

**National Society of Compliance Professionals
2003 Midwest Regional Meeting
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Northern Trust Bank, Chicago, Illinois**

Research Analyst Conflicts

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RESEARCH ANALYST CONFLICTS

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NATIONAL SOCIETY OF COMPLIANCE PROFESSIONAL
2003 MIDWEST REGIONAL MEETING

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RESEARCH ANALYST CONFLICTS

I. Background

Conflicts 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 and NYSE developed and submitted to the SEC new rules with respect to research conflicts. The pressures were 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 in record time on May 10, 2002 and are now effective.¹ These rules are discussed at length below.

Even before the ink was dry on amended NASD Rule 2711 and NYSE Rule 472, the SEC proposed Regulation A-C which is discussed below.² This proposal would require certification of analyst's reports and other matters. On July 31, 2002, the Sarbanes-Oxley Act of 2002 was passed, amending, among other things, the Securities Exchange Act of 1934 by inserting a new Section 15D requiring the SEC to adopt or requiring SROs to adopt within one year after the date of enactment additional rules designed to address conflicts of interest that may arise in connection with securities analyst recommendation of equity securities.³ This Section 15D has various conceptual provisions that are substantively similar to NASD Rule 2711 and NYSE Rule 472. However, other provisions conflict with NASD Rule 2711 and NYSE Rule 472 and proposed Regulation A-C as will be discussed below. As a result of Section 15D, the NASD and the NYSE have proposed significant amendments to their respective rules 2711 and 472. In addition, other new rules have been proposed requiring substantial additional requirements, including continuing education and registration of analysts, blackout periods for analysts during the lock up period and a variety of other provisions discussed below.⁴

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¹ Release 34-45908, 67 FR 34,968 (May 16, 2002).

² Release 34-46301, 68 FR 5150 (August 8, 2002).

³ 15 U.S.C. §78o(D).

⁴ Release 34-47110, 68 FR 826 (January 7, 2003).

Disclosure of analyst conflicts is not new. The NASD and the NYSE have long had rules to address conflicts with respect to research recommendations.⁵ These conflicts were a concern of former SEC Chairman Levitt as early as 1999.⁶ However, these issues first drew significant media attention as the result of a speech of Acting SEC Chairman Unger in April 2001.⁷ 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. 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 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.⁸

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.⁹ As explained below, there are differences between NASD Rule 2711 and NYSE Rule 472, even though the rules were designed to be substantively the same. Unfortunately, these differences have created some interpretive differences between the rule, some of which are addressed and eliminated by the NASD Interpretation Memo. As noted above, the SEC has proposed Regulation A-C which contains a number of definitions that conflict with the definitions in NASD Rule 2711 and NYSE Rule 472. This outline discusses proposed Regulation A-C and the new Section 15D of the Securities Exchange Act of 1934 as adopted by the Sarbanes-Oxley Act of 2002. The proposed amendments to NASD Rule 2711 and NYSE Rule 472 are discussed. Last but not least, the outline discusses practical issues in implementing compliance under the rules.

II. The Rules of the NASD and the NYSE Before the Recent Amendments

The Rules of the NASD and NYSE before the current amendments of May 10, 2002 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 See NYSE Rule 472, NASD Rule 2210.

⁶ sec.gov/news/press/2000-183.txt sec.gov/news/speech/speecharchive/1999/spch266.htm.

⁷ sec.gov/news/speeches/spch477.htm.

⁸ sec.gov/news/speech/speecharchive/1999-spch266.htm.

⁹ 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).

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.

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.

The new rules as discussed below require disclosure of material conflicts of interest and the above would clearly be material conflicts of interest. The NYSE, however, changed significantly Rule 472.

III. Rule 10b-5, Anti-fraud Provisions and SRO Standards of High Commercial Honor and Just and Equitable Principals of Trade

Failure to disclose material analyst conflicts may violate the anti-fraud provisions of federal and state securities laws, in particular SEC Rule 10b-5.¹⁰ In some cases, violation of the anti-fraud provisions would require scienter and would have to be in connection with the purchase or sale of a security. In particular, SEC Rule 10b-5 would require that the failure to disclose a material conflict be in connection with the purchase or sale of a security and would require scienter as an element. Other anti-fraud rules, such as Section 17(b) of the Securities Act of 1933¹¹ would not require scienter.

