Bruce Jacobs's Comments on AIMR's Proposed Research Objectivity Standards

August 12, 2002

Dear AIMR:

The proposed Research Objectivity Standards regarding analyst conflicts of interest are welcome, but AIMR should also look a little closer to home for conflicts of interest that have the potential to taint research and to inflict harm on investors. Just as the research conducted by analysts at brokerage firms and investment banks is susceptible to the influence of commercial interests that may conflict with the best interests of their clients, so too the work done for and by AIMR and its professional publications and conferences is susceptible to being influenced by interests that may conflict with the best interests of members and investors in general. I believe that the Research Objectivity Standards as proposed should be expanded to deal with these conflicts of interest.

For instance, AIMR's own *Financial Analysts Journal* (*FAJ*) plays a critical role in communicating the latest research and findings on investment instruments, techniques, and theories. Although the articles published generally do not make recommendations regarding individual securities, they do recommend particular strategies and instruments for investing, particular methods for evaluating stocks, and particular theories of how markets and/or investors "work." Many of these articles form the basis for investment research tools, quantitative analysis and portfolio decision-making. These articles can thus have very real effects in terms of shaping what investments are made and the way they are made and, consequently, on the results experienced by investors.

As a vital link between research and practice, the *FAJ* provides an invaluable service to the investing community. However, the procedures by which this service is rendered are too often rife with conflicts of interest. This is especially true today, as the boundary between the academic and practitioner research communities becomes ever more porous. Academics move back and forth between the university and Wall Street, take on paid consulting roles, and/or start their own businesses; investment firms, too, have taken a broader role in funding research undertaken by academics, either directly or indirectly via their support of bodies such as The Research Foundation of AIMR. In such an environment, it is all but inevitable that individuals' financial interests will influence (consciously or not) the types of research that are undertaken and that get published.

Transparency, in the form of disclosure of the business affiliations of authors of articles in the *FAJ* or of Research Foundation monographs, allows readers themselves to assess the possible effects of conflicts of interest on authors' research. However, readers are not privy to conflicts of interest affecting Editors, Editorial Board members, reviewers and others involved in the processes underlying publication, including peer reviews of manuscripts and grant proposals, which have the potential to bias decisions regarding what gets published (and what doesn't). Authors, readers, and the investment community in general could place greater trust in the objectivity of AIMR's publications if the organization had a clear, publicly stated policy explicitly governing conflicts of interest. In effect, AIMR is currently in the same position as the investment institutions and media it finds at fault for lacking such policies!

The medical profession has been grappling with the effects of conflicts of interest on their published research for about two decades.[(1)] A recent editorial in the *New England Journal of Medicine*, signed by the editors of the world's leading general medical journals, quotes extensively from the "Uniform Requirements for Manuscripts Submitted to Biomedical Journals," which begins with a statement on the importance of controlling conflicts of interest:[(2)]

> Public trust in the peer review process and the credibility of published articles depend in part on how well conflict of interest is handled during writing, peer review, and editorial decision making. Conflict of interest exists when an author (or the author's institution), reviewer, or editor has financial or personal relationships with other persons or organizations that inappropriately influence (bias) his or her actions. The potential for such relationships to create bias varies from negligible to extremely great; the existence of such relationships does not necessarily represent true conflict of interest . . . . The potential for conflict of interest can exist whether or not an individual believes that the relationship affects his or her scientific judgment. Financial relationships . . . are the most easily identifiable conflicts of interest and the most likely to undermine the credibility of the journal, the authors, and of science itself. Conflicts can occur for other reasons, however, such as personal and family relationships, academic competition, and intellectual passion.

