with external rules and regulations (84%), and factual verification (72%).

Remuneration of analysts

20. 7% (generally smaller firms in this group) state that their analysts are paid fixed salaries, while the remaining 93% remunerate their analysts on fixed salaries plus bonuses. The most common factors for determining an analyst's remuneration, as shown in Table 4, are feedback from management, performance of the firm, and feedback from clients.

Table 4: Factors determining analysts' remuneration

Factors	Proportion of respondents stating the factor
Feedback from management	83%
Earning performance of the firm	80%
Feedback from clients	67%
Price performance of recommended stocks	50%
External industry survey	43%
Commission generated	20%

Difficulties faced by analysts

21. 57% of Group 1 firms state that their analysts encounter difficulty in gaining access to information on subject companies. 27% state that their analysts had been subject to pressure from those companies, while 37% report having encountered no difficulties while conducting research.

Distribution of research reports

22. ***Distribution channel*** – Electronic means (email or website) are the most popular means for distributing research reports. All respondents are using this channel. 73% also distribute by mail, and 43% also use fax.
23. ***Distribution sequence*** – 83% disseminate research reports to clients simultaneously. 10% have no defined sequence for distributing or does not simultaneously disseminate their research reports.
24. ***Distribution timing*** – 57% do not have any policy on the timing for releasing research reports. 27% normally release their research reports before, and 17% after the close, of the Hong Kong securities market.

Criteria of coverage and cessation policy

25. As to the deciding factors for adding or deleting a stock from the coverage list, the most common criteria are “trading volume of the stock”, “performance of the stock” and “clients’ request”. Table 5 lists the proportions of Group 1 firms for the various criteria.

Table 5: Criteria for coverage of stock

Criteria	Proportion of respondents stating the criterion
Trading volume of the stock	83%
Performance of the stock	67%
Clients' request	53%
Management or other department's request	40%
Coverage by other firms	17%
Others	43%

26. On procedures undertaken upon cessation of coverage of a specific stock:
- 57% would notify readers of the cessation.
 - 37% would take no specific action.
 - A few firms would keep the stock on the coverage list and add a cessation remark.

Use of pen names on print media by analysts

27. Only one respondent has analysts who use pen names in contributing articles to the print media. The firm does not foresee any difficulties if its analysts are required to disclose their real names.

Internal control measures

28. Most of the firms in this group have established internal control procedures to address analyst conflicts. As indicated in Table 6, over 90% of them require analysts to disclose possible conflicts, impose restrictions on personal trading, and have established procedures for analysts being brought over the Chinese Wall. 80% of the firms have trading blackout periods for their analysts.

Table 6: Group 1 firms' internal control measures

Internal control measures	Proportion of respondents having the internal control measure
Requirement to disclose possible conflicts of interest	100%
Procedure for analysts being brought over the Chinese Wall	97%
Segregation of duties	93%
Restrictions on personal trading by analysts	93%
Blackout periods for trading by analysts	80%
Others	37%

Responses of Group 2 firms

Rating or recommendation

29. Similar to those of Group 1 firms, analysts of Group 2 firms also tend to assign more positive than negative ratings to their subject companies. Please see Charts 8 and 9.

Chart 8: Proportion of ratings assigned by Group 2 analysts in 2002

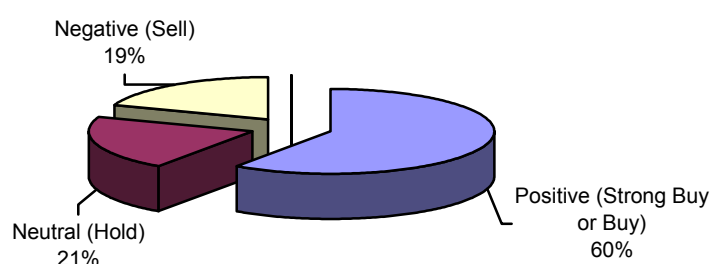
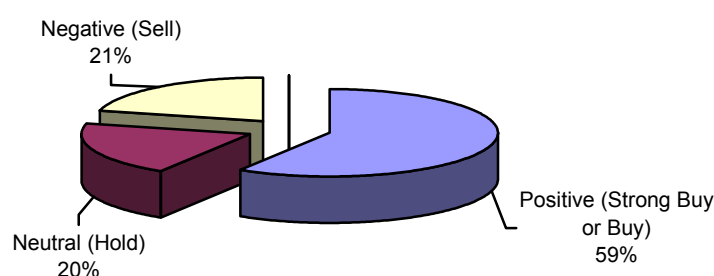


Chart 9: Proportion of ratings assigned by Group 2 analysts in 2001



Firms' business activities

30. As Table 7 indicates, the majority of Group 2 firms also engage in securities dealing besides investment research. A significant proportion of them, especially the NEPs, also give advice on securities.

