SHEARMAN & STERLING LLP

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Amendments to NASD and NYSE Research Rules Prohibiting Research Analyst Participation in Road Shows Take Effect

I. INTRODUCTION

On April 21, 2005, the Securities and Exchange Commission approved rule filing proposals (the "Amended Rules") made by the National Association of Securities Dealers, Inc. ("NASD") and the New York Stock Exchange ("NYSE") in respect of the conduct of research analysts. The adoption of the Amended Rules follows the 2003 adoption and subsequent effectiveness of substantial amendments to NASD Rule 2711 and NYSE Rule 472 (collectively, the "Research Rules"),[1] and the court approval of the "Global Research Settlement" among ten of the largest U.S. broker-dealers, the SEC, the NASD and the NYSE, and state regulators consenting to, among other things, near complete separation of investment banking and research departments within these financial institutions. The Amended Rules became effective June 6, 2005.

The Research Rules create a number of prohibited categories of communication in respect of the activities of research analysts that are associated persons of NASD and NYSE member firms.[2] The Amended Rules define certain additional communications that NASD and the NYSE feel are impermissible, specifically in the context of the investment banking transaction marketing activities of NASD and NYSE members. In its Notice to Members discussing the Amended Rules, NASD states that the purpose of the Amended Rules is to "fortify the wall" between research and investment banking activities within member firms.[3] In this regard, NTM 05-34 states, "[w]hile the rules generally foster objectivity through extensive conflict of interest disclosure requirements, they also prohibit certain conduct to minimize the primary source of biased research: the influences of investment banking."

II. DESCRIPTION OF THE AMENDED RULE

2.1 *Prohibitions on Research Analysts*

The Amended Rules impose two basic restrictions on research analysts. Research analysts are prohibited from (directly or indirectly):

- participating in a road show related to an investment banking transaction; and
- engaging in any communication with a current or prospective customer in the presence of investment banking department personnel or company management about an investment banking services transaction.[4]

The SEC notes in its adopting release[5] that this prohibition eliminates the opportunity for "three-way"

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[1] For more information regarding the Research Rules, please *see* "SEC Approves Changes to NASD and NYSE Rules Relating to Research Analyst Conflicts of Interest" (August 2003), currently available at http://www.shearman.com/documents/SD_08_03.pdf, and *see also* "NASD and NYSE Issue Second 'Joint Memorandum' Regarding Research Rules" (June 2004), currently available at http://www.shearman.com/documents/CM_0604.pdf.

[2] NASD Rule 2711 defines the term "research analyst" as follows: "the associated person who is primarily responsible for, and any associated person who reports directly or indirectly to such a research analyst in connection with, preparation of the substance of a research report, whether or not any such person has the job title of "research analyst." NASD Rule 472 has a substantially identical definition.

[3] *See* NASD Notice to Members 05-34, "SEC Approves Amendments to Rule 2711 to Prohibit Research Analysts from Participating in a Road Show and from Communicating with Customers in the Presence of Investment Banking Personnel or Company Management about an Investment Banking Services Transaction" (May 2005) ("NTM 05-34") at page 2. NASD Notices to Members are available at NASD's Internet Website, www.nasd.com. Though this client publication principally describes the changes to NASD Rule 2711, substantially similar amendments have been adopted to both Research Rules: *see* NYSE Information Memo 05-34, "Prohibition On Research Analyst Participation In Road Shows" (May 2005). NYSE Information Memos are available at the NYSE's Internet Website, www.nyse.com.

[4] *See* NASD Rule 2711(c)(5), NYSE Rule 472(b)(6)(i).

