

**National Regulatory Services  
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**Conflicts Regarding Research Recommendations**

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NATIONAL REGULATORY SERVICE  
FALL COMPLIANCE CONFERENCE

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CONFLICTS REGARDING RESEARCH RECOMMENDATIONS

**I. Background**

Conflicts resulting between research recommendations and the other activities of a broker-dealer, such as investment banking, market making and proprietary trading, have been a long-standing issue in the securities industry. Because of the Enron debacle, reforms resulting from these issues are at the forefront of the agenda of Congress, the SEC, the states and the self-regulatory organizations. Notwithstanding the current publicity, these issues have been under consideration for the last several years. However, because of the Enron debacle and its resulting publicity, and because of Congressional, SEC and industry pressure, the NASD developed and submitted to the SEC in record time Rule 2711, a new rule with respect to research conflicts. The new Rule 2711 is far more encompassing than the proposals to amend NASD Rule 2210 set forth in Notice to Members 01-45 last year. The pressures are so great that the new NASD Rule 2711 was not submitted to members of the NASD for approval but was approved by the Board of the NASD and filed on February 8, 2002 with the SEC for approval. The NYSE filed a similar rule, Rule 472 at the same time. The rules were approved by the SEC on May 10, 2002.<sup>1</sup> Interestingly, the rule filing was so hurried that the NASD did not deal with the proposed amendments to NASD Rule 2210 involving disclosure of research analyst conflicts, but stated that the disclosures in Rule 2711 and the other substantive provisions in Rule 2711 would be in addition to anything required by current Rule 2210.

Disclosure of analyst conflicts was a concern of former SEC Chairman Levitt in 1999.<sup>2</sup> However, the issues drew the attention of the media as the result of a speech of Acting SEC Chairman Unger in April of last year.<sup>3</sup> On April 19, 2001, Acting Chairperson Laura Unger at the Northwestern University Garrett Institute firmly urged the securities industry to restore public confidence in recommendations by prominently disclosing conflicts of interest, particularly those involving investment banking relationships. The NASD and the NYSE have long had rules to address conflicts with respect to research recommendations.<sup>4</sup> In late 2000, the NASD and the NYSE announced that they would consider new rules for addressing disclosure of analysts' conflicts of interest. This announcement was undoubtedly the result of concerns about conflicts

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<sup>1</sup> 34 Act Release No. 45908 (May 10, 2002).

<sup>2</sup> [sec.gov/news/press/2000-183.txt](http://sec.gov/news/press/2000-183.txt) [sec.gov/news/speech/speecharchive/1999/spch266.htm](http://sec.gov/news/speech/speecharchive/1999/spch266.htm).

<sup>3</sup> [sec.gov/news/speeches/spch477.htm](http://sec.gov/news/speeches/spch477.htm).

<sup>4</sup> See NYSE Rule 472, NASD Rule 2210.

involving investment banking relationships that were not clearly disclosed when a broker-dealer's research department was recommending a buy or sell of a security.<sup>5</sup>

This outline discusses NASD Rule 2711 because the parallel NYSE rule is similar although there are minor differences. In addition, the NASD and NYSE have published a joint interpretation memo ("NASD Interpretation Memo") which provide a joint interpretation of certain questions raised under the rules.<sup>6</sup>

## **II. The Rules of NASD and the NYSE Before the Amendments**

The Rules of the NASD and NYSE before the current amendments were similar in many respects:

1. Both NYSE Rules and NASD Rules required that an analyst making a recommendation have a reasonable basis for the recommendation.
2. Both rules required that the firm disclose market making activities in the issuer's securities.
3. Both rules applied to communications to the public in written sales literature and advertisements.
4. Both rules required disclosure of underwriting activities as manager or co-manager for the securities.
5. Both rules applied to communication not only with customers of the firm but any other communication generally made to the public.

The NYSE Rule required:

1. Disclosure that there may be positions in the securities recommended held by the firm or the analyst involved in the report.
2. Disclosure as to whether a person associated with a broker-dealer is a director of the issuer.
3. Application to electronic communication, interviews and press statements.

The NASD Rule did not require disclosure of directorships or stock positions. It did require, though, disclosure if the member firm or persons associated with it owned more than a nominal amount of options, rights or warrants to purchase the recommended securities. The NASD Rule did not appear to cover public interviews and similar spontaneous appearances, but that was not clear.

