**Introduction to Business Valuation and Restructuring**

**Learning Outcomes**

After completing this module, students will be able to:

1. Explain the different measures of value for a business or its assets and liabilities.
2. Identify applications of business valuation principles.
3. Differentiate between a sell-side and buy-side analyst and their potential conflicts of interest.
4. Define the income, market, asset-based, and residual income methods used to value a business.
5. Describe the format of an investment research report and the content of each section.
6. Summarize the role and educational requirements of the Chartered Business Valuator (CBV) and Chartered Financial Analyst (CFA) professional designations.
7. Apply the research standards in the CFA Code of Ethics and Standards of Professional Conduct and CFA Research Objectivity Standards.

**Introduction**

Accountants and financial analysts must frequently estimate the fair market value of a business enterprise, its assets/liabilities separately, or damages that it has caused or incurred as a result of actions such as breach of contract or patent infringement. Fair market value is the price that willing and rational buyers and sellers with full information agree upon.

Business valuation is a complex process that is prone to errors because of difficulties accurately forecasting a company’s future operations. Therefore, having an experienced professional with a background in valuations is important to an organization. In Canada, professionals can earn the Chartered Business Valuator (CBV) or Chartered Financial Analyst (CFA) designations to develop their skills in this critical area. Many public accounting firms offer business valuation services in addition to their traditional services in business advisory, taxation, financial reporting, and insolvency. Investment bankers apply valuation principles when advising clients on public offerings or corporate restructurings. Venture capitalists employ them to price start-up companies. Portfolio managers use business valuation to help make informed investment decisions.

The income, market multiples, asset-based and residual income approaches are used to value a business. With the income approach, a business’s future operating cash flows are forecasted and then discounted using an appropriate cost of capital. The market multiples approach is a simpler method that uses industry average ratios such as price/ earnings, price/book value, or price/sales. These ratios are multiplied by a company’s earnings, book value, or sales per share to determine its fair market value. The asset-based approach takes a business’s historical cost balance sheet and restates its assets and liabilities at their fair value typically including an estimate of goodwill. Finally, residual income starts with a firm’s book value and adds any income it expects to earn over its equity investors’ required rate of return.

These business valuation methods are also used in the Module: Mergers and Acquisitions and Corporate Restructuring to determine take-over bids for business acquisitions.

**1.1 | Business Valuation Basics**

**Definitions of Value**

The value of a business can be defined in several ways.

**Market value.** The price that a business or its specific assets or liabilities trade at in efficient markets.

**Fair market value.** The price that a business or its specific assets or liabilities should trade at in efficient markets. Fair market value is estimated by business valuators when a market value is not available, or markets are not operating efficiently.

**Investment or acquisition value.** By combining two companies, the acquirer can realize synergies such as higher prices or economies of scale that justify paying more than the target firm’s fair market value.

**Intrinsic value.** What an equity analyst believes a firm is worth after considering all relevant information and removing any short-term pricing irregularities. If financial markets are efficient, the intrinsic value should match the market value or the fair market value meaning there is no mispricing due to market inefficiencies. Passive investors believe markets are efficient and typically invest in stock index mutual funds or exchange-traded funds (ETFs) with minimal stock turnover. Active investors think that abnormal returns or alphas can be earned by finding mispriced shares. If the current share price is lower than its intrinsic value, the analyst will issue a buy recommendation believing the company is undervalued. The opposite will happen if the share price is above its intrinsic value. Continuous trading in search of alpha results in high stock turnover and trading costs. Passive investors feel this extra cost does not justify the alpha earned while active traders feel it is justified.

**Going-concern value.** The value of a business that operates on an ongoing basis to maximize shareholder value. Companies trade at a premium to the market value of their net assets and liabilities because of the goodwill an organization can generate with its strong reputation, experienced workforce, and established systems and procedures. Market, investment, and intrinsic value all assume a business operates as a going concern.

**Liquidation or breakup value.** The value of a business or its specific assets or liabilities when a company plans to discontinue operations. The liquidation value is generally below the going-concern value, but in some cases when a company is poorly managed, under competitive pressures, or experiencing financial distress, it may be higher. These firms are said to be worth more “dead than alive.”

**Applications of Business Valuation**

There are numerous situations where a company needs to value a business or its specific assets or liabilities. The most important are:

**Private company transactions.** Most corporations are privately held by a small group of investors including the founder(s), their family members, managers, and employees. These investors may want to buy more shares or sell them upon their death, disability, termination of employment, or if they decide to retire, change jobs, or diversify their investment portfolios. These shares do not trade publicly, so business valuators can supply an estimate of their fair market value. Valuators also help improve a private company’s operations before it is sold, so shareholders receive the best possible price. This includes finding interested buyers, overseeing the bidding process, and completing all purchase or shareholder/partner rights agreements with the new buyers.

**Initial or secondary public offerings.** Private companies go public to improve their access to capital and provide shareholders with greater market liquidity. Public companies use secondary offerings to raise additional equity capital to fund growth opportunities when retained earnings are insufficient. Business valuators help determine an appropriate offering price in both scenarios.

**Buy, sell, or hold recommendations.** Major public companies are followed on an ongoing basis by a group of equity analysts who regularly issue earnings forecasts and prepare formal research reports. In these reports, analysts make buy, sell, or hold recommendations to their clients based on a thorough review of the company, its industry, and the overall economy and an estimate of the share’s intrinsic value.

**Timing stock repurchases.** Stock repurchases provide management with greater financial flexibility as they are not committed to paying regular cash dividends. Repurchases are best made when a company’s shares are undervalued to earn a profit for the remaining shareholders. A business valuator can help determine when these shares are mispriced.

**Internal management.** A manager’s primary goal is to maximize shareholder value, so they want to know if their firm’s share is undervalued. If it is, they will act to correct the market’s misperception. Management also wants to know the effect new strategic initiates will have on the share price, so they can better sell these ideas to the firm’s board of directors, shareholders, and stock analysts.

**Take-over bids.** Companies sometimes buy other businesses to generate synergies for themselves and the target firm leading to a higher share price post-acquisition. Business valuators carefully assess these synergies, so the acquirer does not overpay.

**Fairness opinions.** If shareholders receive a take-over bid from a potential acquirer, government regulators require that the firm’s management provide them with a fairness opinion before the offer expires. This opinion includes a valuation of the company and a recommendation on whether to accept or reject the offer.