¹⁰ 17 C.F.R. 240.10b-5.

¹¹ 15 U.S.C. §77q(b).

In addition, failure to disclose a material conflict may violate, under certain circumstances, the requirements of high commercial honor and fair and equitable principals of trade contained in NASD Rule 2110 and NYSE Rule 476(a)(6). While violation of NASD Rule 2110 and NYSE Rule 476(a)(6) for high commercial honor and just and equitable principals of trade would not require scienter, it is in fact a factor in self-regulatory organization proceedings. Furthermore, there is no cause of action under NASD or NYSE rules although the rules are from time to time raised as being actionable in connection with arbitrations. Notwithstanding compliance with the new NASD Rule 2711 and NYSE Rule 472 and the proposed amendments to those rules and the other requirements, the basic anti-fraud provisions and NASD and NYSE general requirement of high commercial honor and equitable and just principals of trade continue to apply to all material conflicts involving research analysts. These background laws should always be kept in mind and applied where the specific provisions of NASD Rule 2711 and NYSE Rule 472 do not specifically apply.

IV. NASD Rule 2711

For purposes of this outline, we will deal only with the NASD Rule 2711 because it is a rule that would be most applicable to NSCP members. However, it should be noted that although NASD Rule 2711 and NYSE Rule 472 were adopted and approved in a joint release by the SEC and were designed to be interpreted consistently, the rules are written differently and there are certain differences between the rules described below.

A. The Concepts of NASD Rule 2711 and NYSE Rule 472

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 Definitions of NASD Rule 2711

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.¹²

The NASD Interpretation Memo mentioned above 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 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.¹³

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.¹⁴ "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.

¹² NASD Interpretation Memo, pp. 367 & 368.

¹³ *Id.*, pp. 368 & 369.

¹⁴ *Id.*, p. 365.

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 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 requires 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 139¹⁵ under the Securities Act of 1933 for issuers whose securities are actively traded as defined in Rule 101(c)(1) of Regulation M.¹⁶ 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

¹⁵ 17 C.F.R. 230.139.

¹⁶ 17 C.F.R. 242.101(c)(1).

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 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 Memo¹⁷ 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

¹⁷ NASD Interpretation Memo, p. 372.

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.¹⁸ 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 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 NASD had indicated, however, that if the disclosures were edited out of a program, the analyst should in the future 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.¹⁹ The NYSE differed with the NASD and was of the view that an analyst will not be responsible for disclosures being edited out and could again appear on a program provided the analyst did not encourage or assist in deleting the required disclosures. A recent rule filing by the 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 in future appearances from being certain that it is included.²⁰ This problem may have been resolved. But see Sections VIII.F & H below.

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.

¹⁸ Id., pp. 378 & 379.

¹⁹ Id., p. 379.

²⁰ Release 34-47110, 68 FR 826 at 836 (January 7, 2002).

The determination of beneficial ownership is based upon the beneficial ownership rules under Sections 13(d) and (g) of the Exchange Act.²¹ 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:

- 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.²²

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.

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

²² NASD Interpretation Memo, p. 374.

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.
- 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 IV.I.11 Compendium Reports for a detailed discussion.

The NASD Interpretation Memo answers a number of questions concerning the required charts.²³ 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.

²³ Id., pp. 376 & 377.

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 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 is 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 need to fall within the safe harbor for disclosure of soft information which will lengthen research reports and make them considerably more complex.²⁴

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.²⁵

²⁴ See, e.g., Securities Act of 1933 §27A, 15 U.S.C. §77aaA; Securities Exchange Act of 1934 §21E, 15 U.S.C. §78uE.

²⁵ NASD Interpretation Memo, p. 378.

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.²⁶

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.

