

# Client Alert

A report  
for clients  
and friends  
of the firm

October 2003

## Further Amendments To Research Analyst Conflicts Of Interest Rules

In previous Client Alerts, we outlined the rules adopted by the New York Stock Exchange ("NYSE") and NASD (collectively, the "SROs") to address research and research analyst conflicts of interest<sup>1</sup> and subsequent SRO amendments to those rules.<sup>2</sup> On July 29, 2003, in order to further meet its obligations under the Sarbanes-Oxley Act ("Sarbanes-Oxley"), the SEC approved additional amendments to these rules which provide for further separation of analyst compensation from investment banking influence, prohibit analysts from issuing "booster shot" research upon the expiration of lock-up periods, prohibit analysts from soliciting investment banking business, expand the disclosures required in research reports and public appearances concerning compensation received from the subject company and require firms to publish a final research report when they terminate coverage of a company.<sup>3</sup> The amended rules also prohibit retaliation against analysts for the substance of their reports, make permanent a small firm exemption from certain aspects of the rules, establish new categories of registration for research analysts and require their inclusion in certain continuing education requirements. Except where noted, the provisions became effective on September 29, 2003.

### Compensation Committee

Research analysts primarily responsible for the preparation of the substance of research reports must have their compensation reviewed and approved at least annually by a committee that reports to the firm's board, or to a senior executive officer when there is no board of directors. The committee may not include investment banking personnel and the analyst's contributions to investment banking may not be considered.

The compensation committee must consider the following in setting the analyst's compensation: (i) individual performance, including productivity and the quality of the research, (ii) the correlation between the analyst's recommendations and the stocks' price performance and (iii) the overall rating received from clients, sales force, peers independent of investment banking and other independent rating services. The basis for approval of the compensation must be documented. Both the NYSE and NASD require an annual attestation, by April 1 of each year, as to the review and documentation of the basis of compensation for each analyst under these rules. *NYSE 472(h)(2)*; *NASD 2711(d)(2)*. This process must be implemented by October 27, 2003.

### No Solicitation

Analysts may no longer participate in "pitches" or any other forms of solicitation of investment banking business. *NYSE 472(b)(5)*; *NASD 2711(c)(4)*. This provision effectively precludes joint meetings of analysts and investment bankers with clients which either expressly or impliedly promise research coverage as a condition of obtaining

<sup>1</sup> See Proskauer Rose Client Alert, *SEC Approves New Research Analyst Rules*, June 2002.

<sup>2</sup> See Proskauer Rose Client Alert, *Research Analyst Conflicts of Interest*, June 2003.

<sup>3</sup> SEC Release No. 34-48252, July 29, 2003.

investment banking business and prohibits any other communication by an analyst with a client for the purpose of soliciting investment banking business. It should be noted that this provision applies to all types of investment banking business, not only underwriting activity.

### **Quiet Periods**

The 40 and 10 day quiet periods applicable to managers and co-managers of initial public offerings and secondary offerings now preclude public appearances by research analysts during these periods, with exceptions for significant news events and Rule 139. Managers and co-managers of any offering are now precluded from issuing a research report or making a public appearance for 15 days prior to and 15 days after the expiration of a lock-up agreement pertaining to the offering, subject to the same significant news event or Rule 139 exceptions. *NYSE 472(f)(4); NASD 2711(f)(4)*. In addition, underwriters other than managers or co-managers are now subject to a 25 day quiet period after the date of the offering, to which there are no exceptions. *NYSE 472(f)(3); NASD 2711(f)(2)*.

### **Termination of Coverage**

If a firm decides to terminate coverage of a company, it must give notice of the termination and make available a final research report disseminated in the same manner as it usually provides such reports. It must be comparable in scope and detail to prior reports and contain a final recommendation or rating, unless it is impracticable. *NYSE 472(f)(6); NASD 2711(f)(5)*. NASD is expected to issue guidance as to what constitutes "termination," as opposed to withdrawal or discontinuance.

### **Personal Trading Restrictions**

"Blind trusts," which are controlled by a person other than a research analyst or a member of the analyst's household and in which neither the analyst nor any member of the analyst's household is aware of the investments, are excluded from the definition of "research analyst account" and are not subject to the analyst trading restrictions. *NYSE 472.40; NASD 2711(a)(6)*. Research supervisory personnel, such as the director of research, a supervisory analyst or members of a committee overseeing the substance of research reports, must have all personal securities transactions pre-approved by legal or compliance personnel. *NYSE 472(e)(5); NASD 2711(g)(6)*.

