

Client Alert

A report
for clients
and friends
of the firm June 2002

SEC Approves New Research Analyst Rules

The Securities and Exchange Commission ("SEC") has approved proposals by the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers, Inc. ("NASD") (collectively, the "SROs") to amend their rules to deal with actual and perceived conflicts of interest in the preparation and issuance of research reports by research analysts. NYSE amended Rules 472 and 351 and new NASD Rule 2711 (collectively, the "Amended Rules") are intended to address conflicts which arise when an analyst is employed by a firm which may have an investment banking relationship with the issuer of a recommended security, or when the analyst or the firm owns securities of such an issuer.

The well-publicized New York State Attorney General investigation of the research practices at Merrill Lynch and other firms and the coordinated investigations of various firms by other states are separate from this rule amendment process. Merrill Lynch has agreed to certain practices which go beyond the requirements of the Amended Rules, and other firms have adopted these practices voluntarily. In short, firms should be aware that the ultimate resolution of these investigations and the separate investigation being conducted by the SEC of industry research practices may lead to additional requirements being imposed directly or indirectly on the entire industry.

Background

Current NYSE Rule 472 and NASD Rule 2210 require disclosure of potential conflicts of interest in written research reports. However, these rules are inconsistent in their disclosure requirements, which generally are relegated to boilerplate language, and do not apply to oral

recommendations, such as in television appearances by analysts.¹ The Amended Rules correct these inconsistencies. More significantly, they require organizational barriers within a firm to strengthen analysts' independence from the firm's investment banking department, impose trading limitations on analysts before and after the issuance of research, limit the issuance of research after a public offering and require additional disclosure of potential conflicts and information to render recommendations and ratings more meaningful.

"Research report" for the purposes of the Amended Rules is now defined as "a written or electronic communication which includes an analysis of equity securities of individual companies or industries, and which provides information reasonably sufficient upon which to base an investment decision and includes a recommendation." The definition is narrower than that applicable under Rules 137, 138 and 139 of the Securities Act of 1933 (the "Securities Act"). However, in response to commenters' concerns that the definition may cover communications beyond the intent of the amended rules, the SROs intend to issue written interpretations on practical issues raised by the definition in specific cases.²

Key Elements of Amended Rules

Separation Between Research and Investment Banking Departments

In order to insulate research analysts from pressures that may impair their objectivity, the Amended Rules prohibit supervision or control of a research analyst by the firm's investment banking department. In addition, investment banking personnel may not discuss pending research reports with research analysts prior to their distribution, except to verify factual accuracy of public or non-material information contained in the report or to identify potential conflicts of interest. Even in those instances, any written or oral communication between

1 NASD Rule 2210 requires the disclosure of ownership by the firm (and its officers or partners) of options, warrants or other rights to acquire the subject's securities, but ownership of common shares and any ownership interest of the analyst need not be disclosed. Current NYSE Rule 472 requires disclosure of all ownership interests by the firm and its analysts, but ownership of options may be disclosed conditionally.

2 Particularly, the SROs intend to examine abstracts, updates, weekly and monthly summaries, industry/market segment reports, portfolio strategy pieces, quantitative research and technical analysis, and general market commentary and trading strategies, to determine whether they fit within the definition.

investment banking personnel and an analyst must be intermediated through an authorized legal or compliance representative of the firm.

Contact With Subject Companies

A subject company may not review a research report prior to publication, except to verify the factual accuracy of public information contained in the report. When so submitted, the subject company may not receive the research summary, the rating or the price target, and the legal or compliance department must receive a complete copy of the report and approve any subsequent change in rating or price target. A subject company can only be informed of a change in its rating no earlier than the business day prior to the change in rating, after the close of the principal trading market for its securities.

Disclosure of Compensation Arrangements

No part of an analyst's compensation may be tied to a specific investment banking transaction. While analysts are still permitted to be compensated out of the firm's overall investment banking revenues, the fact that the research analyst who prepared the report may be so compensated must be disclosed in each research report. Further, a report must disclose if: (i) the firm managed or co-managed a public offering of the subject company's securities in the past 12 months; (ii) the firm received compensation for investment banking services from the subject company during the past 12 months;³ or (iii) expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months. An analyst also must disclose in public appearances if the subject company is a client of the firm or any affiliate.