V. **REGULATION ANALYST CERTIFICATION**

A. Required Certifications

On February 20, 2003, the SEC adopted Regulation Analyst Certification (“Regulation AC”).²⁷ The new rules are effective April 14, 2003. In summary, Regulation AC requires that a broker-dealer (“BD”) or “covered person” that publishes, circulates or provides a research report to include a certification by the preparing research analyst that:

1. the views expressed in any report or public appearance accurately reflect the analyst’s personal views about the subject securities and issuers;
2. no part of his or her compensation was or will be directly or indirectly related to specific recommendations or views contained in the research report or alternatively describe the compensation that has been received, the source and amount, the purpose and that the compensation may influence the recommendation in the research report.

²⁶ Id., p. 378.

²⁷ SEC Regulation Analyst Certification, 17 C.F.R. Part 242, Release Nos. 33-8193; 34-47384 (February 20, 2003) (hereinafter “AC Release”).

In connection with public appearances, BDs are required to keep records related to public appearances by each research analyst and make a record within 30 days after each calendar quarter in which a research analyst makes any public appearance that includes a written statement by each analyst attesting that:

1. the views expressed by the analyst in all public appearances during the quarter accurately reflected the research analyst's personal views at that time about any or all of the subject securities or issuers;
2. no part of the research analyst's compensation was or will be directly or indirectly related to any specific recommendation or views expressed in any such public appearance.

If the certification is not made to the BD, the BD must promptly notify its examining authority pursuant to Section 17(d) of the 34 Act and Rule 17d-2 thereunder.²⁸ Thereafter, the BD must disclose in any research report authored by that analyst that the analyst did not provide certification specified in Rule 502(a) of Regulation AC.

The Rule requires certification by the analyst or analysts primarily responsible. This presents a dilemma for a firm that operates by a committee of analysts because often there are four or five persons on the committee. If one or two members of the committee disagree with the report or the recommendation of the committee as a whole, it seems impossible then to issue the report, because the rule appears to require unanimity. This is a serious flaw for which there appears to be no answer at this time. Hopefully, the SEC will develop some sort of rationale to permit dissenters.

Another issue is quantitative and technical research where a model is developed and used by the firm and no analyst is primarily responsible. The AC Release permits the firm in that case to certify in lieu of the research analyst.²⁹

In compendium reports under the rules of the SROs, if there are six or more securities, the regulations permit disclosures to appear in a place other than the report itself provided the firm agrees to supply the disclosure upon request. The SEC specifically rejected that methodology with respect to Regulation AC and each report must have a certification even if it is a compendium.³⁰

In footnote 11 to the AC Release, the SEC states "the Commission expects that certifications will be included on the front page of the research report or that the front page will specify the page or pages on which such certification is found."³¹ Disclosures and references to disclosures must be clear and prominent. Electronic research reports may utilize hyperlinks to the disclosure provided that the first screen that the investor sees clearly and prominently labels the

²⁸ 34 Act, §17(d), 15 U.S.C. 78r(d); SEC Rule 17d-2, 17 C.F.R. 240.17d-2.

²⁹ AC Release, p. 8.

³⁰ AC Release, p. 9.

³¹ AC Release, p. 26.

hyperlinks to the required disclosures. When hyperlinks are not possible, such as in a report in PDF format, firms should follow the requirements for paper reports.

B. Key Definitions

1. Research Analyst Definition

It should be noted that the definition of “research analyst” is broader than that of the SRO analyst rules because it covers any natural person whether an associated person of a member or not.

2. Covered Person

“Covered persons” means any “associated person” of a BD as defined in the 34 Act.³² Interestingly in response to comments to the SEC with respect to the proposed rule being too broad, there is a definition of “covered person” that excludes an entity associated with a BD that is independent of that BD. Rule 500 of Regulation AC defines a “covered person” to exclude an associated entity of a BD that:

- a. has no officers (or other persons performing similar functions) or employees in common with the BD who can influence activities of a research analyst or the content of research reports;
- b. maintains and enforces written policies and procedures reasonably designed to prevent the BD and any controlling persons, officers (or persons performing similar functions) and employees of the BD from influencing the activities of research analysts and the content of the research reports prepared by the associated person.³³

The purpose of this is to give a firm that has an independent investment advisory affiliate providing research to the street not to be subject to the rules.