**Ownership percentages for venture capitalists.** Venture capitalists supply needed financing to risky start-up companies when other investors will not. The value of a start-up must be measured, so the venture capitalist receives a suitable portion of the firm’s equity in exchange for their investment. This is particularly difficult for new companies as their growth prospects are uncertain and their shares do not yet trade publicly.

**Valuing divestiture, spin-off, or going-private transactions.** A company may sell or spin-off part of its operations for a variety of reasons such as to focus on its core business or to raise needed capital. A majority owner or group of managers may also decide to take a public company private to avoid the scrutiny of the financial markets, so they can focus on a business turnaround. A business valuator needs to determine a fair asking price.

**Liquidations or reorganizations.** When a company experiences financial distress and is declared bankrupt by the courts, it can either sell its assets and pay what it raises to its creditors (i.e. liquidation) or attempt to restructure its operations to successfully re-emerge from bankruptcy (i.e. reorganization). Being able to accurately value a business’s assets is critical to getting the most possible for creditors in a liquidation. In a reorganization, valuation principles are used to determine the percentage ownership creditors will receive in a debt-for-equity swap for new equity financing.

**Share-based compensation.** A substantial portion of management compensation comes from stock options and restricted shares to directly tie pay to share performance thus reducing agency costs. Business valuation tools are used to design these plans, so companies provide their executives with adequate compensation.

**Fair value accounting in financial reporting.** International Financial Reporting Standards (IFRS) allow companies to report many of their tangible and intangible assets and liabilities at fair market value instead of historical cost to improve the quality of financial reporting. Intangible assets like brand names or trademarks are particularly difficult to appraise. Valuation principles are also used to allocate an acquisition’s purchase price between a target company’s fixed assets, intangible assets, and goodwill and to measure any subsequent goodwill impairments.

**Transfer pricing.** Transfer pricing provides an accurate measure of a division’s or geographic area’s performance by fairly valuing intercompany sales. Companies may manipulate transfer prices to lower taxable income in a high-tax jurisdiction or increase profits in a certain business unit. Business valuators can help companies develop fair transfer pricing systems, mediate any company disputes, and provide expert testimony when the fairness of transfer prices is challenged in the courts.

**Fair value of assets for tax purposes.** Under the Income Tax Act (ITA), an asset’s fair market value is used to calculate any capital gains taxes owed in a deemed disposition of property or a non-arm’s length transaction. A deemed disposition occurs when a person is considered to have disposed of property even though a sale did not occur. This is common with the transfer of property as a gift or when a business is given to a family member upon the death of a taxpayer. Non-arm’s length transactions are with related persons where the fairness of the consideration is often questioned.

**Litigation support.** The fair market value of damages must be quantified for cases such as breach of contract, insurance claims, intellectual property infringement, business interruption, product or professional liability, asset expropriations, construction contract matters, personal injury, matrimonial property issues, or disputes with minority shareholders.If the parties cannot reach an agreement, the matter is referred to the courts and a business valuation professional may give expert testimony concerning appropriate damages.

**Sell-Side Analysts, Buy-Side Analysts, and Issuer-Paid Research**

Financial markets are divided into sell-side and buy-side activities. The sell-side primarily consists of investment bankers who construct, promote, and sell financial instruments such as stocks, bonds, and derivatives. These securities are sold to the buy-side of the market consisting of both retail and institutional investors including pension plans, insurance companies, banks, trust companies, hedge funds, mutual funds, ETF companies, and other investment management firms.

Investment banks employ sell-side analysts to assist in pricing initial and secondary public offerings and provide ongoing coverage of these shares in the secondary market. The earnings forecasts, research reports, and buy, sell, or hold recommendations these sell-side analysts provide are valuable sources of information. The website of a large corporation often lists the sell-side analysts that follow their firm.

Buy-side analysts work for institutional investors making investment recommendations that are used in managing their funds. These analysts collect information from company financial disclosures, research reports from other sell-side analysts, conference calls with management, company visits, interviews with industry experts, news media articles, social media postings, and financial information providers such as Bloomberg or Thomson Financial. Any information is used by the institutional investor only and not shared with the public.

Whether the recommendations made by sell-side analysts are objective is a contentious issue in the investment industry. Investment bankers directly benefit from any favorable coverage provided by their sell-side analysts through a higher initial public offering price or a corporate client’s promise of future work. Many investment bankers also provide investment advisory services to individual and institutional investors. Financial firms attempt to separate the activities of these units through strict ethical standards relating to the exchange of information. Despite this, investment advisory clients worry that their financial advisors will be forced to purchase shares on their behalf to support a corporate client’s share price contrary to their best interests. The movement of insider information between the investment banking and investment advisory units about possible corporate acquisitions, changes in dividend policy, or other corporate finance issues that will affect the share price is also a concern.

Many smaller public companies are not covered by sell-side analysts from the major investment firms. To increase their visibility in the financial markets especially when issuing new securities, these companies can hire an outside analyst to prepare a research report. This “issuer-paid” research compensates for the poor coverage provided by investment firms, but its objectivity is even more suspect than that provided by sell-side analysts.

**Business Valuation Methods**

A business can be valued using the income, market multiples, asset-based, and residual income methods, but it is an imprecise process. Instead of relying on one approach, most analysts employ several different valuation methods to improve the accuracy of their results. Some methods may be eliminated because their inputs are difficult to estimate, or the final valuation is an outlier. A weighted average of the remaining valuations is then calculated.

**Income.** A share’s value equals the present value of all future dividends an investor expects to receive.

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A one, two, or three-stage dividend discount model (DDM) and a historical, forward-looking, or sustainable growth rate of dividends are employed depending on the circumstances. Due to the stable nature of dividends and greater use of stock repurchases, free cash flow to equity (FCFE) or free cash flow to the firm (FCFF) is often substituted for dividends to provide a more accurate valuation. The model can also be adapted for companies with a significant amount of non-operating assets, multi-business operations, cyclical sales, or those experiencing financial distress. Estimating future cash flows and the proper discount rate is both time-consuming and error-prone so accurate results are difficult to achieve.

**Market multiples.** A benchmark multiple relates share price (P) to a measure of a firm’s financial performance such as earnings per share (EPS), book value per share (BVPS), or sales per share (SPS). This multiple is calculated using fundamentals, comparable company data, multi-regression analysis, or historical average multiples. The company then multiplies this benchmark by the firm’s own historical (i.e. trailing) or estimated (i.e. leading) EPS, BVPS, or SPS to determine the appropriate share price. Finally, this price is multiplied by the number of common shares to calculate the intrinsic value (V0) of the firm.

