SHEARMAN & STERLING LLP

Client Publication *August 2003*

SEC Approves Changes to NASD and NYSE Rules Relating to Research Analyst Conflicts of Interest

1. INTRODUCTION

On July 29, 2003, the Securities and Exchange Commission ("SEC") approved amendments to a series of self-regulatory organization rules regarding securities research (the "Amendments"), including the National Association of Securities Dealers, Inc. (the "NASD") Conduct Rule 2711 and the New York Stock Exchange, Inc. (the "NYSE", and, together with the NASD, the "SROs") Rule 472.[1] The Amendments represent the latest chapter in ongoing SEC and SRO rulemaking activity regarding securities research, and in particular regarding conflicts of interest between research analysts and the securities firms with which they work. The NASD and NYSE rules, as amended by the Amendments, are referred to herein as the "Rules."

In addition to the Amendments, the last 18 months has also seen the adoption of SEC Regulation AC[2] and the proposal of a global settlement (the "Global Research Settlement") addressing enforcement actions relating to research analyst conflicts of interests against 10 of the world's largest financial institutions.

As stated in the Release, the principal purpose of the Amendments is to further address research analyst conflicts of interest in a manner that achieves "full compliance" with provisions relating to research analyst conflicts of interest of the Sarbanes-Oxley Act of 2002 (the "SOA").[3]

In general, the Amendments place additional requirements on broker-dealers regarding specific areas of concern, including (a) the review and disclosure of research analyst and member compensation, (b) prohibitions on when research reports may be published, (c) licensure of research analysts, and (d) the activities of research analysts with respect to companies that are the subject of research reports and other clients of the research analyst's financial institution, whether existing or potential.

The Amendments will be implemented over time in order to provide reasonable time periods for members to develop and implement policies, procedures and systems to comply with the new requirements. The SRO's have agreed upon an implementation schedule that appears in SEC Release 34-48252.

2. BROAD DEFINITIONS OF "RESEARCH REPORT" AND "PUBLIC APPEARANCE"

2.1 A Research Report Does Not Require a Recommendation

As adopted, the Amendments contain a definition of the term "research report" that does not contain any requirement that a research report include a recommendation. Instead, a research report is defined to be any written communication (including any electronic

1. The amendments to NASD Rule 2711 and NYSE Rule 472 are published in SEC Release 34-48252, "Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc. Relating to Exchange Rules 344 ('Supervisory Analysts'), 345A ('Continuing Education for Registered Persons'), 351 ('Reporting Requirements') and 472 ('Communications with the Public') and by the National Association of Securities Dealers, Inc. Relating to Research Analyst Conflicts of Interest and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3 to the Proposed Rule Change by the New York Stock Exchange, Inc and Amendment No. 3 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Research Analyst Conflicts of Interest" (Published June 30, 2003) (the "Release"). As of the date of this publication, the Release is available at http://www.sec.gov/rules/sro/34-48252.htm. The SEC Press Release describing the Amendments is available at www.sec.gov/news/press/2003-89.htm.

2. For information regarding Regulation AC, see "Final Rule: Regulation AC" (Shearman & Sterling LLP, March 2003) at http://www.shearman.com/publications/cm_pubs.html.

3. See Pub. L. 107-204, 116 Stat. 745 (2002). The SOA required, among other things, that the SEC, or upon SEC authorization, a registered securities association or national securities exchange, adopt certain rules relating to research analyst conflicts of interest.

communication) that includes an analysis of the equity securities of individual companies or industries, and provides sufficient information on which to base an investment decision. While the adopted definition is substantially similar to the definition of "research report" found in Regulation AC, NASD and NYSE members must now be careful to apply the considerable restrictions found in the Rules to research reports, as more broadly defined.[4]

In addition, the Release specifically discusses the application of this broadened definition to research reports that are based on technical analysis. Specifically, the Release notes that the Rules do not create any blanket exemption for technical research that otherwise meets the definition of research report found in the Rules.[5]