Table 7: Firms' business activities

Business activity	Proportion of respondents having the business activity
Securities dealing	63%
Corporate finance / investment banking	0%
Securities advising	47%
Asset management	22%

Analysts' business functions

31. The majority of Group 2 firm's analysts undertake investment research for publication, as well as provide commentaries or contribute articles to the print or broadcast media. A significant proportion of their analysts also advise clients. Table 8 outlines the analysts' various functions.

Table 8: Business functions of Group 2 firms' analysts

Business function	Proportion of respondents' analysts engaging in the function
Undertake investment research for publication	78%
Advise clients	34%
Assist in corporate finance / investment banking	0%
Provide commentaries or articles to the media	53%
Execute orders for clients	3%
Others	0%

Reporting lines of analysts

32. 75% of Group 2 firms' research departments do not report to heads of other departments.
33. In terms of work review, only 17% state that their compliance department would review or endorse the research reports before publication. The main purposes of this practice are to ensure consistency with internal policy (60%), compliance with external rules and regulations (50%), and factual verification (40%).

Remuneration of analysts

34. 44% of Group 2 firms' analysts are remunerated on fixed salaries. 50% state that their analysts are paid fixed salaries plus bonuses. The most common factors for determining an analyst's remuneration are feedback from management and the performance of the firm. Please see Table 9.

Table 9: Factors determining analysts' remuneration

Factor	Proportion of respondents stating the factor
Feedback from management	44%
Earning performance of the firm	56%
Feedback from clients	25%
Price performance of recommended stocks	22%
External industry survey	13%
Commission generated	6%

Difficulties faced by analysts

35. 34% state that their analysts have difficulty in gaining access to information on subject companies. A few state that their analysts had been subject to pressure from subject companies, while 56% report having encountered no difficulties while conducting research.

Distribution of research reports

36. **Distribution channel** – Electronic means are the most popular means for distributing research reports. 88% of the respondents use this channel. 38% issue research reports by mail, whereas 31% use fax.
37. **Distribution sequence** – 63% disseminate research reports to clients simultaneously. 19% have no defined sequence for distributing or does not simultaneously disseminate their research reports.
38. **Distribution timing** – 66% do not have any policy on the timing for releasing research reports. 13% would release their research reports before the opening of the Hong Kong market.

Criteria of coverage and cessation policy

39. As to the criteria for adding or deleting a stock from the coverage list, the most common factors are “management or other departments’ request”, “performance of the stock” and “clients’ request”. Please see Table 10.

Table 10: Criteria for coverage of stock

Criteria	Proportion of respondents stating the criterion
Trading volume of the stock	37%
Performance of the stock	47%
Clients’ request	40%
Management or other departments’ request	47%
Coverage by other firms	3%
Others	33%

40. On procedures undertaken upon cessation of coverage of a specific stock:
- 70% would take no specific action.
 - 10% would notify readers of the cessation.
 - 7% would keep the stock on the coverage list and add a cessation remark.

Use of pen names on print media by analysts

41. Only one respondent has analysts who use pen names in contributing articles to the print media. The firm does not foresee any difficulties if its analysts are required to disclose their real names.

Internal control measures

42. As Table 11 illustrates, significantly fewer firms, especially the smaller ones, in this group have established internal control measures to specifically address analyst conflicts of interest.

Table 11: Group 2 firms' internal controls measures

Internal control measure	Proportion of respondents having the internal control measure
Requirements to disclose possible conflicts of interest	53%
Procedures for analysts being brought over the Chinese Wall	22%
Segregation of duties	44%
Restrictions on personal trading by analysts	59%
Blackout periods for trading of analysts	31%
Others	13%

Respondents' general comments

43. In general, most respondents comment that similar to all other major markets, conflicts of interest faced by analysts is an issue in Hong Kong and which should be addressed. Many view the issue as arising from situations where an analyst reports on companies that have an investment banking relationship with their accredited firm.
44. While a significant proportion of respondents think that research reports produced by analysts in Hong Kong are of reasonable quality, many call for clearer guidelines in this area. Some advocate that since retail investors are less able to protect themselves, further investor education may be necessary to enhance their awareness on this issue.