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<sup>5</sup> [sec.gov/news/speech/speecharchive/1999-spch266.htm](http://sec.gov/news/speech/speecharchive/1999-spch266.htm).

<sup>6</sup> NASD Notice to Members 02-39 Attachment B (July 2002) (hereinafter cited "NASD Interpretation Memo"); New York Stock Exchange Information Memo 02-26 (June 26, 2002).

As noted above, the NASD did not amend its Rule 2210 and consequently the Rule still is applicable, including the following specific provisions:

1. a reasonable basis for the recommendation;
2. disclosure of market making activities;
3. disclosure of underwriting activities as manager or co-manager;

Although the new rule as discussed below requires disclosure of material conflicts of interest and the above would clearly be material conflicts of interest, Rule 2210 was not repealed. The NYSE, however, changed completely 472. For purposes of this outline, we will deal only with NASD Rule 2711.

### **III. New NASD Rule 2711**

#### **A. The Concepts**

The new rules have the following concepts imbedded in them:

1. Significant restrictions on an investment banking firm relationship with the firm's research department.
2. Significant restrictions on review of a research report by the subject issuer or company.
3. Prohibition on certain forms of research analyst compensation.
4. Prohibition on a promise of any favorable research report to issuer.
5. Imposition of quiet periods in which a firm may not publish a research about a subject company.
6. Significant restrictions on personal trading by research analysts.
7. Notwithstanding current Rule 2210, additional disclosure requirements regarding ownership, conflicts of interest, receipt of compensation, position as an officer or director, meaning of ratings, distribution of ratings, price charts, price targets, market making, and prominence of disclosures.
8. Adoption and implementation of written supervisory procedures.

#### **B. The Rule's Definitions**

The rule broadly defines "investment banking department", "investment banking services", "research report", "subject company" and "research department". "Research report" is

broadly defined to mean any type of “written or electronic communication which includes the following:

1. an analysis of equity securities of individual companies or industries,
2. which provides information reasonably sufficient upon which to base an investment decision and
3. includes a recommendation”.

The NASD Interpretation Memo excludes a number of reports as set forth below:

1. reports discussing broad-based indices,... that do not recommend or rate individual securities.
2. reports commenting on economic, political or market conditions that do not recommend or rate individual securities.
3. technical analysis concerning the demand and supply for a sector, index or industry based on trading volume and price.
4. statistical summaries of multiple companies’ financial data (including listings of current ratings) that do not include any narrative discussion or analysis of individual companies data.
5. reports that recommend increasing or decreasing holdings in particular industries or sectors but that do not contain recommendations or ratings for individual securities.
6. notices of ratings or price target changes that do not contain any narrative discussion or analysis of the company, provided that the member simultaneously directs the readers of the notice as to where they may obtain the most recent research report on the subject company that includes the disclosures required by the SRO Rules. In no event should such a notice refer to a research report that contains materially misleading disclosure, i.e., where disclosures are no longer applicable or new disclosures would pertain.
7. an analysis prepared by a registered representative for a specific customer’s account.
8. internal communications that are not given to customers.<sup>7</sup>

The NASD Interpretation Memo addresses various questions dealing with third party research. In the first instance, the memo states that the rule is intended to primarily address conflicts of interest that arise when a member produces its own research. When a member distributes research

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<sup>7</sup> NASD Interpretation Memo, pp. 367 & 368.

produced by an independent third party, the member's disclosure requirements do not apply with respect to the distributing member but they do apply to the entity generating the research if it is also a NASD or NYSE member. Where a member distributes research produced by a non-member affiliate, such as a foreign broker-dealer, investment adviser, or independent third party other than through a soft dollar arrangement, the member must accompany the research with the following disclosures:

1. the member's and its affiliates' ownership of the subject company's securities;
2. that the member or its affiliates managed or co-managed a public offering of the subject company's securities in the past 12 months, received compensation for investment banking services from the subject company in the past 12 months, or expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months;
3. that the member was making a market in the subject company's securities at the time the research report was published; and
4. any other actual, material conflict of interest of the member known at the time of distribution of the research report.<sup>8</sup>

A "research analyst" is defined as a person who is principally responsible for and any other associated person who directly or indirectly reports to such analyst in connection with preparation of the substance of a research report, regardless of job title.