In order to ameliorate the ill effects of conflicts of interest, the "Uniform Requirements" calls for "All participants in the peer review and publication process [to] . . . disclose all relationships that could be viewed as presenting a potential conflict of interest." Thus authors submitting a manuscript or letter are required to disclose all financial and personal relationships that may bias their work; it is up to the Editors to decide whether this information should be included if the manuscript is published.[(3)] Reviewers of manuscripts are required to state whether there exist conflicts of interest that could bias their opinion of the manuscript and to disclose such conflicts if they exist; they should disqualify themselves from reviewing particular manuscripts if appropriate. Editors can have no personal, professional, or financial involvement in any issues they might judge; other members of the editorial staff involved with editorial decisions must disclose to Editors their current financial interests and disqualify themselves from any decisions where they have a conflict of interest. Editors should avoid submitting research they have authored or co-authored to their own journals; if they do so, they should delegate editorial decisions on those manuscripts to others.[(4)] Editors should publish regular disclosure statements about potential conflicts of interest related to commitments of the journal's staff.

My own experience illustrates that conflicts of interest are not being controlled, or perhaps even considered, at the *FAJ*. For example, in the late 1980s, I submitted to the *FAJ* a manuscript on portfolio insurance and its contribution to the stock market crash of 1987. In the early 1980s, well prior to that crash, I had submitted a manuscript on the pitfalls of portfolio insurance to another journal. Those manuscripts were rejected for publication on the basis of reviews by the leading purveyor of portfolio insurance at the time (who was also a member of the Editorial Boards of both journals). If conflict of interest standards had been in place and enforced, the Editor would not have assigned the work to this particular reviewer or, if the Editor had, the reviewer would have recused himself.

Of course, this was in the 1980s. One might hope that standards have improved since. My experience suggests otherwise. In 1999, I published a book, *Capital Ideas and Market Realities*, which discusses the dangers to market stability posed by certain derivatives-based strategies, using portfolio insurance and the crash of 1987 as an example.[(5)] Given my past experience with the *FAJ*, I was pleasantly surprised to see a favorable review of the book in the July/August 2000 issue. This review, written by the *FAJ*'s Book Review Editor, stated: "Jacobs' meticulously documented book presents compelling evidence . . . that portfolio insurance failed to deliver on its lofty promises." In the January/February 2001 issue of the *FAJ*, however, the same Book Review Editor published an unprecedented "Postscript," which charged that I had "marshaled selected quotations" to make my case and asserted, on the basis of various unnamed sources, that presentations made by the leading portfolio insurance purveyor were "candid in describing the likely impact of greater-than-expected volatility." (See my "Open Letter to AIMR and the *Financial Analysts Journal*," October 1, 2001, at **http://www.CIMRbook.com/cimr/ethicalissues.html**.[(6)])

Pensions & Investments subsequently uncovered the fact that the Book Review Editor wrote this "Postscript" at the suggestion of the same Editorial Board member and leading portfolio insurance purveyor who had rejected my original manuscripts.[(7)] It is interesting to note that, before the public was made aware of the influence this Editorial Board member had brought to bear on the book review process, the *FAJ*'s own Editor had declared that "If there was pressure from someone on the editorial board [in regard to the 'Postscript'], I would see that person would not be on the board."[(8)] After the facts were made public, the *FAJ*'s Editor (himself a vendor of portfolio insurance products) declined to investigate further. The whole episode has the appearance, at the very least, of egregious conflicts of interest.[(9)]

The problems I have encountered go beyond a mere matter of wounded pride. I believe, and my book argues, on the basis of copious evidence, that portfolio insurance and the way in which it was marketed in the 1980s had tremendous impact on the market (particularly in the 1987 crash) and has repercussions for the securities markets today. This view is open to debate. However, rather than allowing an open debate, the *FAJ*, by permitting an Editorial Board member with a substantial financial interest in portfolio insurance products (amounting to $54 billion in assets under management in 1987[(10)]) to quash criticism of it, effectively curtailed the free flow of ideas so necessary to an educated investment community and a healthy market. In the interests of fair and full disclosure to investors, AIMR now rightly seeks to institute standards that would prevent investment bankers and corporate issuers from influencing analyst recommendations and from taking retribution against analysts whose recommendations they disagree with. AIMR's own journal and its readership should benefit from similar standards.