V0 = Benchmark () (EPS) (Number of common shares)

V0 = Benchmark () (SPS) (Number of common shares)

V0 = Benchmark () (BVPS) (Number of common shares)

Given the uncertainty of business valuations, analysts typically use more than one type of benchmark multiple to improve the accuracy of their results. Increasingly economic value (EV) and earnings before interest and taxes (EBITDA) are used instead of P and EPS to provide more accurate valuations.

**Asset-based.** The asset-based approach values a company by taking its historical cost balance sheet and restating all its assets and liabilities at their fair value. The difference between total assets and liabilities is the fair market value of the business. This approach is used sparingly because of the difficulty valuators have accurately pricing non-financial assets including land, building, equipment, and particularly intangible assets and goodwill. Also, more information is generally available about an entire business operating as a going concern than its assets/liabilities. With IFRS, more assets and liabilities are now recorded at fair value instead of historical cost which makes this method simpler to apply.

**Residual income.** Some managers feel that if a firm is profitable it is creating value for its investors. This is incorrect because although net income (NI) includes interest expense which fairly compensates debt holders, there is no deduction for the cost of common equity. If NI is insufficient to meet the shareholders’ required rate of return (RRR), the company is destroying value.

Residual income (RI) is the difference between a company’s NI and its shareholders’ RRR. If this amount is positive, the firm is creating value and its share price will rise above its BVPS. If RI is negative, the share price will fall below BVPS as the firm is destroying value. If the firm generates no RI, its BVPS should approximate its share price. The following formulas are equivalent and demonstrate this relationship and the different ways to calculate RI:

**1.2 | Format of a Research Report**

The CFA Institute defines a research report as a “written or electronic communication that firms sell or distribute to clients or the general public, which presents information about a corporate issuer and may express an opinion or make a recommendation about the investment potential of the corporate issuer’s equity securities, fixed income securities, or derivatives of such securities.” A firm’s research reports are attractively formatted and have a consistent appearance for quality control purposes. A two-column layout is normally used with a large column for the text of the report and a smaller sidebar containing supporting figures. If a figure is too large to fit in the side margin, it can be stretched across the page. The report is concisely written in simple language and the figures are used to summarize important information whenever possible. Instead of trying to discuss all points, the analyst focuses on the key elements that influenced their recommendation. The report is usually no more than 10 pages excluding appendices. Appendices provide supporting information and each appendix should be referenced in the report. Good research analysts avoid overloading users with too much information. A typical research report is divided into the following sections:

**Investment summary.** This is an executive summary of the key elements of the report including any major trends or developments, earnings projections, a summary of the valuation results, and a specific buy, hold, or sell recommendation.

**Business description.** The analyst briefly summarizes the company’s history, business focus, head office location, ownership structure, and the stock exchange it is listed on. Detailed information is also given about its business segments, product lines, customers, and geographical locations including exports, and their contributions to revenues, profits, and total assets.

**Industry overview and competitive positioning.** A company’s growth and profitability are closely aligned with the general state of the economy and the structure of its industry. The general state of the economy refers to its position in the business cycle. The economy is strong and growth prospects are high during periods of economic growth and weak when the economy contracts. Different economic factors such as monetary policy, fiscal policy, GDP growth, unemployment, productivity, inflation, and exchanges rates are used to evaluate the state of the economy. Industry structure is assessed using Michael Porter’s Five Forces which are industry rivalry, the threat of new entrants, the threat of substitutes, the bargaining power of suppliers, and the bargaining power of customers.

**Exhibit 1: Porter’s Five Forces**

Fast-growing industries with few competitors and product choices generally have less inter-company rivalry resulting in higher industry prices especially if there is a minimal threat of new entrants. Entry is discouraged by barriers such as economies of scale; limited access to distribution channels; experienced competitors; high capital or advertising expenditures; patent protection and government regulations such as licenses, quotas, or trade restrictions; and product differentiation like high product quality, customer loyalty, technical innovation, or brand recognition. Industry prices are lower if customers are large, can easily substitute other products, incur low switching costs, realize high savings from switching, and are not loyal to their existing brands. If there are only a few large suppliers, they can charge more because of their market power especially if they control key resources or technologies. Recent industry developments and long-term trends such as new government policies or technological changes also affect a company’s prospects.

A firm’s competitive positioning explains how it establishes an advantage over other companies in the industry. Porter identifies three general strategies to achieve this which include cost leadership, differentiation, and focus. Cost leadership means to be the low-cost producer and generate high profits through low prices and high turnover. Differentiation means developing a unique appeal such as high quality, superior technology, or brand recognition that allows a firm to charge a premium price. Focus means to target a specific market segment and to serve it better employing either cost leadership or differentiation strategies. In addition to these general strategies, specific marketing, operational, research and development, human resource, and finance strategies are also summarized in the research report.

A SWOT analysis (strengths, weaknesses, opportunities, and threats) is another tool that analysts use to evaluate a firm’s competitive position in their industry. Strengths are what a company does well such as superior quality or product design. Weaknesses are where it needs to improve such as poor overseas sales or high debt. Opportunities are business developments that may enhance future growth and profitability such as a new bilateral trade agreement or greater government support for R&D spending. Threats are potential obstacles such as higher taxes or an aging workforce. As the examples show, strengths and weaknesses are determined by internal company factors while opportunities and threats depend on the external business environment. Companies must build on strengths, address weaknesses, exploit opportunities, and overcome threats to be successful.

**Exhibit 2: SWOT Analysis**

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| --- | --- | --- |
|  | **Favourable** | **Harmful** |
| **Internal** | * Superior brand * Valuable intellectual property * Modern equipment * High customer retention * Good supplier relationships | * Gaps in management expertise * High staff turnover * Low asset turnover * Slow collections * Lack of financing |
| **External** | * Increasing domestic population * Rising disposable income * Expanding overseas markets * New materials technology * Growing environmental conscientious | * Skilled labour shortage * Increasing overseas competition * More product substitutes * Higher rate of technological change * Greater government regulation |

Porter’s Value Chain Analysis helps analysts better understand the sources of a firm’s competitive advantage over its peers. Its operations are divided into the primary and support activities that make up the value chain used to produce goods and services. Primary activities focus on acquiring inputs, converting them into finished products, and delivering them to customers, while support activities assist in this process. Each activity is then analyzed to identify the firm’s strengths and areas of improvement.