The "research analyst account" means any account in which the research analyst or any member of the person's household has a beneficial interest or over which the analyst or household member has discretion or control other than an investment company registered under the 1940 Act. The household includes individuals whose principal residence is the same as the research analyst's principal residence. The NASD Interpretation Memo excludes non-related individuals in the same household who are not financially dependent upon the analyst.<sup>9</sup> "Public appearance" is broadly defined to include any participation in a seminar forum, including interactive electronic forum, radio or television interview, or public speaking activity in which a research analyst makes a recommendation or offers an opinion concerning an equity security.

C. Restriction on Investment Banking Department Relationships with the Research Department

Research analysts cannot be subject to the supervision or control of any employee of a firm's investment banking department. Further, no employee of an investment banking department may review or approve a research report of a member before its publication with one exception. Investment banking personnel may review a research report before publication to verify

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<sup>8</sup> Id., pp. 368 & 369.

<sup>9</sup> Id., p. 365.



the factual accuracy of information or any potential conflict of interest, but only under the following conditions:

1. Any written communication between the banking and research department must be made through an authorized legal or compliance officer of the member firm with a copy to such person; and
2. Any oral communication between banking and research departments concerning a research report must be documented and made either through an authorized legal or compliance official acting as an intermediary or in a conversation conducted in the presence of such official.

These restrictions are rather strict, but are probably necessary from a political standpoint in view of the temper of the public and the United States Congress. What this means is that it will be highly unlikely that there will be significant communication. Firms will need to have supervisory procedures to facilitate such communications where necessary. It is likely that most firms will tape any oral conversations.

D. Restrictions on Review of a Research Report by the Subject Company

Generally, Rule 2711 prohibits a member from submitting a research report to a subject company before its publication. However, there are two exceptions. The first exception permits submitting a research report to the subject company to verify factual accuracy of information, but only if:

1. the part of the research report submitted to the subject company does not contain a summary, rating or price target;
2. a complete draft of the report is provided to the legal or compliance department before sections of the report are submitted to the subject company;
3. if after such submission to the subject company the research department intends to change the proposed recommendation rating or price target, it must provide written justification and receive written authorization from the legal and compliance department for the change;
4. copies of all drafts and the final version of research must be retained for three years after publication.

The other exception permits a member to notify the subject company of a change in rating of the company's securities provided the notification is no earlier than the day before the announcement of the rating change after the close of trading in the principal market for the company's securities. Submitting part of a research report to a subject company for verification of accuracy will require a great deal of care. Many factual statements are in fact factual conclusions and may involve judgment. Hopefully the definition of "research summary" means ultimate research recommendation as opposed to certain factual conclusions. For example, is a statement factual if it

states that the debt of the company imposes a significant burden and will require a specific amount of dollars to liquidate on an annual basis having a negative impact effecting the company's cash flow? The author would consider such a statement factual that might need verification. The rule is unclear as to whether this would be permitted.

E. Prohibition of Certain Forms of Research and Analyst Compensation

Rule 2711 explicitly prohibits the payment of any bonus, salary or other form of compensation to a research analyst based upon specific investment banking services transactions. The rule does not prohibit an analyst from receiving compensation based upon general revenues of investment banking generated by transactions. However, to the extent that specific investment banking service transactions are part of the general revenues, there is a question as to whether compensation of the analyst tied in any way to the investment banking department's revenues would be permitted. However, it appears to be permitted because the disclosure requirement requires the member to disclose the general compensation received by the analyst as a result of investment banking department revenues.

F. Prohibition of Promise of Favorable Research

The rule explicitly prohibits the direct or indirect offer of favorable research, a specific rating or price target or threaten to change any research rating or price target to a subject company as consideration for an inducement of receipt of business or compensation.

G. Imposition of Quiet Periods

Research reports may not be published by a manager or co-manager of an underwriting of an initial public offering ("IPO") for forty days following the date of the offering, or in the case of a secondary offering ten calendar days following the date of the offering. There is an exception created for secondary offerings where the research reports are issued pursuant to Rule 139<sup>10</sup> under the Securities Act of 1933 for issuers whose securities are actively traded as defined in Rule 101(c)(1) of Regulation M.<sup>11</sup> However, subject to prior authorization by the legal and compliance department, a research report may be issued during the quiet periods if it concerns the effects of significant news or a significant event about the subject company during the quiet period. The determination of significant news or a significant event is certainly something that companies will have to be careful in evaluating and in many cases it is likely that the legal or compliance department, in the exercise of caution, will prohibit the dissemination of a research report although it may be of importance to the public to change a prior recommendation. In such cases, any research report that is outstanding would have to be withdrawn with no comment as to why.

