

**Joint Report by NASD and the NYSE  
On the Operation and Effectiveness of the  
Research Analyst Conflict of Interest Rules**

**December 2005**

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## **EXHIBITS**

### Exhibit A – SRO Rules

NYSE Rules 472 and 472(k) Interpretation, 351, 344 and 344 Interpretation, and 345A

NASD Rules 2711, 1050 and 1120

### Exhibit B – July 2002 Joint Memorandum

NYSE Information Memo No. 02-26 (June 26, 2002) and NASD *Notice to Members* 02-39 (July 2002)

### Exhibit C – March 2004 Joint Memorandum

NYSE Information Memo No. 04-10 (Mar. 9, 2004) and NASD *Notice to Members* 04-18 (Mar. 2004)

### Exhibit D – Chart Comparing SRO Rules and Global Settlement

## INTRODUCTION

Beginning in 2002, the New York Stock Exchange (“NYSE”) and NASD (together, “the SROs”) implemented a series of rule changes (“SRO Rules”) to improve objectivity and transparency in equity research and provide investors with more reliable and useful information to make investment decisions. The rules were intended to restore public confidence in the validity of research and the veracity of research analysts, who are expected to function as unbiased intermediaries between issuers and the investors who buy and sell their securities. The trustworthiness of research had eroded due to the pervasive influences of investment banking and other conflicts that had manifest themselves during the market boom of the late 1990s.

Generally, the SRO Rules require clear, comprehensive and prominent disclosure of conflicts of interest in research reports and public appearances by research analysts. The rules further prohibit certain conduct – investment banking personnel involvement in the content of research and determination of analyst compensation, for example – where the conflicts are considered too pronounced to be cured by mere disclosure. Together with the Securities and Exchange Commission’s (“SEC” or the “Commission”) Regulation Analyst Certification and the settlement terms of certain enforcement proceedings, including the “Global Settlement” among the SROs, the Commission, the North American Securities Administrators Association (“NASAA”) and ten<sup>1</sup> of the largest investment banks, the SRO Rules have resulted in sweeping changes to the way firms produce research, utilize and compensate research analysts, and structure the operations of their research and investment banking departments. Evidence suggests that these reforms have resulted in more objective, reliable and valuable research for investors. However, the new rules also have added costs and administrative burdens to firms and contributed to a reduction in research coverage and analyst compensation.

The SEC has requested that the SROs submit this joint report on the operation and effectiveness of the SRO Rules, including any staff recommended changes to the current rule provisions.<sup>2</sup> The report contains six sections. Section I provides background on the conflicts that gave rise to the SRO Rules and sets forth the history of the SRO rulemaking and other regulatory initiatives with respect to research-related activity. Section II discusses the registration and qualification requirements for research analysts and their supervisors, including statistics concerning the levels of registration and qualification. Section III contains a review of SRO examinations, sweeps and enforcement activity since the SRO Rules became effective. Section IV discusses the impact of the SRO Rules as reported in academic studies and media reports and commentary. Section V contains a detailed review of the SRO Rule provisions, including member feedback and recommended changes. Finally, Section VI is the Conclusion.

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<sup>1</sup> In August 2004, two additional firms settled with regulators under the same terms as the April 2003 Global Settlement.

<sup>2</sup> The views provided in this report are solely those of the NASD and NYSE staffs and have not been endorsed by the Board of Governors of NASD or the Board of Directors of the NYSE.

## I. BACKGROUND

### A. Conflicts that Led to Regulation

Prior to implementation of the SRO Rules, research analysts were subject to a host of pressures and influences that could – and in many instances, did – compromise the objectivity of their research. The primary biasing forces came from investment bankers who pressured research analysts to speak favorably of current and prospective clients and, with management acquiescence, linked analysts’ compensation directly to their role in landing lucrative investment banking deals. In the succinct words of a retired Wall Street research analyst who testified before Congress in the summer of 2001: “Investment banking now dominates equity research.”<sup>3</sup> Other conflicts also existed, most notably analysts’ personal financial interest in the securities they covered and their firms’ ownership positions in covered securities. In addition, research analysts were subject to pressure from subject companies and their major shareholders to maintain favorable ratings.<sup>4</sup>

In testimony before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises (the “Subcommittee”), SEC Acting Chair Laura Unger identified a number of then commonplace practices that illustrated the conflicts of interest faced by research analysts.<sup>5</sup> First, research analysts were compensated based on their contributions in support of investment banking transactions and the profitability of that unit. To that end, research analysts typically consulted on possible transactions, participated in road shows and initiated favorable coverage on current and prospective investment banking clients. Moreover, investment bankers at some firms evaluated research analysts for compensation purposes, particularly bonuses.