**Exhibit 3: Value Chain Analysis**

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| --- | --- | --- | --- | --- | --- | --- |
| **Support Activities** | **Firm Infrastructure** | | | | | **Value or Profit** |
| **Human Resources** | | | | |
| **Research and Development** | | | | |
| **Procurement** | | | | |
| **Primary Activities** | **Inbound Logistics** | **Operations** | **Outbound Logistics** | **Marketing and Sales** | **After-sales Service** |

**Management, governance, social responsibility, and sustainability**. A company’s management structure and the experience, successes, and failures of its senior executive team are discussed. The strengths and weaknesses of the corporate governance and executive compensation system are identified along with any initiatives in the areas of social responsibility and sustainability such as hiring more women and visible minorities and different green initiatives. Independent environmental, social, and governance (ESG) ratings are also examined.

**Investment risks.** In addition to identifying the most important risks, research analysts may indicate their impact (i.e. low, medium, high) and probability (i.e. low, medium, high) and outline any risk mitigation factors the company is undertaking to limit potential losses.

**Exhibit 4: Types of Investment Risks**

|  |  |
| --- | --- |
| Market risk | * Slowing economy * Rising interest rates * Higher input costs * Lower product prices * Changing exchange rates * Rising protectionism |
| Operating risk | * New lower-cost competition * Expanded product offering by competitors * Industry overcapacity * Failed acquisitions strategy * Outdated technology * Declining product quality or customer service * Falling net working capital and fixed asset utilization * Reliance on a single customer, product, or geographical area * Higher political risk in certain countries or regions * Risk of natural disaster |
| Legal, tax, and regulatory risk | * Pending lawsuits * Rising tax rates * Lower CCA rates and fewer fast write-offs * Shorter loss carryback and carryforward provisions * New health and safety regulations * Higher pollution standards |
| Financial risk | * Higher financial leverage and debt servicing costs * Limited liquidity using cash and unused lines of credit * Inability to afford required capital expenditures * Lower bond rating * Potential violation of loan covenants |
| Other risks | * Poor corporate governance and compensation practices * Difficulty attracting new executive talent |

**Financial analysis.** The business’s liquidity, asset management, long-term paying ability, profitability, and market valuation are carefully analyzed using ratio analysis, a 5-way analysis of return on equity, segmented analysis, cash flow statement analysis, and cash flow-based financial ratios. Major financial trends such as rapidly increasing sales, declining profit margins, changing sales mix towards higher profit margin products or customers, increasing financial leverage, rising net working capital and fixed asset turnover, higher capital expenditures (CAPEX), or shrinking cash flow from operations are the focus.

**Valuation.** This includes an estimate of the firm’s cost of capital; revenue, profit margin, and CAPEX projections for the next three to five years; terminal growth estimates for the subsequent periods; income and market multiples valuation model inputs and results; and any sensitivity, scenario or simulation analysis.

**Appendices.** This detailed information expands on the main report. It may include a glossary of key terms; historical and projected financial statements; current macroeconomic data and forecasts; cost of capital calculations; valuation model results; sensitivity, scenario, and simulation analysis findings; Porter’s Five Forces; SWOT analysis; governance information including board membership; governance ratings; organizational structure and executive biographical information; M-Scores measuring earnings quality; Z-Scores measuring the probability of bankruptcy; and a ratio analysis including peer benchmarking.

Much of the information used to prepare a research report is found in the company’s audited financial statements, notes to the financial statements, management discussion and analysis, annual information form, management information circular, and other disclosures available on its website or through the Canadian Securities Administrators’ (CSA) System for Electronic Documents and Retrieval (SEDAR). Financial information providers like Bloomberg or Thomson Financial provide much of the same information along with industry comparisons. Analysts participate in conference calls with the company’s executives and site visits sponsored by the firm’s investors relations department. They also interview industry experts, customers, suppliers, contractors, and competitors and review research reports of sell-side analysts and social media posts about the company.

The CFA Institute Research Challenge invites finance students from across the globe to compete in preparing and presenting company research reports that include a buy, hold, or sell recommendation. The competition starts at the local level where student teams are assigned a domestic company to research under the joint supervision of a faculty advisor and industry practitioner. The report is presented to a panel of judges composed of CFA members. Successful teams go onto regional competitions in the Americas; Asia Pacific; and Europe, Middle East, and Africa, and those winners qualify for the global finals. Students gain valuable experience preparing and presenting their high-quality research reports to industry experts.

**1.3 | Professional Designations**

There are two professional designations available in Canada for those interested in a career in business valuations.

**Chartered Business Valuator.** These professionals focus on valuing individual transactions, assets, liabilities, or entire business enterprises as well as litigation support which includes quantifying business damages arising in legal disputes and supplying expert testimony at trial if necessary. Most CBVs in Canada are also CPAs who work primarily as associates or partners in public accounting firms supplying business valuation and other accounting services including business advisory, taxation, financial reporting, and insolvency. Candidates usually complete their CPA first and then pursue a CBV designation to further develop their skills. Public accounting firms offer excellent mentorship opportunities for candidates and the opportunity to participate in a variety of complex valuation engagements. After becoming a CBV, members may join firms specializing in business valuations, while others work as self-employed contractors.

To be accepted into the CBV program, candidates must have a degree or hold either a CPA or CFA designation. To earn a CBV, candidates must:

1. Complete six courses

Level I – Introductory Business Valuation

Level II – Intermediate Business Valuation

Level III – Advanced Business Valuation

Level IV – Special Topics in Business Valuation

Two electives from the following:

Litigation Support in Business Valuation

Corporate Finance

Valuation for Financial Reporting

Private Investments

2. Acquire a minimum of 1,500 hours of suitable experience

1. Pass the Membership Qualification Exam (MQE)

The 1,500 hours of work experience must have at least 750 hours of Core Valuation Experience. According to the CBV Institute, this experience “… involves activities in connection with business valuations, corporate finance, private investments, and litigation support, where a conclusion as to the value related to a business, or where a conclusion of economic loss is reached.” The remaining hours consist of Non-Core Valuation Experience and are activities in similar areas that do not result in a conclusion of value. The MQE is four hours in length and is held every September. Candidates must complete their work experience within three years of writing the MQE to qualify for the designation. CPAs, CFAs, and graduates of some university courses in business valuations receive program exemptions.