Finally, it is noted in the Release that the SROs intend to review the definition of "research report" in the Global Research Settlement and provide additional guidance as necessary.[6]

2.2 Public Appearances Include Print Media

Under the Rules, the term "public appearance" has been defined to include appearances in print media.[7] Several of the comments received by the SEC with respect to the Rules showed concern that the disclaimer and disclosure requirements of the Rules, combined with the SRO statement in the Joint Memorandum that a research analyst should refuse further interview requests from media outlets that refuse to print disclaimers required by the Rules, would impugn the editorial discretion of the media.[8] The SROs have since modified their guidance in this regard, stating that an analyst would not violate the Rules by continuing to make appearances despite a past failure to print disclaimers and disclosures, so long as such disclosures continue to be made in good faith.[9]

The Rules require records of public appearances to be made in a manner consistent with SEC Rules 17a-3 and 17a-4.[10] Under NYSE Rule 472, such records must be made within 48 hours of the interview or public appearance, while, under NASD Rule 2711, no express time limit is set for the production of such records.

3. Summary of New Rules

3.1 Establishment of a Compensation Committee to Approve Analyst Compensation

The Rules require members to establish a compensation committee reporting either to senior management or to the board of directors, the role of which is to review and approve[11] research analyst compensation.[12] Employees of a member's investment banking department may not sit on the committee. The review and approval of the committee regarding research analyst compensation is only required for research analysts who are primarily responsible for the substance of research reports.

---

4. The SROs have stated that certain securities research activities are partially or wholly exempt from the Rules. In a 2002 joint memorandum (the "Joint Memorandum"), the SROs gave specific examples of communications that would not constitute research reports for purposes of the Rules, including (a) reports discussing broad-based indices, such as the Russell 2000 or S&P 500 index, that do not recommend or rate individual securities, (b) technical analysis concerning the demand and supply for a sector, index or industry based on trading volume and price, (c) reports that recommend increasing or decreasing holdings in particular industries or sectors but that do not contain recommendations or ratings for individual securities, (d) 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 Rules, or (e) an analysis prepared by a registered representative for a specific customer's account. The Joint Memorandum is reproduced in NASD Notice to Members 02-39, which is available as of the date of this publication at http://www.nasdr.com/pdf-text/0239ntm.pdf.

5. The NASD does, however, acknowledge the possibility that certain quantitative models may operate so as to eliminate research analyst subjectivity from the report in such a way as to render reports generated by such a model outside of the definition of "research report." The NASD suggests that situations will have to be evaluated on a case-by-case basis. See the Release at III.C.

6. See the Release at III.C.

7. See NYSE Rule 472.50, NASD Rule 2711(a).

8. See the Release at III.D; see also the Joint Memorandum, reproduced at NASD Notice to Members 02-39 at page 379.

9. See the Release at III.D.

10. Rule 17a-4 requires that such records be kept for three years; such records must be kept in an easily accessible place during the first two years after their production. For more on the record-keeping requirements of broker-dealers, including recent amendments thereto, see "SEC Amendments to Books and Records Requirements for Brokers and Dealers Under the Securities Exchange Act of 1934 Take Effect", available at http://www.shearman.com/documents/CM_04_05_03.pdf.

11. Under the Rules, the role of the committee is to "review and approve" compensation; other than the general prohibition under the Rules that research analyst compensation may not be determined by investment banking personnel, the Rules are silent as to who within a member may set compensation. See the Release at III.B.

12. See the Release at III.B.

The Rules prescribe certain factors that must be considered[13] by the committee in its review and approval of research analyst compensation, and specifically prohibit any consideration by the committee of contributions by the research analyst to investment banking revenues or business. In reviewing and approving compensation, however, the committee may consider the revenues or performance of the firm as a whole.[14] Further, research analysts may be evaluated with respect to permitted contacts that they have had with investment banking departments, such as advising their firm's investment banking department regarding whether a potential issuer is prepared for an offering.[15] The committee may not, however, give undue weight to such considerations. To record the committee's activities, the committee must certify, on an annual basis, that it has fulfilled the required functions under the Rules.[16]

3.2 Prohibition on "Booster Shot" Reports

In addition to the quiet periods provided for prior to the effectiveness of the Amendments (discussed below), the Rules now place a prohibition on so-called "booster shot" research reports that are published within 15 days before or after the expiration or waiver of any lock-up agreement.[17] While the Release recognizes that the broker-dealers serving as underwriters in an offering may not be aware of any waiver granted by the lead underwriter, the Release suggests that such issues may be dealt with by inserting appropriate notification provisions in underwriting agreements.