H. Restrictions on Personal Trading by the Research Analyst

The restrictions on the purchase or sale of securities by research analysts and their household members are again relatively draconian. The rule prohibits a research analyst and their household members from purchasing or receiving any securities before an IPO if the issuer is

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<sup>10</sup> 17 C.F.R. 230.139.

<sup>11</sup> 17 C.F.R. 242-101(c)(1).

principally engaged in the same type of business as companies that the research analyst follows. Research analysts may purchase or sell a security issued by a company that the research analyst follows or any option or derivative of any such security provided it is purchased or sold prior to thirty calendar days before and ending five calendar days after the publication of a research report concerning the company or any change in a recommendation, rating or price target. Notwithstanding such restrictions, a member firm may:

1. permit a research analyst to sell all of the securities that are issued by a company that the research analyst follows within thirty calendar days after the research analyst began following the company;
2. permit a research analyst to purchase or sell any security issued by a subject company within thirty calendar days before the publication of a research report, change in rating or price target due to significant news or a significant event concerning the company provided the legal or compliance department pre-approves the research report and any change.

A research analyst account may not purchase or sell any security, option or derivative of a security inconsistent with the research analyst recommendation as reflected in his most recent report that has been published by the member.

A member's legal or compliance department may authorize a transaction that is otherwise prohibited during the blackout period or that may not be purchased or sold because it is inconsistent with the research report based upon significant personal financial circumstances of the beneficial owner or owners of the research analyst account. This relief, however, is subject to a number of conditions as follows:

1. The legal or compliance department must authorize the transaction before it is entered.
2. Each exception granted must be in compliance with supervisory procedures and policies adopted by the member reasonably designed to ensure that the transactions do not result in a conflict of interest between the professional and personal activities of the analyst.
3. The member must retain written records concerning the transaction and the justification for a period of three years following the date on which the transaction is approved.

The prohibitions on securities transactions by the analyst do not apply to the purchase or sale of securities of:

1. diversified investment companies registered under Section 5(b)(1) of the Investment Company Act of 1940;

2. any other investment fund over which neither the research analyst nor a member of the analyst's household has any investment discretion or control provided:
  - a. the analyst's account collectively owned an interest representing no more than one percent of the assets of the fund;
  - b. the fund invests no more than twenty percent of its assets in securities of issuers principally engaged in the same type of business as companies that the research analyst follows; and
  - c. the investment fund does not distribute securities in kind to the research analyst or household member before the issuer's initial public offering unless the research analyst or household member either divests those securities immediately or refrains from participation working on a research report regarding the issue.

The NASD Interpretation Memo<sup>12</sup> provides that investment funds purchased or received prior to July 9, 2002 are excluded from the trading restrictions. However, any further investment in the fund would bring into play all of the trading restrictions.

#### I. Specific Disclosure Requirements

The specific disclosure requirements, as noted below, are in addition to NASD Rule 2210 and are extremely detailed. Also as explained below, they must be set forth conspicuously at the front of the research report or there must be a reference on the front page to where the disclosure will be found. It is important to understand that the disclosure requirements include disclosures of many types of conflicts, not just those arising from investment banking. For example, they include disclosure of conflicts involving market making trading, personal trading by the research analyst, receipt of compensation, officer and director positions. Furthermore, as discussed below, they include disclosure concerning the meaning of ratings and the distribution of ratings. Specific disclosure is required about price charts and price targets, all of which apply to any firm which promulgates any type of research reports.

##### 1. Public Appearances

When an analyst makes a public appearance at which a recommendation is made, there must be specific disclosures as discussed in more detail below. The disclosures include financial interest held by the analyst or his or her household members, whether the member firm and its affiliates held an ownership interest in the company that is the subject of the recommendation, whether or not the company is a client of the member or affiliates and any other material conflict. The disclosures also apply to public appearances outside the United States.<sup>13</sup> A client includes any client from whom the member received revenues from investment and banking services within the last twelve months or for whom the member expects to receive investment and

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<sup>12</sup> NASD Interpretation Memo, p. 372.