Second, research analysts provided research reports on companies underwritten by the analysts’ firms. Third, research analysts invested in pre-initial public offering (“IPO”) private placements of companies they subsequently covered and for which their firms had acted as underwriters. Fourth, research analysts provided investment bankers with prior notice of changes in recommendations. Fifth, research analysts issued “booster-shot” research reports or “buy” recommendations close to expiration of the lock-up period. Such reports served to generate buying interest in the stock and help increase the price while the firm, its clients, or the analysts sold their shares. Sixth, research analysts owned securities in the companies they covered and either failed to disclose those interests or did so in an opaque manner. In some cases, analysts executed trades for their personal accounts that were contrary to the recommendations in their research reports.<sup>6</sup> Finally, analysts rarely revealed any conflicts of interest to investors during

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<sup>3</sup> *Analyzing the Analysts: Hearings Before the H. Comm. On Capital Markets, Insurance, and Government Sponsored Enterprises of the Comm. On Financial Services*, 107<sup>th</sup> Cong., at 243 (2001) (prepared testimony of Ronald Glantz, retired) (“Glantz Testimony”).

<sup>4</sup> *See, e.g., Analyzing the Analysts* at 251 (prepared testimony of Charles L. Hill, Director of Financial Research, Thomson Financial/First Call) (“analyst objectivity is subject to pressure from four different places”: (1) analysts themselves; (2) investment banking; (3) public companies; and (4) institutional shareholders).

<sup>5</sup> *Analyzing the Analysts* at 227-240 (written testimony of Laura S. Unger, Acting Chair of the Securities and Exchange Commission) (“Unger Testimony”).

<sup>6</sup> *Id.* at 233. *See also, e.g., Analyzing the Analysts* at 160 (prepared testimony of Gregg Hymowitz, Founder and Principal of EnTrust Capital Inc.); Glantz Testimony, *supra* note 3; *Analyzing the Analysts* at 266

media appearances in which they routinely recommended securities, and while most firms affirmatively stated that they acted as an underwriter or market maker, others merely stated that they “may” have acted in that capacity.<sup>7</sup>

While these conflicts were not new, they had deepened in the existing market environment. As another witness who testified before the Subcommittee observed:

[T]he pressures on the analyst have escalated in an environment where penny changes in earnings-per-share forecasts make dramatic differences in share price, where profits from investment-banking activities outpace profits from brokerage and research, where the demographics of the investors who use and rely on sell-side research have shifted, and where investment research and recommendations are now prime-time news.<sup>8</sup>

The industry itself seemed to recognize that the conflicts in research had intensified. As the SROs began rulemaking, discussed in Section I.B below, the industry took steps on its own to address these conflicts. Several firms amended or adopted policies regarding research analysts’ ownership of securities of covered companies.<sup>9</sup>

In addition, in June 2001, the Securities Industry Association (“SIA”) endorsed a compilation of “best practices”<sup>10</sup> designed to restore the integrity of research and “reaffirm that the securities analyst serves only one master: The investor.”<sup>11</sup> The practices were compiled by an ad hoc committee of senior research professionals from the SIA’s largest member firms, and included several key recommendations focused on analyst compensation and stock ownership, relations

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(prepared testimony of Adam Lashinsky, Silicon Valley Columnist, The Street.com); *Id.* at 253 (prepared testimony of Matt Winkler, Editor-in-Chief, Bloomberg News).

<sup>7</sup> Unger Testimony, *supra* note 5, at 234.

<sup>8</sup> *Analyzing the Analysts* at 196 (statement of Thomas A. Bowman, CFA, President and Chief Executive Officer, The Association for Investment Management and Research).