Further, the Rules provide an exception to the imposition of a quiet period within 15 days of the expiration or waiver of any lock-up agreement for issuers whose securities are actively traded securities, (as that term is defined in Regulation M) or to public appearances by research analysts regarding such issuers.[18]

3.3 Extension of Quiet Periods

Prior to the adoption of the Amendments, there was imposed 40- and 10-day quiet periods following an initial public offering and a secondary offering, respectively, during which no research may be published by any member firm acting in that offering as manager or co-manager. In order to comply with SOA requirements that require the establishment of "quiet periods" applying to broker-dealers participating in public offerings, the Rules now impose a 25-day quiet period after the date of any initial public offering[19] during which no research may be published and no public appearances may be made by any member participating in that initial public offering.[20]

The Rules also extend the previously existing 40- and 10-day quiet periods to public appearances by research analysts in respect of securities that are subject to such quiet periods.

3.4 Prohibition on Analyst Participation in Solicitation

The amendments to the Rules, as originally proposed, prohibited the distribution of any research report or making any public appearance concerning a subject company in an attempt to obtain investment banking business. As adopted, the Amendments now also prohibit any research analyst from participating in efforts to solicit investment-banking business generally.[21] Accordingly, no research analyst may, among other things, participate in any pitch for investment banking business to prospective investment banking clients, or have other communications with companies for the purpose of soliciting investment-banking business.[22] In this regard, the Rules continue to state that no research analyst may directly or indirectly offer favorable research as an inducement for or as compensation for the receipt of business or compensation from any client.[23]

---

13. Under the Rules, the compensation committee must take into account (a) the individual performance of the research analyst under review, (e.g., productivity, and quality of research product), (b) the correlation between the associated person's recommendations and stock price performance, and (c) the overall ratings received from clients, sales force, and peers independent of the investment banking department, and other independent rating services. See NYSE Rule 472(h), NASD Rule 2711(d).

14. Note, however, that if the committee's considerations encompass the performance of the firm as a whole, the firm must disclose in research reports that research analyst compensation is based in part on the firm's investment banking revenues. The committee may not, however consider any specific investment banking transaction in its deliberations: See the Release at III.B.

15. See the Release at III.B.

16. See the Release at III.B; see also NYSE Rule 472(h), NASD Rule 2711(d).

17. See NYSE Rule 472(f), NASD Rule 2711(f).

18. For a description, see the Release at III.H.

19. The SRO Rules define the "date of the offering" to mean the later of (a) the effective date of the issuer's registration statement and (b) the first date on which the security was bona fide offered to the public. See NYSE Rule 472.120, NASD Rule 2711(f)(3).

20. See NYSE Rule 472(f), NASD Rule 2711(f).

21. See NYSE Rule 472(b)(5), NASD Rule 2711(c)(4).

22. Note that the Global Research Settlement also prohibits research analyst participation in solicitation of investment banking business.

23. See NYSE Rule 472(g), NASD Rule 2711(e).

3.5 Notice to Customers Regarding Termination of Research Coverage

The Rules require that a firm must notify its customers when it terminates research coverage of an issuer. In response to various comments received by the SEC, the NASD has stated that it intends to provide guidance regarding what constitutes termination of coverage, and to consider whether notification is required by firms on a case-by-case basis.[24]

Under the Rules, a member must distribute the final research report regarding an issuer using means of dissemination equivalent to its customary means of distribution with respect to research regarding that issuer.[25] Similarly, the final research report must be in substance comparable to prior research reports regarding that issuer. While the Rules contain a requirement that the final research report regarding an issuer must contain a recommendation or rating, the Rules now specify that a final recommendation or rating is not required where it would be impractical for the member firm to provide that rating (for example, if coverage is being terminated because the particular research analyst responsible for covering that issuer is no longer employed by the member firm, or because the member firm has terminated coverage on an industry-wide basis).