Avoidance of Favorable Research As Inducement for Business

The amended rules contain explicit prohibitions against offering favorable research, a specific rating or a specific price target, or threatening to change research or lower a rating or a price target as consideration or inducement for business from a subject company. In order to buttress this prohibition, managers and co-managers of public offerings must comply with a "quiet period" of 40 calendar days following an initial public offering ("IPO"), or 10 days after a secondary offering, during which no research may be published on the issuer. This requirement effectively adds 15 days to the "quiet period" for the managers

and co-managers of most offerings. Exceptions are made for significant news events during the applicable 40 or 10 day period, and for research issued during the 10 day period for secondary offerings pursuant to Securities Act Rule 139 for issuers with "actively-traded securities," as defined in Rule 101(c)(1) of Regulation M, under the Securities Exchange Act of 1934 (the "Exchange Act").⁴

Analyst Trading Restrictions

In order to minimize personal conflicts of analysts, analysts (and members of their households)⁵ may not purchase or receive⁶ securities of any company in an industry which the analyst covers prior to that company's initial public offering. An analyst may not purchase [sell] any security of an issuer which the analyst follows, or an option or a derivative on such a security, for 30 days prior to and five days after the publication of a report on the company or a change in the rating or price target of the company. In addition, an analyst's personal transactions may not be inconsistent with the analyst's recommendations in the most recently published report.

Exceptions to the above restrictions include:

- an analyst may sell securities of the subject company held in his account at the time of his commencement of coverage of the company during the 30 day period following commencement of the coverage;
- an analyst may purchase or sell securities of a subject company during the 30 day period prior to the issuance of a report (subject to customer preference requirements) if a significant news event concerning the company warrants a change in the rating or price target occurs during such period, provided that approval of the change in rating is made by the firm's legal or compliance department.
- an analyst may purchase or sell securities of the subject company if an unanticipated significant change in the analyst's personal financial circumstances occurs, and: the legal or compliance department pre-approves the transaction, the approval is pursuant to a written policy reasonably designed to prevent conflicts, and written records of the transaction and the reason for the exception are maintained for three years.

3 "Investment banking services" are defined narrowly as including: acting as an underwriter in an offering for the issuer; acting as a financial adviser in a merger or acquisition; providing venture capital, equity lines of credit, PIPEs (private investment, public equity) or similar investments; or serving as placement agent for the issuer.

4 Securities having an average daily trading volume ("ADTV") of at least \$1 million and issued by an issuer whose common equity securities have a public float value of at least \$150 million.

5 The final rule adoption rejected suggestions that the restrictions should apply only to family members. It was recognized that "household members" may require further interpretation in individual cases.

6 This provision is intended to eliminate the conflict where an analyst either purchases at low cost or receives securities at no cost from a company in an industry which he or she covers, and there is a prospect of substantial gain when the company goes public.

Other exceptions apply under certain conditions to specific transactions in mutual fund shares.

Disclosures on Ownership

Certain ownership interests of the firm and/or the analyst in the subject company must be disclosed in research reports issued by the firm and in public appearances by the analyst. In both instances, any financial interest of the analyst or members of his or her household in securities of a recommended company must be disclosed.⁷ If the firm or an affiliate, as of the end of the month immediately preceding the date of the publication of the research report or the public appearance (or the end of the second most recent month if the publication date is less than 10 calendar days after the end of the most recent month), beneficially owns 1% or more of any class of common equity securities of the subject company, that fact must be disclosed.⁸

Disclosure also must be made of any other actual, material conflict of interest of the research analyst which the research analyst or the firm knows or has reason to know at the time of the report's publication or of which the research analyst knows or has reason to know at the time of the public appearance, and any other actual, material conflict of interest of the firm of which the firm knows or has reason to know at the time of the publication of the report, or of which the research analyst knows or has reason to know at the time of the public appearance.

Meaning of Ratings

The amended rules also require certain disclosure to inform investors about the credibility of a firm's research reports. The firm must define in its reports the meaning of its ratings, and the definition must be consistent with its plain meaning. Each report must disclose the percentage of all securities rated by the firm that it would assign a "buy," "hold/neutral" or "sell" rating, regardless of how the firm actually classifies its ratings, and the percentage of subject companies within each of these three categories for whom it has provided investment banking services within the previous twelve months. This information must be current as of the end of the most recent calendar quarter (or the second most recent quarter if the publication date is less than 15 calendar days after the most recent calendar quarter).