<sup>9</sup> For example, Merrill Lynch, Edward Jones and Credit Suisse First Boston announced new policies prohibiting analysts from owning shares in companies they follow. *See id.* at 120 (opening statement of Honorable Paul Kanjorski). Goldman Sachs initiated a policy that would permit analysts to own shares in companies they cover under the following conditions: (1) approval of management and the firm’s compliance committee would be required for purchases; (2) purchases would be subject to a minimum 30-day holding period; (3) analysts would be permitted to purchase only stocks that were rated a “trading buy” or already on the firm’s recommended list; (4) analysts would be prohibited from selling securities unless they were rated below a “trading buy”; and (5) there would be a twenty-four hour restriction imposed after a change in the rating of a company. *See* Adam Lashinsky, *Wall Street’s Discovery of Ethics Is Too Little, Too Late*, TheStreet.com, July 10, 2001, <http://www.thestreet.com/markets/adamlashinsky/1486552.html>.

Prior to this time, Robertson Stephens had implemented a policy in September 2000 pursuant to which: (1) analysts cannot own stock in companies they cover, and (2) if they already own shares in a company they want to cover, they are required to sell their shares or place them in a blind trust. *Id.*

<sup>10</sup> *See Best Practices for Research*, June 2001, and Press Release, *SIA Endorses “Best Practices” To Ensure Ongoing Integrity of Research* (June 21, 2001); *Analyzing the Analysts* at 172 (statement of Marc E. Lackritz, President, SIA).

<sup>11</sup> *See Best Practices for Research*, June 2001, and Press Release, *supra* note 10.

with investment banking units and disclosures: (1) research departments should not report to investment banking or any other business units that might compromise their independence, and there should be no outside or investment banking approval of the analyst's opinions or recommendations; (2) analysts' compensation should not be directly linked to specific investment banking transactions, sales and trading revenues or asset management fees; (3) personal financial interests in covered securities should be disclosed; and (4) analysts should not trade contrary to their recommendations, except after consultation with research department, legal and/or compliance personnel.<sup>12</sup>

Similarly, in July 2001, the Association for Investment Management and Research ("AIMR"), which is now named the CFA Institute, released a white paper discussing a wide range of potential influences on the objectivity of brokerage-firm research.<sup>13</sup> The white paper also set forth recommendations for a more objective research environment, including: (1) brokerage firm management must foster a corporate culture that fully supports independence and objectivity; (2) firms must establish or reinforce separate reporting structures so that investment banking can never influence a research report or investment recommendation; (3) firms should implement compensation arrangements that do not link analysts' compensation to investment banking work; and (4) firms should require public disclosure of actual conflicts of interest to investors.<sup>14</sup>

However, the guidelines set forth by the industry associations lacked the force and effect of law. Moreover, some lawmakers felt the voluntary industry efforts were inadequate in scope. As Congressman Richard Baker remarked on the second day of hearings before the Subcommittee, "[T]he existing industry association best-practices proposal doesn't go far enough to address the problems, nor, I might add, do subsequent actions taken by individual firms . . . ."<sup>15</sup> Congressman John LaFalce expressed that "more disclosure of these conflicts, in itself will not suffice to protect the individual investor."<sup>16</sup>

## **B. Summary of Rule Filings and Other Regulatory Actions**

### **1. NASD/NYSE Rule Filings**

The SROs enacted the research analyst conflict rules in two primary tranches and, more recently, adopted additional amendments prohibiting analysts from participating in road shows. *See* Exhibit A for the complete text of the SRO Rules. In addition, the SROs supplemented their rulemaking with two joint memoranda that provided interpretive guidance to their members on a number of issues. *See* Exhibits B and C for the joint interpretive memoranda. The NASD and NYSE rules and interpretations are virtually identical and are intended to operate uniformly.

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<sup>12</sup> *Id.*

<sup>13</sup> *See Preserving The Integrity of Research*, Association for Investment Management and Research (July 2001), and CFA Institute Press Release, *Global Investment Association AIMR Issues Report On Analyst Objectivity* (July 11, 2001).

<sup>14</sup> *Id.*

<sup>15</sup> *Analyzing the Analysts* at 210 (opening statement of Honorable Richard H. Baker, Chairman).

<sup>16</sup> *Id.* at 219 (statement of Honorable John J. LaFalce, Ranking Committee Member).