**Chartered Financial Analyst.** CFAs manage investment portfolios of high net worth individuals or institutions such as pension funds, endowments, insurance companies, or mutual funds and are experts in the different areas of investing including equities, fixed income, and alternative investments like real estate, venture capital, and private equity. They are also skilled in risk management and hedging against commodity price movements, currency fluctuations, and credit risk. CFAs, unlike CBVs, focus primarily on the valuation of financial securities.

To be accepted into the CFA program, candidates must normally have a degree but can enroll in and complete the first level of the program before graduating. They are also admitted if they have a combination of four years of post-secondary education and full-time work experience in an investment or non-investment area.

To earn the CFA designation, candidates must complete three levels of study over three years and pass a six-hour exam at the end of each level. The program requires well over 900 hours of self-study in 10 topical areas including ethical and professional standards, quantitative methods, economics, financial reporting and analysis, corporate finance, equity investments, fixed income, derivatives, alternative investments, and portfolio management and wealth planning. The curriculum is based on an ongoing analysis of what practicing professionals feel is needed to succeed in the competitive investment industry.

To assist candidates in preparing for their very rigorous accreditation exams, the CFA Institute provides a detailed online curriculum and other learning resources such as end-of-reading problems and mock exams. Private educational companies also supply preparation courses and practice exams to supplement what the CFA Institute offers. Before receiving their professional designations, candidates must complete 4,000 hours of qualified work experience and receive letters of reference from three professionals who attest to their experience and character. Compared to an MBA or Master of Finance, the CFA is an affordable program that allows professionals to complete a graduate-level credential in finance without taking time off work.

**1.4 | CFA Institute Research Standards**

CFA Institute members agree annually to follow the Institute’s Code of Ethics and Standards of Professional Conduct which governs their behaviour as investment professionals.

**The Code of Ethics**

CFA Institute members and CFA candidates must:

* Act with integrity, competence, diligence, respect, and in an ethical manner with the public, clients, and prospective clients, employers, employees, colleagues in the investment profession, and other participants in the global capital markets.
* Place the integrity of the investment profession and the interests of clients above their own personal interests.
* Use reasonable care and exercise independent professional judgement when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.
* Practice and encourage others to practice in a professional and ethical manner that will reflect credit on themselves and the profession.
* Promote the integrity and viability of the global markets for the ultimate benefit of society.
* Maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals.

**Standards of Professional Conduct**

1. **Professionalism**
2. **Knowledge of the Law.** Members and Candidates must understand and comply with all applicable laws, rules, and regulations (including the CFA Institute Code of Ethics and Standards of Professional Conduct) of any government, regulatory organization, licensing agency, or professional association governing their professional activities. In the event of conflict, Members and Candidates must comply with the more strict law, rule, or regulation. Members and Candidates must not knowingly participate or assist in and must dissociate from any violation of such laws, rules, or regulations.
3. **Independence and Objectivity.** Members and Candidates must use reasonable care and judgement to achieve and maintain independence and objectivity in their professional activities. Members and Candidates must not offer, solicit, or accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise their own or another’s independence and objectivity.
4. **Misrepresentation.** Members and Candidates must not knowingly make any misrepresentation relating to investment analysis, recommendations, actions, or other professional activities.
5. **Misconduct.** Members and Candidates must not engage in any professional conduct involving dishonesty, fraud, or deceit or commit any act that reflects adversely on their professional reputation, integrity, or competence.
6. **Integrity of Capital Markets**
7. **Material Nonpublic Information.** Members and Candidates who possess material non-public information that could affect the value of an investment must not act or cause others to act on the information.
8. **Market Manipulation.** Members and Candidates must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.
9. **Duties to Clients**
10. **Loyalty, Prudence, Care.** Members and Candidates have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. Members and Candidates must act for the benefit of their clients and place their clients’ interests before their employer’s or their own interests.
11. **Fair Dealing.** Members and Candidates must deal fairly and objectively with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities.
12. **Suitability**
13. When Members and Candidates are in an advisory relationship with a client, they must:

a. Make a reasonable inquiry into a client’s or prospective client’s investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly.

b. Determine that an investment is suitable to the client’s financial situation and consistent with the client’s written objectives, mandates, and constraints before making an investment recommendation or taking investment action.

c. Judge the suitability of investments in the context of the client’s total portfolio.

2. When Members and Candidates are responsible for managing a portfolio to a specific mandate, strategy, or style, they must make only investment recommendations or take only investment actions that are consistent with the stated objectives and constraints of the portfolio.

1. **Performance Presentation.** When communicating investment performance information, Members and Candidates must make reasonable efforts to ensure that it is fair, accurate, and complete.
2. **Preservation of Confidentiality.** Members and Candidates must keep information about current, former, and prospective clients confidential unless:

1. The information concerns illegal activities on the part of the client or prospective client,

2. Disclosure is required by law, or

3. The client or prospective client permits disclosure of the information.

1. **Duties to Employers**
2. **Loyalty.** In matters related to their employment, Members and Candidates must act for the benefit of their employer and not deprive their employer of the advantage of their skills and abilities, divulge confidential information, or otherwise cause harm to their employer.
3. **Additional Compensation Arrangements.** Members and Candidates must not accept gifts, benefits, compensation, or consideration that competes with or might reasonably be expected to create a conflict of interest with their employer’s interest unless they obtain written consent from all parties involved.
4. **Responsibilities of Supervisors.** Members and Candidates must make reasonable efforts to ensure that anyone subject to their supervision or authority complies with applicable laws, rules, regulations, and the Code and Standards.
5. **Investment Analyst, Recommendations, and Actions**
6. **Diligence and Reasonable Basis.** Members and Candidates must:

1. Exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions.

2. Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.

1. **Communication with Clients.** Members and Candidates must:

1. Disclose to clients and prospective clients the basic format and general principles of the investment processes they use to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.

2. Disclose to clients and prospective clients significant limitations and risks associated with the investment process.

3. Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients.

4. Distinguish between fact and opinion in the presentation of investment analysis and recommendations.

1. **Record Retention.** Members and Candidates must develop and maintain appropriate records to support their investment analyses, recommendations, actions, and other investment-related communications with clients and prospective clients.
2. **Conflicts of Interest**
3. **Disclosure of Conflicts.** Members and Candidates must make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with respective duties to their clients, prospective clients, and employer. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.
4. **Priority of Transactions.** Investment transactions for clients and employers must have priority over investment transactions in which a Member or Candidate is the beneficial owner.
5. **Referral Fees.** Members and Candidates must disclose to their employer, clients, and prospective clients, as appropriate, any compensation, consideration, or benefit received from or paid to others for the recommendation of products or services.
6. **Responsibilities as a CFA Institute Member or CFA Candidate**
7. **Conduct as Participants in CFA Institute Programs.** Members and Candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of the CFA Institute programs.
8. **Reference to CFA Institute, the CFA Designation, and the CFA Program.** When referring to CFA Institute, CFA Institute membership, the CFA designation, or candidacy in the CFA Program, Members and Candidates must not misrepresent or exaggerate the meaning or implications of membership in CFA Institute, holding the CFA designation, or candidacy in the CFA program.