Rule 504, a new provision, requires the BD that issues research reports to notify its analysts and associated persons as to whether the BD qualifies under (a) and (b) above in the exclusionary definition of a covered person.³⁴ Rule 504 thus requires a BD to notify its associated persons that issue research reports as to whether the BD maintains and enforces such written policies and procedures and whether there are any common officers.

3. State Registered IAs

Also excluded from the definition of covered persons is an investment adviser not registered with the SEC as a federal investment adviser because of the provisions of

³² 34 Act §3(a)(18), 15 U.S.C. 78c(a)(18).

³³ Rule 500, 17 C.F.R. 242.500.

³⁴ Rule 504, 17 C.F.R. 242.504.

Section 203 of the Investment Advisers Act of 1940³⁵ and not registered or required to be registered with the SEC as a BD.

4. Research Report

The definition of “research report” in Rule 500 is important and includes both equity and debt securities. “Research report” means “any written communication including (any electronic communication) that includes an analysis of a security of an issuer and provides information reasonably sufficient upon which to base an investment decision.”³⁶ A research report would include any rating of a security or issuer. Importantly, a research report need not include a recommendation. The SEC in the definition was explicit in providing that any electronic communication meeting the requirements would be included.

The SEC elaborated in the adopting release examples of what would not be a research report which are as follows:

In general, however, the following communications would not be research reports if they do not include an analysis of, or recommend or rate, individual securities or companies:

- Reports discussing broad-based indices, such as the Russell 2000 or S&P 500 index.
- Reports commenting on economic, political, or market conditions.
- Reports commenting on or analyzing particular types of debt securities or characteristics of debt securities.
- Technical analysis concerning the demand and supply for a sector, index, or industry based on trading volume and price.
- Reports that recommend increasing or decreasing holdings in particular industries or sectors or types of securities.

The following communications would generally not be research reports even if they recommend or rate individual securities or companies:

- Statistical summaries of multiple companies’ financial data (including listings of current ratings) that do not include any analysis of individual companies’ data.
- An analysis prepared for a specific person or a limited group of fewer than fifteen persons.
- Periodic reports or other communications prepared for investment company shareholders or discretionary investment account clients discussing past performance or

³⁵ 15 U.S.C. 80b-3(a).

³⁶ Rule 500, 17 C.F.R. 242.500.

the basis for previously made discretionary investment decisions.

- Internal communications that are not given to customers.³⁷

5. Third Party Research Analyst

A third party research analyst is defined in Rule 500 as follows:

- a. With respect to a covered person, any research analyst not employed by that BD or any of its associated persons.
- b. With respect to a covered person of a BD, any research analyst not employed by that covered person, by its associated BD or by any other associated person of the BD with whom that covered person is associated.

This is a broad definition to be certain that a third party analyst is not influenced by a BD.

6. Public Appearance

Rule 500 defines public appearance very broadly to include just about any appearance or participation in a seminar, forum, radio, television, interview or other type of public activity. However, it does have a limitation that applies that only if the analyst makes a specific recommendation or provides information reasonably sufficient upon which to base an investment decision about a security or an issuer.

C. Banks and Investment Advisers

The SEC specifically includes investment advisers and banks within the framework of Regulation AC if they are a covered person. However, if an investment adviser or bank meets the exclusions specifically provided in Rule 500 for exclusion from covered person (such as independent research; *see* Section V.B.2), they would not be subject to Regulation AC.

D. Exclusions and Exemptions

1. Independent Research Firms

As discussed above in Section V.B.2, an entity that is associated with a BD may be considered excluded from Regulation AC if it is independent.

2. Third Party Research

The certification provision in connection with research reports specifically provides an exemption for third party research that is circulated by a BD or covered person provided the third party research analyst has no officers or employees in common with the BD or

³⁷ AC Release, pp. 7 & 8.

covered person and with respect to a covered person the BD with whom the covered person is associated maintains and enforces written policies and procedures reasonably designed to prevent the BD, any controlling person or officers and any employees of the BD from influencing activities of the third party research analyst contents of its reports.