How many manuscripts submitted to the *FAJ* have been subjected to review and dismissal by a reviewer with vested financial interests that would, under enforced conflict of interest standards, have disqualified him or her from vetting those manuscripts?[(11)] In most of these cases, we may assume that it was not the intent of the reviewer to reject the manuscript merely because it represented a threat to the reviewer's financial interests. Nevertheless, there is no way for the investment community to determine the *FAJ*'s independence and objectivity as long as it continues to operate under a cloak of secrecy, without publicly stated conflict of interest standards.[(12)] In the interest of fairness to authors and to the investment community in general, and in the interest of holding our professional journal to the highest ethical standards, even the appearance of conflict of interest should be avoided.[(13)]

AIMR states that one of the objectives of its proposed standards is to promote "a work environment for all investment professionals that supports, encourages, and rewards ethical behavior." I believe that the Research Objectivity Standards, which address "journalists and the media," do not go far enough to ensure this goal, especially as regards AIMR's own publications. For the *FAJ*, I believe that what is required are Research Objectivity Standards that directly reflect the AIMR Code of Ethics and Standards of Professional Conduct, something along the following lines:

I. Staff and volunteers associated with the *Financial Analysts Journal* (including the Editor and other members of the Editorial Board, whether or not members of AIMR or any of its constituent societies) shall be familiar with and abide by the AIMR Code of Ethics and Standards of Professional Conduct. This is in line with AIMR Standard I(A).

II. The person designated Editor or Editor-in-Chief shall be considered in a supervisory position vis-à-vis staff, other members of the Editorial Board, and others (including manuscript reviewers and authors) insofar as their activities contribute to the *FAJ*. Delegation of responsibilities connected with the *FAJ* does not absolve the designated Editor of supervisory responsibilities. The Editor is responsible for ensuring that those under his or her supervision abide by proposed *FAJ* Standard I above, including an annual acknowledgment of understanding and attestation of compliance. The Editor is responsible for ensuring that the independence and objectivity of the Editorial Board is maintained, that AIMR Code and Standards are followed as they relate to the *FAJ*, and that the Research Objectivity Standards for the *FAJ* are followed and enforced. This is in line with AIMR Standard III(E).

III. The person designated as the AIMR staff representative to the *FAJ* shall be considered in a supervisory position vis-à-vis the designated *FAJ* Editor and shall be responsible for the *FAJ*'s compliance with the Research Objectivity Standards (as outlined in *FAJ* Standard II above).

IV. Those persons falling under *FAJ* Standard I above have a duty to disclose to their supervisors at the *FAJ* or AIMR all matters that reasonably could be expected to interfere with the duties they undertake on behalf of the *FAJ* and/or their ability to make independent, objective and unbiased decisions. In this regard, the Editor should disclose to AIMR any interests, including personal business interests, that could interfere with his or her ability to carry out the duties of *FAJ* Editor in an independent, objective and unbiased manner. Other members of the Editorial Board should disclose same to the Editor. This is in line with AIMR Standard III(C).

The *FAJ* has a duty to disclose to readers material facts or conditions that could reasonably be

V. expected to impair the independence and objectivity of the work published in the *FAJ*. Thus, the Editor as supervisor should solicit from prospective authors the existence of any such interests, and such interests should be disclosed with publication of authors' articles. This is in line with AIMR Standard IV(B).

VI. Persons falling under *FAJ* Standard I above shall use reasonable care and judgment to achieve and maintain independence and objectivity in undertaking their duties on behalf of the *FAJ*. Thus, for example, members of the Editorial Board or others who review manuscripts for possible publication in the *FAJ* should not be influenced by business or other interests that could interfere with their independence and objectivity in the review process. If a potential conflict of interest exists with regard to a particular manuscript, Editorial Board members should recuse themselves from the review process. This is in line with AIMR Standard IV(A).

VII. Persons who fall under *FAJ* Standard I above, when acting on behalf of the *FAJ*, have a duty to put the interests of the *FAJ* above their own interests. Thus, for example, members of the Editorial Board should not use their positions to further their own personal or business interests by influencing the editorial process or by other means. This is in line with AIMR Standard IV(B).

VIII. The standards under which the *FAJ* operates should be published annually in the *FAJ*, posted on the AIMR website, and made available to interested parties upon request.