<sup>13</sup> Id., pp. 378 & 379.

banking services in the next three months. The NASD has made it clear that in public appearances, unless all of the disclosures are made that are required, no recommendation may be made by the analyst nor may the analyst offer an opinion. In a TV or similar interview, in lieu of oral disclosures, a graphic or a scroll across the screen including all of the required information would be adequate as long as it is readable. The rule filing by NASD with the SEC indicates that in the event that disclosures are edited out of television or other pre-recorded programs, that the analyst would not be responsible from being certain that it is included.<sup>14</sup> The NASD Interpretation Memo indicates, however, that if the disclosures are edited out of a program, the analyst may not appear on the same program or a similar program by the same producers absent specific assurances that the disclosures will not be edited out. To avoid this problem, it is important for firms to have an agreement and possibly a save harmless clause with any TV producer or station that the disclosures will be made and not edited out of an analyst presentation.

## 2. Ownership and Material Conflicts of Interest Disclosure

In all research reports members must disclose and in all appearances research analysts must disclose:

- a. Any interest of the analyst or member's household member in the securities of subject company and the nature of the financial interest;
- b. Whether the member or its affiliates beneficially own one percent or more of any class of common equity securities of the subject company (as of month end before the publication of a research or public appearance unless publication in the first 10 days of a month in which case the second prior month end may be used);
- c. Any other material conflict of interest which the member or analyst knows or has reason to know at the time of publication or public appearance;
- d. Any other material conflict of interest which the member knows or has reason to know at the time of the publication of the research or which the analyst knows or has reason to know at the time of a public appearance.

The determination of beneficial ownership is based upon the beneficial ownership rules under Sections 13(d) and (g) of the Exchange Act.<sup>15</sup> It should be noted that the words "any interest of the analyst or member's household member" are used. Financial interest is a broad-ranging term that could include pledges and a variety of other types of interests.

## 3. Receipt of Compensation

Research reports must disclose the following:

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<sup>14</sup> *Id.*, p. 379.

<sup>15</sup> 15 U.S.C. §78m(d) and (g). *See, also*, Rule 13d-3, 17 C.F.R. 240.13d-3.

- a. Compensation received by the analyst principally responsible for the report that is based upon, among other factors, the member's investment banking revenues;
- b. If the member or its affiliates received investment banking services compensation for the company that is the subject of the research reports within twelve months prior to the report or expects to receive compensation within three months following publication of the research report;
- c. The member or its affiliates managed or co-managed a public offering within the last twelve months.
- d. In public appearances whether the analyst knows or has reason to know that any subject company which he discusses is a client of the member or its affiliates.

The NASD Interpretation Memo clearly states that an affiliate means any company that controls, is controlled by or is under common control with the member, but affiliates do not include individuals employed by the member or an affiliate.<sup>16</sup>

#### 4. Position as an Officer or Director

In research reports and appearances, there must be a disclosure if the research analyst or a member of the analyst's household serves as an officer, director or advisory board of a company about which a report is presented.

#### 5. Meaning of Ratings

A member must define in its research reports the meaning of each rating used by the member in its rating system. The definition must be in plain English and be consistent with its plain meaning.

#### 6. Distribution of Ratings

Research reports must disclose the following concerning distribution of ratings:

- a. The percentage of all securities rated by the member to which the member would assign a buy, hold or sell rating.
- b. The percentage of subject companies within each of these three categories for whom the member has provided investment banking services within the last twelve months.

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<sup>16</sup> NASD Interpretation Memo, p. 374.

- c. The rating information must be current as of the end of the most recent calendar quarter or second most recent calendar quarter if the publication date is less than fifteen calendar days after the most recent calendar quarter.

## 7. Price Charts

If a research report concerning an equity security has had a rating assigned to that security for at least one year, the report must contain a line graph of the security's prices for the period that the member has assigned any rating or for a three year period, whichever is shorter. The graph must show:

- a. the dates on which the member assigned or changed the rating;
- b. each rating or price target is assigned or changed on those dates; and
- c. be current as of the most recent calendar quarter (or second most recent calendar quarter if the publication date is less than fifteen calendar days after the most recent calendar quarter).

The rules specifically provide that a chart need not be provided in a research report involving six or more subject companies. However, if it is not, there must be a prominent disclosure as to where such required disclosures may be obtained. See Section III.I.11 Compendium Reports for a detailed discussion.