3. Foreign Research Reports

Rule 503³⁸ provides a specific exemption for foreign research reports provided the foreign person is located out of the United States and not associated with a registered BD, the research report concerns foreign securities and the report is provided pursuant to requirements of SEC Rule 15a-6(a)(2). This is a very narrow exemption because of the restrictive limitation of Rule 15a-6(a)(2).

4. Public Appearances Outside the United States

Rule 502(c) in connection with certifications for public appearances provides that a research analyst who is employed outside the United States by a foreign entity that is also located outside the United States shall not be subject to the public appearances except if the analyst makes a public appearance when he is physically present in the United States.³⁹

5. News Media

In addition, because of the comments from the news media, there is a specific exclusion by Rule 505⁴⁰ from Regulation AC for any publisher of a bona fide newspaper, news magazine, business or financial publication of general or regular circulation that is not registered or required to be registered with the SEC as a BD or investment adviser.

E. Practical Comments

Regulation AC appears to be a significant amount of overkill designed by the SEC after criticism arose in the press. Unfortunately, it does not conform with NASD Rule 2711 or corresponding NYSE Rule in connection with its definitions and other provisions. That is unfortunate because the rules must operate together and it creates a series of traps for the unwarranted. Key definitions such as “research report,” “research analyst,” “covered person,” “third party research,” and a variety of other definitions and positions are different, sometimes only to a minor degree but still different from those of the NASD and NYSE. Unfortunately this creates traps for the unwary that could occur even in a firm that is operating as carefully as possible.

VI. The Sarbanes-Oxley Act of 2002 Provisions Regarding Research Analyst Conflicts

As noted above, Title V of the Sarbanes-Oxley Act of 2002 (“Act”) amends the Securities Exchange Act of 1934 by inserting a new Section 15D requiring the SEC to adopt or require SROs to adopt, within one year after the date of the enactment, rules designed to address conflicts of

³⁸ Rule 503, 17 C.F.R. 242.503.

³⁹ Rule 502(c), 17 C.F.R. 242.502(c).

⁴⁰ Rule 505, 17 C.F.R. 242.505.

interest that may arise when a security analyst recommends equity securities in research reports or in public appearances.⁴¹ A good part of Section 15D and the mandated rules cover areas already covered in NASD Rule 2711 and NYSE Rule 472. However, Section 15D mandates specific rule provisions that will create some difficulties for the SEC in drafting its rules and for broker-dealers operating under the rules. The definition of “security analyst” in the Act includes any associated person of a registered broker-dealer that is “principally responsible for and any associated person who directly or indirectly reports to a security analyst” in connection with the preparation of the substance of a research report. Importantly, unlike Regulation A-C and the SRO rules, the term “research report” applies to any communication that includes an “analysis of equity securities of individual companies or industry and provides information reasonably sufficient upon which to base an investment decision.” The research report need not include a recommendation.

Section 15D also has a specific provision requiring the rules to prevent retaliation against a research analyst who has an adverse, negative or otherwise unfavorable research report that may adversely affect present or prospective investment banking relationships. Further, the rules are required to establish structural and institutional safeguards within registered broker-dealers to assure that security analysts are separated by appropriate information barriers within the firm from the review, pressure or oversight of those who are involved in investment banking activities.

The provisions of the Act make no distinction between public appearances and reports. The Section also requires the Commission’s rules to provide for disclosure of specific activities. Furthermore, any compensation received by the broker-dealer from the issuer would need to be disclosed, not just investment banking compensation. The legislation would also appear to require the SEC to prohibit research reports that are provided at the end of a lock-up period. The quiet period required by the Section 15D mandates would apply to all syndicate members, not just members or co-managers.

VII. The Proposed New Rules and Amendments to NASD Rule 2711 and NYSE Rule 472

A. Introduction

As a result of the addition of Section 15D of the Securities Exchange Act of 1934 added by Title V of the Act, the NASD and the NYSE have submitted rule proposal packages to the SEC and the SEC has published the proposals for comment.⁴² Additional rules by the SEC under Section 15D will also be proposed but as of the date of this outline have not been proposed.