3.6 Restrictions on Prepublication Review of Research by Firm Personnel

Prior to the approval of the Amendments, the Rules prohibited investment banking department review and approval of research reports prior to distribution.[26] In order to comply with the SOA, the Amendments now prohibit any other employee of a member firm who is not directly responsible for research from review of research in advance of publication, other than legal or compliance department personnel. Such personnel, including investment-banking personnel, may still verify the factual accuracy of information in the research report. This "fact checking," however, is subject to two limitations. First, fact checking must be made either with legal or compliance personnel acting as "gate-keepers."[27] Second, oral communication in the nature of such fact checking or verification must be documented, and must be made either with legal or compliance personnel acting as intermediary, or in a conversation conducted in the presence of legal or compliance personnel.

The Rules continue to maintain restrictions on prepublication review of research by subject companies.[28]

3.7 Prohibition on Retaliation Against Research Analysts

In addition to the limitations established regarding contact between research and investment banking divisions at member firms, the Amendments seek to establish protections for research analysts. Specifically, the Rules now provide that no member firm, or employee of a member firm involved with the firm's investment banking activities, may directly or indirectly retaliate against, or threaten to retaliate against, any research analyst employed by the firm (or its affiliates) as a result of an adverse, negative, or otherwise unfavorable research report, or public appearance made by that person.[29]

3.8 Disclosure of Compensation from Issuers

Prior to the adoption Amendments, member firms were required to disclose whether they had received investment banking compensation from a company that was the subject of a research report in the 12 months prior to the publication of the report.

The Amendments expand the compensation disclosure requirements by requiring disclosure by a member in research reports, to the extent the member knows or has reason to know, and by a research analyst in public appearances, to the extent the analyst knows or has reason to know, of whether the member, or any affiliate thereof (including the research analyst), received compensation during the past 12 months from the issuer that is the subject of the report or public appearance.

The Rules provide two safe harbors for disclosures under this provision. First, this disclosure requirement is deemed satisfied if the compensation is disclosed in research reports within 30 days after completion of the last calendar quarter, provided that the member has taken steps "reasonably designed to identify any such compensation during that calendar quarter." This permits member firms to design compliance procedures for identifying that compensation that must be disclosed specifically for this purpose. Second, the research analyst and the member are pre-

24. See the Release at III.G.

25. See NYSE Rule 472(f)(5), NASD Rule 2711(f)(6).

26. See NYSE Rule 472(b), NASD Rule 2711(b).

27. For these purposes, the "gate-keeping" requirement may be satisfied by copying legal or compliance on any communication seeking to verify factual accuracy.

28. See NYSE Rule 472(c), NASD Rule 2711(c).

29. See NYSE Rule 472(g), NASD Rule 2711(j).

sumed[30] not to "have reason to know" whether an affiliate received non-investment banking compensation if the member "maintains and enforces policies and procedures reasonably designed to prevent the research analysts (and other employees of the member with the ability to influence the substance of research reports) from, directly or indirectly, receiving information from the affiliate concerning whether the affiliate received such compensation.

In addition, the disclosure requirements regarding affiliate compensation do not apply to any subject company as to which the member initiated coverage since the beginning of the calendar quarter in which the report is published.

The Amendments further require disclosure of whether the subject company is, or has been during the previous year, a client of the member, and if so, the types of services provided to the issuer. The types of services provided to the company must be described as investment banking services, non-investment banking securities-related services, or non-securities services.

Both the compensation disclosure and client services disclosure provisions provide for an exception in order to prevent the disclosure of material non-public information regarding specific future investment banking transactions of the issuer.