[5] *See* SEC Release No. 34-51593, "Order Approving Proposed Rule Changes to Prohibit Participation by a Research Analyst in a Road Show Related to an Investment Banking Services Transaction and to Require Certain Communications about an Investment Banking Services Transaction to Be Fair, Balanced and Not Misleading" (April 21, 2005), currently available at: http://www.sec.gov/rules/sro/nyse/34-51593.pdf (the "Adopting Release").

communications between research, customers and banking, as well as communications involving research, customers and issuers. Both the SEC and the NASD imply in their adopting materials that situations in which research analysts participate in "road show" or other meetings involving investors and company personnel may serve to pressure such research analysts to give excessively optimistic views regarding the company in question and its prospects.

2.2 *Prohibitions on investment banking personnel of member firms*

Similarly, the Amended Rules create two basic prohibitions on investment banking personnel. Under the Amended Rules, investment banking personnel of NASD and NYSE member firms are prohibited from (directly or indirectly):

- directing a research analyst to engage in sales or marketing efforts related to an investment banking transaction; and from
- directing a research analyst to engage in any communication with a current or prospective customer about an investment banking transaction.[6]

The SEC notes in the Adopting Release that prohibitions on directed communications protect research departments from pressure that may be exerted by investment banking personnel. The Adopting Release states that:

> "We believe that these provisions will further insulate research analysts from investment baking pressure by cutting off the ability of investment banking personnel to directly, or indirectly (e.g. through other parties), direct research analysts to engage in sales or marketing efforts, or otherwise communicate with customers about a transaction. Thus, we believe the proposals would promote analyst objectivity and independence…"[7]

2.3 *General restriction on communication by Research Analysts in respect of investment banking transactions*

In addition, the Amended Rules create a requirement that communications by research analysts related to investment banking transactions must be fair and balanced. The Amended Rule reads, in whole, that:

> "Any written or oral communication by a research analyst with a current or prospective customer or internal personnel related to an investment banking services transaction must be fair, balanced and not misleading, taking into consideration the overall context in which the communication is made."[8]

The SEC notes in the Adopting Release that this aspect Amended Rules "preserve the ability of research analysts to educate investors and internal personnel about investment banking services transactions, provided such communications are fair, balanced and not misleading, considering the overall context in which the communication is made."[9] It is noted in the Adopting Release that the Amended Rules are therefore not intended to interfere with legitimate activities of research analysts.

III. CONCLUSION

Though certain aspects of the Amended Rules are open to interpretation,[10] and may therefore be the subject of future regulatory activity, the Amended Rules are, by and large, an uncontroversial amendment to the Research Rules. However, seen as an incremental step that follows in the wake of substantial investigation, enforcement, and rulemaking activities by U.S. securities regulators, the Amended Rules have the effect of adding additional detail and complexity to an already complex web of regulations. U.S. regulation of securities research now includes the global research settlement, SEC Regulation AC, NASD Rule 2711, NYSE Rule 472. In addition to governmental and regulatory actions, many of the largest investor groups, such as CalPERS, the California pension fund system, have adopted investment guidelines to which any broker-dealer conducting business (or wishing to conduct business) with them must adhere. When viewed as a whole, the formal and informal regulation of broker-dealer research constitutes a difficult set of interconnected requirements for any institution.

For more information regarding the issues described in this client publication, please contact any of the Shearman & Sterling LLP personnel listed below.

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6 *See* NASD Rule 2711(c)(6), NYSE Rule 472(b)(6)(ii).

7 *See* the Adopting Release at pages 9-10.

8 *See* NASD Rule 2711(c)(7), NYSE Rule 472(b)(6)(iii).

9 *See* the Adopting Release at pages 5-6.

10 Some examples of possible future interpretive issues include (i) the definition of "investment banking services transactions" for purposes of the Amended Rules, (ii) whether certain meetings, including meetings attended by a wider audience than that enumerated in the Amended Rules, constitute the kinds of communications that the Amended Rules prohibit, and (iii) what kinds of communications will cause the NASD and NYSE to allege a violation of the "fair and balanced" requirement in respect of evaluations of investment banking transactions.

For more information regarding any of the issues described in this client publication, please contact any of the Shearman & Sterling LLP personnel listed below. 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 on the topics covered in this issue, please contact:

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