For any securities on which the firm has assigned a rating for at least one year, each report must contain a line graph covering the shorter of the period for which the firm has assigned the company a rating or three years. The graph must contain the daily closing prices and indicate the dates on which the firm assigned or changed a rating or price target, and depict each rating and price target assigned or changed on those dates. This information also must be current as of the end of the most recent calendar quarter (or the second most recent quarter if the publication date is less than 15 calendar days after the most recent calendar quarter).

A firm must disclose in reports the valuation methods used to determine a price target. Each price target must have a reasonable basis and be accompanied by a disclosure concerning the risks that may impede achievement of the price target.

Compendium Reports

When a "compendium" report involving six or more subject companies is issued, the report must clearly direct the reader to where any of the required disclosures described above may be found, either in writing or electronically.

Supervisory Procedures and Annual Attestation

Each firm must adopt and implement procedures reasonably designed to ensure compliance with the rules, and a senior officer must annually attest to the NASD and the NYSE, if the firm is a member, that it has adopted and implemented those procedures. Nothing in the amended rules affects the existing supervisory obligations of NYSE supervisory analysts or NASD Principals for the review and approval of research reports.

Implementation Schedule

All of the provisions of the Amended Rules are effective July 9, 2002 except:

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| Legal/compliance department intermediation | September 9, 2002 |
| Charts of ratings distribution | September 9, 2002 |
| Price charts | September 9, 2002 |
| Disclosure of 1% or more firm ownership positions in covered securities | November 6, 2002 |

Interaction With Existing Rules

In addition to the disclosures required by the Amended Rules, recommendations made in sales literature, advertising and research reports will continue to be governed by NASD Rule 2210 and the anti-fraud provisions of the federal securities laws. Therefore, these communications must disclose, as applicable:

- that the firm usually makes a market in the recommended security, or that the member or associated persons will sell it or buy it from customers on a principal basis;
- that the firm and/or its officers or partners own options, rights or warrants to purchase any of the securities of the recommended issuer, unless the extent of the ownership is nominal; and

⁷ "Financial interest" includes any option, right, warrant, future, long or short position.

⁸ Beneficial ownership is determined according to the same standards as under the reporting requirements of Section 13(d) of the Exchange Act.

- that the firm was manager or co-manager of a public offering of any securities of the recommended issuer within the last three years.

In the event that the market making disclosure differs between Rule 2210 and the Amended Rules, the latter will govern (*e.g.* actual market-making in the subject issuer's securities must be disclosed). The other requirements of Rule 2210 are in addition to those under the Amended Rules. Therefore, any ownership of options, etc. by officers or partners (other than nominal) must be disclosed in the communication, as well as acting as manager or co-manager of any securities of the issuer within the prior three years.

Open Issues

While the disclosure rules are intended to apply to research prepared by non-member affiliates (including foreign affiliates) and distributed by member firms, the SROs intend to review on a case-by-case basis the application of the rules to research prepared by unaffiliated third parties and distributed by a member. The applicability of the disclosure requirements will depend on the type of report, the entity that created the report, and the firm's participation in the creation of the report. However, the rules will not apply to independently produced research, such as research distributed under Exchange Act Section 28(e).

Interpretative questions concerning whether certain reports or commentaries fit within the definition of "research report" for the purpose of the amended rules will be addressed on a case-by-case basis.

Interpretations as to whether persons fall within the meaning of "household members" for the purpose of analyst trading restrictions also will be handled on a case-by-case basis.

Certain terms have not been clearly defined, such as the meaning of "affiliate" for the purpose of the required disclosure of firm ownership interests in the securities of a subject company. These and other ambiguities are expected to be addressed in an NASD Notice to Members and an NYSE Information Memo to be released shortly.

The SROs have been requested by the SEC to prepare a report on the operation and effectiveness of the amended rules and any recommendations for changes or additions by November 1, 2003, or sooner, if deemed warranted. In addition, the SEC announced a formal inquiry into market practices on research and the conflicts between research analysts and investment banking which may lead to further SRO rulemaking or additional SEC action.

Conclusion

The amended rules will require active monitoring and certain provisions are dependent on the intermediation of the firm's legal or compliance department. The SROs have compared this "gatekeeping" role to that performed in the area of Chinese Walls and insider trading. However, given the ongoing scrutiny of industry research practices, senior management should be advised of the importance of these requirements, especially as to the separation between research and investment banking, so as to curtail any real or perceived erosion in the independence of research analysts.

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Client Alert

If you have questions about these new rules, need help in developing the required supervisory procedures, or would like information about further developments in this area, please contact any of the following members of the Broker-Dealer Group:

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