## ***Round 1 Amendments***

In February 2002, the SROs filed the first round of proposed SRO Rules (“Round 1 Amendments”) – amendments to NYSE Rules 351 (“Reporting Requirements”) and 472 (“Communications with the Public”) and new NASD Rule 2711 (“Research Analysts and Research Reports”)<sup>17</sup> – which implemented basic reforms to separate research from investment banking and to provide more extensive disclosure of conflicts of interest in research reports and public appearances.

Generally, the Round 1 Amendments, approved by the SEC on May 10, 2002,<sup>18</sup> achieved the following:

- imposed structural reforms to increase analyst independence, including prohibiting investment banking personnel from supervising analysts or approving research reports;
- prohibited offering favorable research to induce investment banking business;
- prohibited research analysts from receiving compensation based on a specific investment banking transaction;
- required disclosure of financial interests in covered companies by the analyst and the firm;
- required disclosure of existing and potential investment banking relationships with subject companies;
- imposed quiet periods for the issuance of research reports after securities offerings managed or co-managed by a member;
- restricted personal trading by analysts;
- required disclosure in research reports of data and price charts that help investors track the correlation between an analyst’s rating and the stock’s price movements; and
- required disclosure in research reports of the distribution of buy/hold/sell ratings and the percentage of investment banking clients in each category.

The Round 1 Amendments were phased-in incrementally to provide members time to implement necessary policies, procedures, systems and other measures to comply with the new

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<sup>17</sup> On February 8, 2002, NASD filed SR-NASD-2002-021. The NYSE filed SR-NYSE-2002-09 on February 27, 2002. On March 7, 2002, NASD filed Amendment No. 1 to SR-NASD-2002-021. The proposals were published for comment in the Federal Register on March 14, 2002. *See* Securities Exchange Act Release No. 45526 (Mar. 8, 2002), 67 FR 11526 (Mar. 14, 2002). On May 1, 2002, NASD filed Amendment No. 2 to SR-NASD-2002-021, and the NYSE filed Amendment No. 1 to SR-NYSE-2002-09.

<sup>18</sup> *See* Securities Exchange Act Release No. 45908 (May 10, 2002), 67 FR 34968 (May 16, 2002) (order approving SR-NYSE-2002-09 and SR-NASD-2002-021).

requirements. Most provisions of the SRO Rules went into effect on July 9, 2002; others became effective on September 9, 2002 or November 6, 2002.<sup>19</sup>

### ***Round 2 Amendments and Sarbanes-Oxley***

On July 29, 2003, the SEC approved a second set of amendments to the SRO Rules (“Round 2 Amendments”)<sup>20</sup> that achieved two purposes. First, the Round 2 Amendments implemented SRO initiatives to further promote analyst objectivity and transparency of conflicts in research reports. The need for some of these additional measures had come to light in the course of joint sweeps undertaken by the SROs and SEC to examine members’ research practices for compliance with industry regulations.<sup>21</sup> Among the most significant SRO initiatives included in the Round 2 Amendments were provisions that:

- further insulated analyst compensation from investment banking influence by requiring that a compensation committee, without investment banking representation, review and approve compensation of research analysts and that such compensation be based on the quality of research produced;
- prohibited analysts from participating in the solicitation of investment banking business;
- prohibited analysts from issuing a research report or making a public appearance concerning a subject company around the time of a lock-up expiration, termination or waiver;
- required members to publish a final research report when they terminate coverage of a subject company and provide notice of such termination;
- imposed registration, qualification and continuing education requirements on research analysts (detailed in Section II below); and
- created an exemption from certain rule provisions for firms that engage in limited underwriting activity.

Second, the Round 2 Amendments implemented changes mandated by the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”).<sup>22</sup> Sarbanes-Oxley required adoption by July 30, 2003 of rules “reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances,” and set forth certain specific rules to be promulgated. Many of those rules had already been adopted in the first round

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<sup>19</sup> Certain small firms with limited underwriting activity were granted delayed effectiveness from certain provisions of the SRO Rules until July 2003, at which time a limited exemption was adopted and codified.

<sup>20</sup> Securities Exchange Act Release No. 48252 (July 29, 2003), 68 FR 45875 (Aug. 4, 2003) (order approving SR-NYSE-2002-49 and SR-NASD-2002-154).

<sup>21</sup> In April 2002, the SROs and the SEC established a Joint Task Force to review practices of designated firms with regard to research reports and recommendations on issuers for which firms had provided or sought investment banking services from January 1999 through April 2002.