IX. Transgressions regarding the standards should be subject to disciplinary proceedings by AIMR.

Although these proposed standards were written with particular reference to the *FAJ*, there is no reason that similar standards could not be adopted by other publications of AIMR, including the CFA Digest, Research Foundation monographs, conferences and proceedings, and webcasts and web-based seminars.[(14)] By adopting Research Objectivity Standards for its own publications and conferences, AIMR can demonstrate that it intends to abide by the standards it is encouraging others to adopt. AIMR now has the opportunity to set the ethical bar for other publications and institutions of the financial community, for the betterment of all.

Sincerely,

Bruce I. Jacobs
AIMR Member and Principal, Jacobs Levy Equity Management

[(1)]See, for example, Relman, "Dealing with Conflicts of Interest," *New England Journal of Medicine* 310 (1984): 1182-1183, as well as the latest discussion in Drazen and Curfman, "Financial Associations of Authors," *New England Journal of Medicine* 346 (2002): 1901-1902.

[(2)]See Davidoff et al., "Sponsorship, Authorship, and Accountability," *New England Journal of Medicine* 345 (2001): 825-827.

[(3)]*The New England Journal of Medicine* goes beyond disclosure with regard to editorials and review articles; it does not allow publication of these if the authors have "any significant interest in a company (or its competitor) that makes a product discussed in the article." See Drazen and Curfman, "Financial Associations of Authors," op. cit.

[(4)]The *New England Journal of Medicine*, to "prevent the appearance of 'insider bias'," requires that all research articles by its editors or consultants be administered by an independent editor-at-large. See Curfman and Drazen, "Too Close to Call," *New England Journal of Medicine* 345 (2001): 832.

[(5)]Jacobs, *Capital Ideas and Market Realities: Option Replication, Investor Behavior, and Stock Market Crashes*, with a foreword by Harry M. Markowitz, Blackwell Publishers, Malden, MA, 1999.

[(6)]See also Jacobs, "FAJ, AIMR Ethical Issues," *Pensions & Investments*, October 1, 2001; Walters, "AIMR Strict on Ethics Code," *Pensions & Investments*, October 15, 2001; and Jacobs, "AIMR's Misinterpretation," *Pensions & Investments*, November 12, 2001.

[(7)]See Burr, "Praise for book turns to criticism," *Pensions & Investments*, June 25, 2001.

[(8)]Ibid.

[(9)]See Burr, "Rubinstein to stay on editorial board of FAJ despite talking with Fridson," *Pensions & Investments*, September 3, 2001. The *FAJ* Editor, Book Review Editor and Editorial Board member involved retain their positions as of this writing.

[(10)]According to the firm's 1987 ADV filing with the SEC.

[(11)]In the medical community, some have begun calling for a more open review process, including identification of reviewers, in part to ameliorate conflict of interest problems. See Godlee, "Making Reviewers Visible: Openness, Accountability, and Credit," *JAMA* 287 (2002): 2762-2763.

[(12)]When I pointed out the apparent conflicts of interest affecting conduct at the *FAJ*, the AIMR's Professional Conduct Officer's response was that proceedings regarding such complaints are undertaken in the utmost secrecy and cannot be discussed under any circumstances (see Walters, "AIMR Strict on Ethics Code," op. cit.). However, Rule 12 of AIMR's Rules of Procedure for Proceedings Related to Professional Conduct does permit public discussion of some complaints under certain conditions, which appear to hold in this instance (see Jacobs, "AIMR's Misinterpretation," op. cit.).

[(13)]According to AIMR Standard III(C), *Standards of Practice Handbook*, Eighth Edition, pp. 51-52: "The mere appearance of conflict of interest may create problems for a member . . . ."

[(14)]AIMR sponsors a series of "Industry Analysis" seminars and proceedings featuring leading sell side analysts. Under the Research Objectivity Standards, the analysts would presumably be required to disclose any potential conflicts of interest at the seminar and in any publication of the proceedings. But what conflict of interest standards govern the AIMR's behavior? How does AIMR deal with conflicts of interest that may arise in the decision of which analysts to invite as participants?