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Certain Standards of Professional Conduct are particularly relevant to analysts when preparing research reports. These include:

**I(B) Independence and Objectivity.** Analysts must avoid situations that impede their independence and objectivity when preparing research reports. Subject companies often pressure analysts to expand coverage of their firms or give more favourable recommendations that inflate their share price especially when they are issuing new securities or exercising executive stock options. Analysts should not:

* Accept gifts, tickets to cultural/sporting events, paid travel or vacations, job referrals, contributions to charities on their behalf, personal favours, or other benefits.
* Accept paid travel for themselves and possibly their families to attend meetings with executives, site visits, investment conferences, or other events sponsored by the subject company.
* Allow professional/personal relationships or biases to influence their recommendations.
* Accept an allocation of shares from a subject company in an oversubscribed initial public offering (IPO) to trade in their personal accounts.
* Be pressured by their firm’s investment banking unit to provide favourable recommendations to benefit a current or prospective client.
* Agree to a compensation arrangement that is linked to the success of a security issue managed by their firm’s investment banking unit.
* Be pressured by a subject company to provide favourable recommendations by threatening not to arrange interviews with executives or permit them to attend or ask questions during conference calls when quarterly earnings are announced. Some subject companies even threaten to take legal action against analysts and/or their firms for negatively impacting their reputation.
* Be pressured by a portfolio manager to give a more favourable recommendation to increase the value of their clients’ investments.
* Circumvent “firewalls” that prevent the flow of confidential information between the investment banking and research units at an investment firm.
* Agree to a compensation arrangement for preparing “issuer-paid” research that is linked to an increase in the subject company’s share price such as with stock options or warrants. Analysts should only accept a flat fee and never attempt to convince readers that the research report is written by someone else.

Investment firms establish compliance policies and procedures to ensure the independence and objectivity of their research analysts.

* Investment recommendations are the unbiased opinions of research analysts and should be free of outside influences. If an investment firm does want an analyst to publish an unfavourable opinion about a client or prospective client, it should cease covering the company and only provide factual information.
* Strict limits are placed on accepting gifts and other benefits. Customary gifts based on local business practices and normal business-related entertainment are acceptable up to a specific amount per gift or an annual limit, but they must never influence the independence and objectivity of the analyst.
* Analysts need to use commercial transportation and pay for their lodgings when meeting with subject companies unless they are unavailable due to a site’s remoteness. The frequency of company visits by analysts is monitored for abuse particularly if they are always being hosted by the subject company.
* Compensation systems are designed so financial analysts are not tempted to put their personal financial interests ahead of their clients.
* A research unit is independent and does not report to another business unit that may try to influence its recommendations.
* An analyst’s personal trading is regulated particularly their involvement in IPOs and private placements where abuses are more common.

**I(C) Misrepresentation.** Truthful investment information is critical in maintaining investor confidence and the integrity of the financial markets. Analysts must not make false or misleading statements or omit material information in their research reports and other communications such as presentations, media interviews, marketing brochures, newsletters, e-mails, texts, or social media posts. Analysts should not exaggerate their qualifications or those of their firm, the services either can competently provide or their performance records. All information sources such as websites must be kept up-to-date and not guarantee investors specific returns. Valuation model results are presented as opinions and not facts and they must incorporate all relevant variables. Investment performance should be measured against an appropriate benchmark. When the returns on illiquid or non-trading assets such as real estate are estimated, analysts should not deceive investors by manipulating the results or seeking out external information providers that supply more favourable valuations. When using investment information from third parties such as credit ratings, other analysts, interviews with outside experts, government and private data sources, or financial filings, analysts must ensure that the information is accurate, the other parties have given their permission to use it, and the sources are identified. Research reports may summarize the work of others but analysts cannot claim the work as their own.

An investment firm should define its qualifications and the services it can provide and clearly communicate them to its employees to avoid any misrepresentation. Each analyst should also maintain an up-to-date summary of their qualifications, experience, and competencies. This information should be reviewed by a supervisor or the compliance department, including random spot checks of claims made by analysts in correspondences or research reports, and then made available to clients. A supervisor or review committee should approve all research reports to ensure they are free of misrepresentations and plagiarism.

**II(A) Material Non-public Information.** Analysts may receive material, non-public information when researching a subject company. Making investment recommendations based on this information erodes investor confidence in the financial markets as the markets appear “rigged” in favour of a select group of wealthier investors who often receive the information first. This leads to lower business investment causing economic activity to decline.

Information is material if it is likely to have a major impact on the price of a company’s securities. This information can be specific to a company like quarterly earnings, a change in senior management, a potential business acquisition, or the loss of a major customer. It can also relate to outside factors that influence the price of a firm’s shares such as the bankruptcy of a competitor, an adjustment to the firm’s credit rating, or new economic data on housing starts, employment, or inflation. Whether this information is material or not is influenced by the reliability of its source. For example, information coming from a company’s vice-president of marketing about the potential success of a new product is likely very material where the opinion of an outside industry expert is probably not. Even if the information comes from a corporate insider like a senior executive, if it is uncertain what impact it will have on security prices, it is less likely to be considered material. For example, a decision to introduce a new human resource management system is likely not material.

Information is non-public if it is disseminated to a select group of investors, either intentionally or by accident, and not the entire market. Material, non-public information told to a meeting of analysts is selective disclosure and could lead to charges of insider trading if acted upon or given to others (i.e. tipping). Companies go to great lengths to ensure all disclosures of material information are made to the general market first usually through a press release on SEDAR. Any subsequent meetings or conference calls with analysts are carefully scripted to ensure executives do not disclose any new material information. If it occurs accidentally, a company immediately contacts any analysts present and instructs them not to trade while they make the information public. Regulators are informed so they can monitor the financial markets for insider trading. Companies are also careful to treat all research analysts fairly. Analysts from larger investment firms do not receive preferred access to information and those who have previously given the company a negative recommendation are not excluded.