B. Registration, Qualification and Continuing Education

The proposed amendments to the NASD and SEC rules would create a new NASD Rule 1050, requiring registration of all persons associated with a member functioning as research analysts. Analysts would be required to pass a qualification exam dealing with research and analyst activities. In addition, the NASD continuing education rule, Rule 1120, would require analysts to participate in continuing education, including both the regulatory and firm elements. The firm element would be required to include both training and education in ethics, professional

⁴¹ 15 U.S.C. 78oD.

⁴² SEC Release No. 34-47110, 68 FR 826, (January 7, 2003).

responsibilities with particular emphasis on the requirements of NASD Rule 2711. The NYSE proposes amendments to its Rule 344 and Rule 345(a) to require similar qualification, registration and education of analysts.

C. Further Restrictions Dealing with Analyst Compensation

The amended rules would require each firm having analysts to have a compensation committee that reports to its board of directors, or in the absence of a board of directors, a senior executive officer. The committee would have as its responsibility the review and approval of analyst compensation for each analyst at least annually. Any such committee is prohibited from having participants who are members of the firm's investment banking department. The proposed amendment to NASD Rule 2711 provides as follows:

“The committee must consider the following factors when reviewing a research analyst compensation, if applicable:

- (a) The research analyst individual performance, including the analyst productivity and the quality of the analyst's research;
- (b) The correlation between the research analyst's recommendations and the stock price performance; and
- (c) The overall ratings received from clients, sales force, peers and independent of the member's banking department and other independent rating services.”

The rule further has a specific prohibition against the committee considering as a factor in compensation, the contributions by an analyst to the member's investment banking business. The committee is required to document the basis upon which a research analyst's compensation is established. As noted above, current Rule 2711(i) requires certification annually of compliance with the rule. Under the proposed rule amendments, the compliance certification must state that the compensation committee has reviewed and approved each research analyst's compensation and documented the basis upon which the compensation was established.

D. Termination of Coverage of an Issuer's Security or Securities

Under the proposed amendments, if a firm determines to terminate coverage of a particular company, it is required to publish a notice of the termination and a final rating or recommendation provided the firm had previously issued a rating or recommendation. The termination notice must be in the same manner and format as any research report when the report was initiated. Importantly, the termination notice must have the same prominence as the original rating.

E. Expansion of the Definition of Public Appearance

The proposed amendments to NASD Rule 2711 and NYSE Rule 472 will revise the definition of public appearance to include interviews with print media and the writing of any print

media article provided that the analyst makes a recommendation or offers an opinion concerning an equity security.

F. Resolution of Interpretive Conflict

In the Release proposing the rules, the NASD also proposes to reconcile its interpretation regarding disclosures in the media in connection with public appearances. There is a conflict as noted above at Section IV.I.1 between the NYSE interpretation and the NASD interpretation concerning a medium that refuses to include disclosures required by NASD Rule 2711 or NYSE 472. The NASD view is that if the medium refuses to make the required disclosures as provided by the analyst or its firm, the analyst may not again appear in that medium. The NYSE seems to have a contrary interpretation. In connection with the proposed amendment to its rules, the NASD states in its purpose statement in the filing with the SEC that it is modifying the guidance discussed in NASD's Notice to Members 02-39. The NASD states that its new policy will be that "An analyst would not violate the rule if the analyst makes the required disclosures to the print, radio or television media in good faith even if the media outlet does not permit or broadcast the information (emphasis added)." The position continues and states that the NASD thus recognizes "the independent editorial discretion of print, radio and television media."⁴³ However, the policy on its face does not specifically seem to reverse the NASD's prior position if the media does not make their disclosures that were required by 2711 as provided by the analyst. Thus there is a question as to whether the analyst may appear again in the same medium because if the medium has not made the disclosures, the analyst might not be acting in good faith. Hopefully this will receive further clarification.