The NASD Interpretation Memo answers a number of questions concerning the required charts.<sup>17</sup> If technology will not allow the transmission of graphic illustrations, a member may use a table in such circumstances provided all of the required data is in the table and it is in an easily readable format. Furthermore, if a table is used, the member may only provide stock closing prices for the day on which the member assigned or changed a reading or price target. However, the NASD Interpretation Memo also provides that where a member employs multiple rating systems, depending on an investor's time horizon, such as short term, intermediate or long, that the chart must show the ratings and price assigned to the subject for each of the rating systems. It is permissible to use an S&P 500 index or similar benchmark in connection with the charts but it may not be overly prominent. Information and ratings prior to the rule becoming effective must be included in charts for any security that has been assigned a rating for at least a year before the research report is issued. When coverage shifts from one analyst to another, price charts must be maintained but may include an indication that there was a shift to a new analyst at a particular point in time.

## 8. Price Targets

A member must disclose in research reports the valuation method used to determine price targets. The rule requires that price targets have a reasonable basis as defined

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<sup>17</sup> Id., pp. 376 & 377.

under NASD rules and most importantly be accompanied by a disclosure concerning the risks that may impede the achievement of price targets.

The disclosure of risk that might impede achievement of price targets will be a formidable undertaking for most firms. Some firms may attempt to use boilerplate language which includes a great variety of circumstances, but that is not what the NASD and SEC have in mind. The disclosures must be specific to the subject company and its operations. Because of a potential liability and regulation, recommendations regarding price targets will need to fall within the safe harbor for disclosure of soft information which will lengthen research reports and make them considerably more complex.<sup>18</sup>

#### 9. Market Making

Any market making activity in the subject company securities must be disclosed at the time the research report was published. This is a long time NASD requirement in Rule 2210.

#### 10. Prominence of Disclosures

The disclosures must be presented on the front page of research reports or the front page must refer to the page on which the disclosures are found. Disclosures and references to disclosures must be clear, comprehensive and prominent. In the comments accompanying the rule filing, the NASD specifically states that disclosures that the firm “may” or “might” have market making activities or receive compensation are not satisfactory for purpose of disclosure. The disclosures have to be explicit and state whether the firm is a market maker or was a market maker and the periods of time. Likewise with respect to investment banking compensation, the disclosures have to be specific and may not be qualified using words such as “could”, “might”, or “may”. Where a required disclosure is required to be made in electronically submitted reports, there may be a hyperlink to the disclosure in lieu of having it on the front page, but it must be clear and it must transmit to the required disclosure with no interruption.<sup>19</sup>

#### 11. Compendium Reports

Where research reports cover six or more subject companies, the member is not obliged to include disclosures required by the SRO rules provided the report directs the readers in a clear manner to where they may obtain the applicable current information for all covered companies in either electric or written form. The compendium report must include a toll-free number or postal address for the required disclosures. For electronic compendiums, research reports may include a hyperlink. Alternatively, a web address may be included.<sup>20</sup>

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<sup>18</sup> See, e.g., Securities Act of 1933 §27A, 15 U.S.C. §77aaA; Securities Exchange Act of 1934 §21E, 15 U.S.C. §78uE.

<sup>19</sup> NASD Interpretation Memo, p. 378.

<sup>20</sup> Id., p. 378.



## J. Supervisory Procedures

As indicated above, although probably not necessary, the rule requires supervisory procedures designed to ensure that the member and its employees comply with the provisions of the rule. It, however, contains a further element that a senior officer of such member must attest on an annual basis to the NASD or that the member has adopted and implemented the required supervisory procedures.

The provision in the supervisory procedures section of the proposed rule requiring the annual attestation by a senior official that the procedures are in place and adequate, imposes a significant personal burden on the senior official who must so certify. Many firms senior officials will not be actually involved with the procedures because the person is a senior official with other responsibilities. For that reason it will be hard, if not impossible, for most senior officials to conscientiously give the attestation. The responsibility should be the firm as a whole or the official but not necessarily a senior official closely involved in monitoring the procedures.