Research analysts want to make inciteful recommendations about subject companies based on thorough research that earns their clients above-average returns. Under the Mosaic Theory, an analyst can make a recommendation based on public information or immaterial non-public information without fear of being prosecuted for insider trading. All analysts should maintain a detailed record of their research, so they can prove to regulators that their superior results were due to skill. Successful analysts whose research has a major impact on security prices are not guilty of insider trading when they selectively disclose their findings to their clients. Analysts should be cautious when they are interviewing industry experts or studying the internet and different social media platforms that they are not receiving material, non-public information. Social media platforms such as blogs that limit membership are particularly concerning.

Investment firms, especially those with both investment banking and research units, implement a variety of compliance policies and procedures to help prevent insider trading. They include:

* Firms physically separate their investment banking and research units and prohibit employees from working in both areas. This limits the exchange of material, non-public information about subject companies that are also investment banking clients.
* “Firewalls” control interdepartmental communications to limit the flow of insider information. An independent compliance officer or supervisor reviews, authorizes, and documents all contacts. Employees who frequently deal with sensitive material are trained to protect it.
* Written policies and procedures on insider trading are circulated to employees. Training is provided on the seriousness of insider training and how to identify it. Analysts are warned not to pressure a subject company to disclose material, non-public information.
* Analysts who obtain insider information, or know of others who have, are instructed to immediately report it to a supervisor or the firm’s compliance department who will encourage the subject company to make it public. The analyst should not trade on this information, encourage others to do so, or alter their investment recommendations until it is made public.
* Analysts report all personal trading activity to their employers so it can be monitored for insider trading. When a firm has material, non-public information about a company, its shares are typically placed on a “restricted” list, and employees are prohibited from trading. Broadly distributing a restricted list to all employees may encourage the same behaviour that the list is trying to prevent, so firms instead use a “watch” list that is only given to compliance personnel who monitor trading.

**V(A) Diligence and Reasonable Basis.** An analyst must demonstrate great care, impartiality, and thoroughness when preparing a research report about a subject company and have a sound basis for their investment recommendation that reflects all pertinent facts. Data from internal or external sources must be carefully monitored to ensure it is reliable. Internet sources such as blogs should be checked more carefully than data from established financial information services firms. Investment firms may pre-approve external information sources, but analysts should only use them if they feel the firm demonstrated due diligence. Analysts need to thoroughly understand all quantitative valuation models and include all relevant variables. Reliable input data representing multiple economic scenarios especially negative market events should be used. Research reports are often prepared by groups of analysts who make a final recommendation by consensus. Even if an analyst does not agree with the recommendation, they can sign the research report if proper research methods were followed.

The investment firm should establish the following compliance policies and procedures to ensure diligence and reasonable basis:

* Research reports follow specific guidelines as to their format and content.
* A supervisor or review committee approves all reports including any quantitative valuation models.
* A supervisor or review committee evaluates the quality of an analyst’s research according to specific criteria which are used to determine their compensation.
* External research providers are regularly evaluated based on set criteria.

**V(B) Communication with Clients.** Analysts must describe to clients and prospective clients the decision-making process they followed when making investment recommendations in their research reports. They should discuss the limitations of the approach and any significant risks that may impact the subject company’s valuation. Analysts can focus on specific areas of the firm’s performance that they feel are important and ignore others as long as it is justified based on a complete analysis of the company. Quantitative models must be thoroughly described including all assumptions and any changes in methodology from previous reports. Analysts need to differentiate between fact and opinion when making investment recommendations. Estimates of future cash flows, comparable company multiples, or the cost of capital are opinions regardless of the complexity of the statistical analysis. Supervisors or review committees must ensure that research reports are thorough and consider all relevant factors so the firm’s clients are well informed. Analysts should maintain detailed records so they can address client’s questions that are not covered in the research report. All reports and recommendations should be kept up-to-date as conditions change. If research findings are communicated in a condensed form such as a simple buy or hold recommendation in an investor presentation, media interview, phone conversation, or e-mail message, the analyst should indicate that the full report is available.

**V(C) Record Retention.** Analysts must maintain appropriate records to support the findings in their research reports. This requirement is not met just by keeping a copy of the report on file. Records should include any other information about a subject company, in paper or electronic form, used to prepare the report including:

* Notes from any conference calls or direct meetings with executives or members of the company’s investor relations department
* Notes from company visits
* Notes from interviews with outside sources such as economists, industry experts, customers, suppliers, contractors, or competitors
* Copies of press releases and financial filings
* Copies of news media articles
* Copies of e-mails, text messages, blog posts, Twitter posts, and other social media communications
* Research reports prepared by other analysts
* Secondary data from governments or financial information services firms
* Discussion of any computer-based valuation models and the inputs used
* Analysis of the valuation model’s outputs

Investment firms establish policies and procedures about what records are required and how they should be stored. The CFA Institute recommends that records be kept for at least seven years unless a firm or industry regulator stipulates a longer period. These records are the property of an analyst’s employer. If an analyst changes firms, they cannot take these records with them without the consent of their employer. They also cannot use the published research report even if it is made public because the supporting records are not available. An analyst can only recreate records using disclosures made directly by the subject company and other public information. An analyst’s memory of what was included in the supporting records cannot be used.

**VI(A) Disclosure of Conflicts.** Research analysts should avoid actual conflicts of interest or the appearance of conflicts with their clients, potential clients, and employers that may impact their ability to act independently and objectively. When conflicts do exist, analysts must disclose them prominently in plain language and update these disclosures as material changes occur. Conflicts exist if the research analyst owns shares in the subject company or serves as a consultant or corporate director where they will likely receive insider information. The analyst’s employer could also be the subject company’s investment banker and require the analyst to help market new security issues and link their compensation to an issue’s success. The subject company may pay the analyst directly for an “issuer-paid” research report where the analyst gives a positive recommendation regardless of the firm’s actual performance. Analysts must inform clients and potential clients of any compensation or other benefits received for their recommendations and how they are determined.

Research analysts are encouraged to purchase the shares of companies they recommend to better align their financial interests with those of their clients and employers. Analysts should trade in a manner that is consistent with their firm’s recommendations and give priority to the trades of their clients and then their employer before engaging in any personal transactions to avoid conflicts of interest. Personal trades are those that benefit the analyst or an immediate family member such as a spouse or child who resides at the same principal residence. Other family members such as parents or siblings are treated the same as regular fee-paying clients. Analysts can trade themselves or through a trust or pension plan in which they are a beneficial owner. They do not have to disclose trades in well-diversified equity and fixed-income funds in trusts or pension plans as these investments are not in specific companies.