3.9 Exceptions from "Gate-keeping" Requirement

Under the Rules, research analysts may not be supervised or controlled by personnel from a firm's investment banking department. The Rules also require that legal or compliance personnel intermediate or be present for certain discussions between research and investment banking personnel.[31] As adopted in the Amendments, these requirements do not apply to members that, over the prior three years, have participated in an annual average of 10 or fewer investment banking services transactions as manager or co-manager and generated an annual average of $5 million or less in gross investment banking revenues from those transactions. It is important to note, however, that firms that qualify for this exemption must make and, for three years, keep records of any communication that otherwise would be subject to the review and monitoring provisions of NYSE Rule 472(b)(1) through (3) and of NASD Rule 2711(b)(3).

It should also be noted that the exemption for small firms does not apply to NASD Rule 2711(c) and NYSE Rule 472(b)(4), which restrict communications between the research department and a subject issuer. This is because the SROs take the view that it would be inappropriate to provide for a permanent exception from the gatekeeper provisions for the voluntary submission of sections of a draft research report to a subject issuer. In addition, for the purposes computing the exemption from the "gate-keeping requirement" for small firms, the SROs have determined that "investment banking services" do not include municipal securities transactions.[32]

3.10 Personal Trading Restrictions and Disclosure for Certain Personnel

The Rules currently contain personal trading restrictions for research analysts, notably restrictions on trading securities of companies close in time to the publication of research reports regarding an issuer, as well as trading contrary to the recommendations of the firm.[33] These restrictions are subject to several exclusions, including transactions pre-approved by legal and compliance, sales of securities purchased prior to the initiation of coverage, and certain transactions in accounts not controlled by the restricted person.

As adopted, the Amendments require that legal or compliance personnel approve all securities transactions of persons who supervise research analysts to the extent such transactions involve equity securities of subject companies covered by the research analysts that they oversee. Further, supervisors, persons who have direct influence and control with respect to the preparation of research reports or establishing ratings or recommendations regarding subject companies must also receive approval with respect to all personal securities transactions to the extent such transactions involve equity securities of subject companies covered by the research analysts that they oversee.[34]

3.11 New Licensing and Examination Requirements

The Rules establish a new licensing requirement for research analysts who are primarily responsible for the substance of research reports. Junior analysts and others who are not principally responsible for the substance of any research report will not be required

30. It should be noted that this safe harbor is phrased in terms of a presumption; if a research analyst or employee of the member firm with an ability to influence the content of the research report actually knows of such compensation, the disclosures must be made. See the Release at III.I.

31. See NYSE Rule 472(b), NASD Rule 2711(b).

32. See the Release at III.L.

33. See NYSE Rule 472(e), NASD Rule 2711(g).

34. See the Release at III.E.

to register and be licensed in this manner.[35] While the SROs have indicated that they may create certain classes of research analysts that are exempt from the examination requirements, it is unlikely that any research analyst, including persons currently employed as research analysts, will be wholly exempt from this licensing requirement.

4. CONCLUSION

The adoption of the Amendments represents the latest chapter in a remarkable period of rulemaking by the SROs. In addition to the unusual circumstance of concurrent and cooperative rulemaking by the SROs, the Rules are remarkable in that they create a thorough set of rules regarding research to which NASD and NYSE members must adhere. When viewed in connection with Regulation AC and the Global Research Settlement, it becomes apparent that the SROs, the SEC and other securities regulators have in the past 18 months created a comprehensive, layered behavioral code to which all broker-dealers must adhere.

35. See NYSE Rules 344 and 345A, NASD Rules 1050 and 1120.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired. For more information regarding the Amendments, the Rules, or the law and regulation governing securities research, please contact:

Charles S. Gittleman	Russell D. Sacks	Heather M. Susac
New York	New York	New York
(+1 212) 848 7317	(+1 212) 848 7317	(+1 212) 848 5105
cgittleman@shearman.com	rsacks@shearman.com	hsusac@Shearman.com