### **Disclosure**

Research reports and analysts in public appearances must disclose whether the analyst primarily responsible for the preparation of the report received any compensation from the subject company in the past 12 months, whether the

firm or an affiliate (to the extent the analyst knows or has reason to know) received any compensation for services other than investment banking services or whether the company is, or was during the past 12 months, a client of the firm or an affiliate and the types of services provided. These services are to be described as investment banking services, non-investment banking securities-related services, and non-securities services. Disclosures otherwise required by these provisions are not required to the extent such disclosures would reveal material non-public information regarding specific potential future investment banking transactions of the subject company. *NYSE 472(k); NASD 2711(h)*. These provisions become effective January 26, 2004, but the period may be extended up to 90 days in individual cases.

"Public appearance" has been expanded for these purposes to include print media interviews or writing an article for a print medium. Records of public appearances sufficient to demonstrate compliance with the disclosure requirements must be created and maintained for three years. *NASD 2711(h)(12)*. The NYSE more specifically requires that when recommending securities in a print media interview, newspaper article or broadcast, a research analyst is required to maintain a record of applicable disclosures, regardless of whether the media outlet publishes or broadcasts the required disclosures. *NYSE 472(k)(2)/01*.

### **No Retaliation**

No firm or investment banking employee of the firm may directly or indirectly retaliate or threaten to retaliate against a research analyst who writes a negative or adverse research report or makes negative or adverse remarks in a public appearance about a subject company that may adversely affect the firm's present or prospective investment banking relationship with the company. The prescription does not apply to normal discipline or termination under the firm's policies for other activity. *NYSE 472(g)(2); NASD 2711(j)*. This provision became effective July 29, 2003.

### **Small Firm Exemption**

The exemption from the requirements that investment banking personnel not have any supervision and control over any research analyst and that communications between research and investment banking be intermediated by legal or compliance personnel has been made permanent. These provisions do not apply to firms which have, on average per year, participated in 10 or fewer investment banking transactions as manager or co-manager and generated less than \$5 million in gross revenues from those transactions for the prior three years. *NYSE*

472(m); NASD 2711(k). This exemption became effective on July 29, 2003. However, unlike the temporary exemption which had been in place, under the permanent exemption such firms are not exempt from the provisions restricting communications between research department personnel and the issuer.

### Registration and Continuing Education

New NASD Rule 1050 and NYSE Rule 344 now require research analysts to pass a qualification examination and be registered under a new "research analyst" registration category within one year after the implementation of a qualification exam, which must be effected by January 26, 2004. Research analysts will be subject to the firm and regulatory element portions of the continuing education requirements in accordance with the schedules applicable to all registered personnel. NYSE 345A(a) and (b)(1); NASD 1120.

### Supervision

The NYSE has amended its Rule 351 to require an annual attestation by April 1 of each year as to the implementation of written procedures reasonably designed to comply with these rules and specifically require certification of the research analyst compensation review process. NYSE 351(f).

### Definition of Research Report

In order to conform to the definition of "research report" in Sarbanes-Oxley, the definition has dropped the requirement that the report "includes a recommendation." A "research report" is now defined to mean "a written or electronic communication that includes an analysis of equity securities or individual companies or industries, and that provides information reasonably sufficient upon which to base an investment decision." NYSE 472.10; NASD 2711(a)(8). Since it is arguable that any material meeting the last portion of this definition contains an implicit recommendation, it does not appear that this change will result in a substantive change in the application of these rules.

### Conclusion

This area is evolving rapidly, and firms should anticipate additional requirements beyond those currently contained in the SRO rules. The SEC has indicated that it intends to adopt industry-wide rules in the near future in furtherance of its obligations under Sarbanes-Oxley. A senior SEC official has stated that the Commission is considering the extent to which the terms of the global settlement involving 10 of the largest investment banking/research firms and the SEC, the New York Attorney General, the NYSE and NASD should be applied across the industry in the development of such rules. The SEC also is actively exam-

ining past practices in the research area, and its actions are likely to impact future rule-making and dictate future modes of behavior, as well as raise issues as to the appropriateness of prior activities that may have been considered acceptable at the time. We will continue to advise you of significant developments as they occur.

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