Investment firms implement different compliance policies and procedures to avoid conflicts of interest and ensure any that occur are properly disclosed. These may include:

* Disclose compensation arrangements such as bonuses, commissions, performance fees, referral fees, or stock option grants that may impact an employee’s ability to act independently and objectively
* Shares in initial public offerings (IPOs) are allocated to all interested clients first before research analysts are allowed to trade. Allocations should be done fairly and not used to reward larger clients or generate future business.
* “Blackout” or “restricted” periods prohibit employees from “front-running” or trading in advance of the firm’s clients when a research recommendation is announced.
* All personal trading is precleared by the compliance department and employees must supply a confirmation once the transaction is completed. Employees also provide a summary of their investment holdings at least annually.

**CFA Institute’s Research Objectivity Standards**

The CFA Institute’s Research Objectivity Standards supplement the requirements in the CFA Code of Ethics and Standards of Professional Conduct. These additional standards focus on sell-side analysts who work for investment banking, wealth management, and independent research firms preparing research reports. Each firm should have a compliance or legal department that implements and enforces these standards and any additional policies and procedures adopted by the company, government, or industry regulators. A summary of the CFA Research Objectivity Standards includes:

* Firms should have a written policy governing research objectivity and independence and distribute it to their covered employees and clients. Employees should receive regular training concerning their responsibilities under the policy. Firms should have an effective compliance system that clearly outlines all potential violations and the appropriate disciplinary actions that will be taken including dismissal. Supervisors will ensure employees comply with the policy and senior officers will attest that it is being followed. The system is monitored and audited on an ongoing basis and proper records are maintained. All types of violations and their corresponding penalties are disclosed to clients.
* Research analysts should provide the audience during a public appearance such as an investment seminar, forum, or media interview with sufficient information to make an informed judgment about the objectivity of the research report and the suitability of the investment for each investor. A copy of the full research report should be made available to audience members at a reasonable price on the firm’s website. During the appearance, analysts should disclose any conflicts of interest, such as whether their firm has an investment banking relationship with the subject company, if their compensation is linked to the firm’s investment banking efforts, or if the research analyst has or is currently participating in the marketing activities of the subject company.
* Research analysts should have a reasonable and adequate basis for their recommendations. A supervisor or review committee should evaluate and approve all reports and recommendations. Written procedures should be developed describing the due diligence process to be followed when determining if there are reasonable and adequate grounds for any recommendation.
* Firms should separate their research and investment banking units and ensure that investment banking personnel are not able to influence recommendations. The research unit cannot report to the investment banking unit and investment banking personnel cannot review, modify, approve, or reject research reports and recommendations. The research unit should only communicate with the investment banking unit to verify information about the company. Any communications between the two units should be documented, and the compliance department should serve as an intermediary. A “quiet period” should be respected for 10 days after a secondary offering and 30 days after an initial public offering. During a quiet period, research analysts are prohibited from issuing any research reports and recommendations or speaking in public about a subject company. This helps them remain objective and avoid disclosing any insider information to select investors.
* Research analysts should be compensated based on the quality of their research and not on the success of their firm’s investment banking activities in which they collaborated. Firms should establish specific criteria to evaluate the quality of an analyst’s research and its accuracy over time.
* Policies should be developed so research analysts remain at arm’s length with the subject company. Analysts need to freely communicate with a subject company in conference calls or company visits, but they cannot accept material gifts or paid travel to attend these events. Research analysts should make sure that any information they receive from the subject company is not insider information. If insider information is disclosed by the subject company, the analyst should work quickly with the company to disclose it publicly. Analysts cannot give the subject company advanced notice of their recommendations, promise a favorable report or specific price target, or threaten to change its recommendation or price target. Subject companies can only be asked to fact-check portions of the report before publication. The compliance department should oversee and document any communication with the subject company. They should receive a copy of the report before it is shared with the subject company and approve any subsequent changes by the research analyst who should provide a written justification for the change.
* Research analysts are encouraged to invest in subject companies to better align their interests with their clients, but policies should be implemented to ensure the interests of the clients always come first. Research analysts or members of their immediate family (i.e. people with whom they share the same residence) should not be allowed to trade in advance of new information (i.e. front-running), purchase securities before an initial or secondary public offering, trade in a manner that is inconsistent with the firm’s current recommendation (i.e. buy, hold, or sell), invest in derivative securities relating to the subject company’s share, or engage in speculative short-term trading. All trades should be approved in advance by the compliance department and each employee needs to regularly provide a listing of their investment holdings. A “restricted period” should be maintained that bars trading in any subject company’s shares before a new security offering, before the release of a research report and other recommendations, or while the firm has material, non-public information to prevent front-running and insider trading. All shares should be held for at least 60 days to stop short-term speculation unless extreme financial hardship can be demonstrated by the analyst. Companies should have a strict definition of what constitutes financial hardship to prevent abuse of this provision.
* Once a firm initiates coverage of the subject company, it should update its recommendation regularly, usually quarterly, or when the company makes a significant announcement that may affect its operations. A firm should not discontinue coverage without providing a final research report and recommendation. They should also provide a clear explanation of why they are stopping coverage.
* Rating systems for stock recommendations can be absolute (e.g. buy, hold, sell) or relative to a market index or other benchmark (e.g. outperform, neutral, underperform). Ratings should also provide the period, typically one year, over which the price target is expected to be achieved and an indication of the riskiness of the investment. All communications of ratings in research reports or public appearances should include these three elements. The firm should only communicate the official rating and provide clients with a description of the rating system. Employees are prohibited from communicating any alternative ratings.
* All of a firm’s or research analyst’s conflicts of interest should be disclosed prominently in language that can be easily understood by clients. Disclosures should be made in the research report, on the company’s website, or using whatever method is most appropriate in the situation. Conflicts of interest may include a firm serving as a subject company’s investment banker; a firm acting as a market maker for a subject company’s shares; an analyst collaborating in a public offering being managed by their firm’s investment banking unit; an analyst assisting in marketing efforts such as “roadshows” to help sell a subject company’s securities; a firm or analyst investing in a subject company; an analyst being compensated based on the success of a public offering; an analyst receiving material gifts from a subject company; or a member of a firm or analyst serving as an advisor, officer, or director of a subject company.