G. Further Prohibition on Publishing Research Reports and Public Appearances

NASD Rule 2711(f) and the similar provisions of NYSE Rule 472 would be expanded to impose a quiet period on members during which they may not publish research reports following either an initial public offering or secondary offering of securities. The quiet period would include any period in which there is a lock up agreement entered into with the subject company or its shareholders. A lock up agreement generally prohibits the sale of similar securities to those that were offered to the public for a period after completion of the securities offering. If the member acting as manager or co-manager has entered into such a lock up agreement, the member would be restricted from publishing research reports about the subject company for 15 days prior to and after the expiration, waiver or termination of the lock up agreement. Importantly, the quiet period restrictions would extend to public appearances by research analysts, including print articles.

H. Prohibition on Investment Banking Solicitations for IPOs

Research analysts would be prohibited from issuing a research report or making a public appearance about an issuer if the research analyst communicated with it in attempting to obtain investment banking business prior to the issuer entering into a letter of intent or other written agreement by which the member is designated as an underwriter of the company's IPO. It is interesting to note that this prohibition is unlike the quiet period because if an analyst is tainted

⁴³ Release 34-47110, 68 FR 826 at 836 (January 7, 2003).

by such prohibited participation, he may never issue reports or give his opinion about the company. Interestingly, the proposed amendments would not apply the prohibition to due diligence communications between an analyst and the issuer, provided that its only purpose is to analyze the financial conditions or operations of the issuer. Because of the prohibitions on receiving compensation related to investment banking, it is questionable whether any such due diligence could be taken into consideration in compensating the analyst. Because of this, it is likely that an analyst may not be used under any circumstance.

I. Extension of Personal Trading Prohibitions to Senior Managers of Research

The provisions of NASD Rule 2711(g) discussed above and its counterpart in NYSE Rule 472 with respect to prohibition on personal transactions and the securities of the issuer that is the subject of a research report or recommendation are extended to an additional class of member associated persons. The analyst, for purposes of the 2711(g) prohibition, would include under the amendments such other persons “as the director of research, supervisory analyst, or member of a committee who have direct influence or control with respect to (A) the preparation of research reports, or (B) establishing or changing a rating or price target of the subject company’s equity securities.”

VIII. Litigation and Enforcement Proceedings

A. Introduction

Post Enron, there have been a number of civil, private class actions, customer claims and enforcement proceedings by the SEC and state securities officials, notably the Attorney General of the state of New York. The civil litigation continues with some dismissals. The enforcement proceedings are generally in the process of being settled on a basis that includes undertakings regarding most of the provisions already included within NASD Rule 2711 and NYSE Rule 472 or in the proposed amendments to those rules. However, in some cases, the settlements go further. Discussed below is a brief summary of some of the litigation.

B. Merrill Lynch

Merrill Lynch’s settlement with the New York Attorney General Elliott Spitzer was highly publicized. The Attorney General attempted to enjoin Merrill Lynch and certain current and former analysts and other personnel from violating the New York Securities Anti-Fraud Law. Merrill Lynch, without admitting or denying any liability, agreed to a \$100 million settlement and certain undertakings. Merrill Lynch also consented to the appointment of a compliance monitor subject to the approval of the New York Attorney General to oversee the firm’s research practices. In addition, Merrill Lynch was required to develop a new ratings system that was designed to be clearer and simpler.

C. Citigroup Settlement

Solomon Smith Barney of the Citigroup agreed to pay a \$5 million fine to the NASD without admitting liability to resolve certain allegations regarding misleading research reports.

D. Credit Suisse First Boston Corporation

The state of Massachusetts has filed an administrative complaint against the Credit Suisse group alleging that one of its units misled investors as a result of undue influence by the firm's investment banking department on certain research department personnel. This matter is in the process of being resolved.