## IV. Some Practical Considerations

### A. Application to Many Firms Not Just Firms with Investment Banking

Although the two proposed rules were initially aimed at firms that had conflicts between research departments and investment banking, the rules are by no means limited to firms that have investment banking departments. The rules apply to any firm that promulgates research reports. This will include many medium and small firms without investment banking departments, but which do have research departments. The disclosures of other types of conflicts, as noted above, such as market making, directorships and a variety of other potential conflicts, must be clearly disclosed. Also important, as explained above, the receipt of any compensation needs to be clearly disclosed. Compensation is very broadly defined. Further, any research report that has ratings requires specific disclosures concerning the meaning of ratings and the distribution of ratings. If price targets are mentioned, there must be disclosures regarding the same.

### B. Supervisory Procedures

Each firm will have to carefully consider the adoption of written supervisory procedures and compliance policies to implement Rule 2711. The procedures and policies will necessarily be complex and have to be adopted to the firm's operation. Firewall procedures between investment banking and research will have to be a careful reviewed.

### C. Personal Trading Policies

Firms will need to change their personal trading policies to conform to the requirements of Rule 2711. Personal trading policies will now need to track carefully not only purchase and sale of transactions by individuals that fall within the definition of research analysts and any accounts of the research analyst, including those of the household members. This would best be accomplished by receiving confirmations with respect to all transactions or requiring an identified analyst and his household members to effect transactions through the firm's own brokerage operation for ease of tracking. Personal trading policies will have to have special

provisions for analysts which will cover things such as the quiet period and the more onerous restrictions on personal trading by the analyst. Trading departments will need to be informed that transactions for analysts will need to be pre-cleared in most cases. The order execution desk will generally not have the capability to ascertain whether or not a particular transaction will qualify within the rather Byzantine provisions of Rule 2711. Consequently, clearance will probably have to be handled by the compliance department for knowledgeable compliance. Firms will probably develop broader, more general prohibitions on purchase and sale transactions than those required by the provisions of Rule 2711 which may create a trap for the unwary.

D. Monitoring Shares and Accounts

Firms will have to carefully monitor and institute compliance procedures to track whether the firm and its affiliates have one percent or more of the outstanding shares within the meaning of the proposed rules. The rules use the broad definitions of ownership under Section 13(d) and 13(g) of the 34 Act.

E. Discretionary Accounts

The NASD rule includes any accounts over which an analyst has discretion or control even if this analyst has no direct financial interest. This will severely restrict a number of firms. In any event, it creates further compliance complication for many firms where research analysts do have discretion over certain accounts, particularly small and medium size firms. Not only will the discretionary accounts have to be identified, but their trading will have to be monitored because it would be considered personal trading by the research analyst.

F. Compensation

The broad definition of compensation in the proposed rule includes not only cash compensation but other arrangements for any kind of investment banking services. Firms will need to set up a procedure to track all agreements, formal or informal, with issuers for which they provide investment, banking or other services. Firms will have to have clear written supervisory procedures for tracking compensation that is received from issuers and their affiliates. This may be particularly difficult when tracking compensation received by affiliates of the member firm for investment banking services or for compensation received by affiliates of the member firm. The compensation provision requires disclosure of any compensation received within twelve months or expected to be received within three months.

G. Firewalls

Many firms today have firewalls between their research analysts who make recommendations and their investment banking departments. The rule's prohibition with respect to conversations between the investment banking department and the research department now mandate firewalls. Procedures will have to be strengthened with respect to such firewalls. The rule will also require that these firewalls be breached to a certain extent because disclosures with respect to the firm's holdings as well as compensation for investment banking services must be made thereby bringing to the attention of the analysts the firm's interest in the compensation received for investment banking services. These firewalls will still need to be maintained for

purposes of avoiding use of inside information or other material undisclosed information in connection with recommendations.

#### H. Public Appearances

In public appearances, particularly on talk shows and similar appearances, the recitation of disclosures will be cumbersome and difficult. However, it appears that it will become a part of public life. Obviously, it will reduce the spontaneity and eventually result in boilerplate disclosures on such shows as *Wall Street Week* and other prominent shows which will eat up significant amount of time. How much effect it will have remains to be seen. The NASD Interpretation Memo states clearly that if the disclosures are made by the analysts or they are designed to be made by scroll or graphics and they are edited out by the television station or the producer, the analyst must decline further appearances absent “assurances” that the disclosures will not be edited out.<sup>21</sup> It may be advisable in all cases for an analyst proposing to make a public appearance as defined in the rule to have a specific contract with the producer of the program or the station or network.