E. Global Settlement of Certain Research Cases

In December, the SEC, NASD, NYSE, New York Attorney General and the National Association of Securities Administrators announced that they had reached a global settlement with respect to investigations into allegations of alleged misconduct in connection with analyst research. Although this settlement has been resolved in principal at the date of preparing this outline, the settlement had not been formalized. The firms that are party to the settlement will pay \$1.4 billion. \$450 million of the settlement will be used to buy independent research materials available to the customers of each of the firms for a five year period. A portion of the settlement will go toward investor education. The remainder may provide funds for investor restitution as a result of conflicts of interest. Interestingly, each of the firms that are parties to the settlement are required to contract with no less than three independent research firms to provide research to customers. This is designed to ensure that individual investors have access to objective recommendations. The firms also agree to certain organizational restructuring to prohibit links between research and investment banking. The remaining provisions include a ban on the practice of spinning IPO shares and a number of other undertakings that duplicate to a large extent the current requirements.

IX. Some Practical Considerations

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

Although the 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 and proposed rules and amendments apply to any firm that promulgates research reports. This includes 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 should have the adopted written supervisory procedures and compliance policies to implement Rule 2711 and NYSE Rule 472. Each firm will have to amend its written supervisory procedures and policies to implement the additional proposed rules dealing with

conflicts of interest and SEC Regulation A-C when they are adopted. Firms should begin the process because it appears that these proposals will be adopted largely as published by the SEC in its notices. Policies and procedures will necessarily be complex, but they will have to be adopted to each firm's operations. Firewalls and structural separation of investment banking and research will have to be carefully designed. The Securities Industry Association has developed a set of best practices for member firms in connection with research operations. These practices include the structures and procedures to avoid potential conflicts of interest. The best practices cover many of the areas covered by NASD Rule 2711 and many of the proposed amendments. Although best practices are broad statements of principal and practice, they are somewhat dated. While they are helpful as a starting place, reference to NASD Rule 2711 and NYSE Rule 472 is recommended. Policies and procedures will have to be further changed for the proposed amendments which expand both the periods and type of bars from personal trading and the individuals that are covered. 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 should have changed their personal trading policies to conform to the requirements of Rule 2711. Personal trading policies 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 is best 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. The amendments would also require tracking accounts of analyst supervisors and their household members. Personal trading policies have to have special provisions for analysts and their supervisors which cover things such as the quiet period, the lock up period and the more onerous restrictions on personal trading by the analyst or analyst supervisors. Trading departments need to be informed that transactions for analysts and their supervisors 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 should probably be handled by the compliance department for knowledgeable compliance. Firms need to 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 need 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 adopted rules, proposed amendments and Regulation A-C includes not only cash compensation but other arrangements for any kind of investment banking services. Firms need to have a procedure to track all agreements, formal or informal, with issuers for which they provide investment, banking or other services. Firms need to have clear written supervisory procedures for tracking compensation that is received from issuers and their affiliates. This is 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 prohibitions 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 rules 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 still need to be maintained for purposes of avoiding use of inside information or other material undisclosed information in connection with recommendations. Sarbanes-Oxley Act gives the SEC in Section 15D the authority to establish rules with respect to the structure between investment banking and research analyst. The SEC may require, as do some of the mandated settlements, complete restructuring of an entity or possibly even having the research analyst in a separate entity. In any event, whether or not the SEC mandates organizational restructuring, many firms have and many firms will consider restructuring as a matter of good compliance.

H. Public Appearances

In public appearances, particularly on talk shows and similar appearances, the recitation of disclosures is cumbersome and difficult. However, it appears that it will become a part of public life. Obviously, it reduces 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 stated 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.⁴⁴ As noted above, the NYSE did not agree with the NASD's interpretation and the NASD has proposed to change its interpretation. However, the NASD's proposed interpretation included in the notice published by the SEC is unclear. *See* discussion at VIII.F above.

I. Ratings and Price

All firms that issue research reports that assign a rating to a particular type of security are required to disclose in plain English the meaning of the rating and the distribution of ratings as described above. This requires 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 requires considerable work and it causes 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. The new provision with respect to publishing termination of following of a security that has been rated will require careful monitoring.

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 of NASD Rule 2711 and NYSE 472 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 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;

⁴⁴ NASD Interpretation Memo, p. 378.

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.

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