#### I. Ratings and Price

All firms that issue research reports that assign a rating to a particular type of security will have to disclose in plain English the meaning of the rating and the distribution of ratings as described above. This will require special procedures. Likewise, there is a requirement for a line graph of a price chart for any security that has been rated for more than a year. Importantly, if there is a price target discussed in a research report, the method of valuation used to determine price targets must be disclosed together with risk. This will require considerable work and it will cause possible civil liability unless it is carefully crafted. Furthermore, recommendations regarding price targets may not necessarily fall within the safe harbor for disclosure of soft information unless all assumptions are clearly set forth.

#### J. Other Material Conflicts

It is most important to remember that any other material conflict of a research analyst in connection with a recommendation of a security and a research report will have to be disclosed. Firms will need to carefully review their relationships with companies or major shareholders of companies whose securities they rate or to ascertain if there are material conflicts. If there are material conflicts, those material conflicts will have to be disclosed.

#### K. Distribution by a Member of Another Member’s Report

The adopting release states that the SROs intend to review the application of the rules to research reports not produced by the member firm on a case-by-case basis. However, generally where a member firm is distributing in the United States research of its affiliate, the member firm should disclose the applicable conflicts that must include the disclosures required by the rules regarding the member. Where a member distributes research produced by a non-member such as a foreign broker-dealer, an investment adviser or other independent third party, other than

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<sup>21</sup> NASD Interpretation Memo, p. 378.

through a soft dollar arrangement, the member must accompany the research with certain disclosures. In such case, the disclosures required include:

1. the member and its affiliate's ownership of the subject company's securities;
2. whether the member or its affiliates have managed or co-managed a public offering of the subject securities in the past twelve months, received compensation for investment banking services from the subject company in the past twelve months or expects to receive or intends to receive compensation from investment banking services from the subject company in the next three months;
3. whether the member was making a market in the subject company's securities at the time the research report is published; and
4. most importantly, any other actual or material conflict which the member knows at the time of distribution of the research report.

L. Implementation Schedule

The implementation schedule is as follows:

1. Disclosure of 1% firm ownership positions, November 6, 2002.
2. Legal and compliance department intermediation, September 9, 2002.
3. Charts of rating distribution, September 9, 2002.
4. Price charts, September 9, 2002.
5. All other provisions, July 9, 2002.
6. Special implementation dates:
  - a. For firms that have over the previous three years on average participated in ten or fewer investment banking transactions as manager or co-manager and generated \$5 million or less in gross investment banking revenues from those transactions will have until November 6, 2002 to implement provisions of subsections (b) and (c) of Rule 2711. However, the NYSE and NASD require that as a condition to delaying implementation until November 6, 2002, that those members that do delay disclose in the research reports that they are delaying implementation of the rule and preserve any communications that would otherwise be subject to the rule.
  - b. Rule 2711(h)(2), as applied to receipt of compensation by a member's foreign affiliate from a subject company, will become

effective on November 6, 2002. If a firm is going to rely on the delayed effective date of November 6, 2002, it must report the same to its designated examining authority and disclose in research reports that it is not making the disclosures required by rule until the implementation date of November 6, 2002. Furthermore, members that delay implementation would have to disclose in research reports that their foreign affiliates may:

- i. have managed or co-managed a public offering of the subject company's report in the past twelve months; or
  - ii. received compensation for investment banking services to the subject company in the last twelve months; or
  - iii. receives or intends to receive compensation for investment banking services from the subject company in the next three months.
- c. Rule 2711(g)(3) will also become effective on November 6, 2002 for research analysts who must divest holdings to comply with the more restrictive policy that prohibits analysts' ownership of securities they cover. Reliance on the delayed divestiture is subject to the following conditions:
- i. that the associated person was employed by the member as of July 9, 2002;
  - ii. the member has adopted a policy that bans a research analyst's ownership of securities covered by the analyst and the policy requires complete divestiture of existing holding in those securities;
  - iii. the associated person abides by a reasonable plan of liquidation under which all shares are to be sold by November 6, 2002, and that such plan is submitted to the member organization's legal or compliance department no later than July 16, 2002;
  - iv. that the associated person receive approval of the liquidation plan; and
  - v. the member organization notifies its designated examining authority that it has an approved plan that delays implementation of the provision.

The special implementation dates have such onerous conditions as noted above that very few firms will want to rely on them. The only one that may be of importance is (c), which delays Rule 2711(g)(3).

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