<sup>22</sup> See Section 15D(a) of the Exchange Act, 15 U.S.C. 78o-6.

of SRO rulemaking. The Round 2 Amendments therefore implemented those specific Sarbanes-Oxley rules that did not already exist and conformed the language of the SRO Rules as necessary. Most notably, the Round 2 Amendments satisfied the following Sarbanes-Oxley requirements:

- modified the definition of “research report” to delete the requirement that the communication contain a recommendation;
- extended quiet periods after securities offerings to all firms that participated in the offering as an underwriter or dealer;
- required disclosure of a client relationship and non-investment banking compensation received by a firm from a covered company; and
- prohibited retaliation against research analysts for publishing unfavorable research on an investment banking client.

As with the Round 1 Amendments, the Round 2 Amendments were phased-in incrementally. Most provisions went into effect on September 29, 2003, while certain other provisions did not become effective until October 27, 2003 or January 26, 2004.<sup>23</sup>

### ***Recent Amendment Prohibiting Analyst Participation in Road Shows***

On April 21, 2005, the Commission approved an amendment to the SRO Rules that prohibits research analysts from participating in a road show related to an investment banking services transaction and from communicating with current or prospective customers in the presence of investment banking department personnel or company management about such an investment banking services transaction.<sup>24</sup> Additionally, the amendment prohibits investment banking personnel from directing a research analyst to engage in sales and marketing efforts and other communications with a current or prospective customer about an investment banking services transaction.

By prohibiting research analysts from participating in road shows and communicating with customers in the presence of investment bankers or company management, the amendment further reduces pressure on research analysts to give an overly optimistic assessment of a particular transaction. It also removes any suggestion to investors in attendance at a road show that the analyst will give positive coverage to the issuer or that the analyst endorses all of the views expressed by the company or investment banking department personnel.

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<sup>23</sup> In 2004, the SROs delayed the effectiveness of certain disclosure provisions in the rules until April 26, 2004. See Securities Exchange Act Release No. 49119 (Jan. 23, 2004), 69 FR 4337 (Jan. 29, 2004) (notice of immediate effectiveness of SR-NASD-2004-003 and SR-NYSE-2004-01).

<sup>24</sup> Securities Exchange Act Release No. 51593 (Apr. 21, 2005), 70 FR 22168 (Apr. 28, 2005) (order approving SR-NASD-2004-141 and SR-NYSE-2005-24). As defined under NASD Rule 2711(a)(2) and NYSE Rule 472.20, “investment banking services” includes, without limitation, 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 transaction), or similar investments; or serving as placement agent for the issuer.

The amendment expressly permits research analysts to educate investors and member personnel about a particular offering or other transaction, provided the communication occurs outside the presence of company management and investment banking department personnel. Such permissible communications to investors and internal personnel must be fair, balanced and not misleading, taking into account the overall context in which such communications are made.<sup>25</sup>

The amendment became effective on June 6, 2005.

## **2. Joint Memoranda and Interpretations**

The Commission noted in its approval order of May 10, 2002 that the SROs would provide interpretive guidance on certain provisions of the SRO Rules. Accordingly, contemporaneous with the first effective date of the new rules, the SROs issued a joint memorandum (“July 2002 Joint Memorandum”) providing interpretive guidance on a number of topics, including: the definitions of “investment banking services” and “research report”; public appearances; quiet periods; the applicability of the SRO Rules to third-party research; the prohibition on certain forms of research analyst compensation; restrictions on personal trading by analysts; and requisite disclosures, including the distribution of ratings and price charts (*see* Exhibit B).<sup>26</sup>

In March 2004, the SROs issued a second joint memorandum (“March 2004 Joint Memorandum”) to provide further interpretive guidance on the amended SRO Rules (*see* Exhibit C).<sup>27</sup> That memorandum generally addressed issues related to the definition of “research report”; the applicability of the “gatekeeper,” blackout and quiet periods provisions; and the scope and prominence of certain disclosure requirements.

The SROs continue to work together on interpretive issues.

## **3. Other Regulatory Initiatives**

### ***Regulation AC***

On February 6, 2003, the SEC adopted Regulation Analyst Certification (“Regulation AC”), which took effect on April 14, 2003.<sup>28</sup> Regulation AC generally requires broker-dealers to include in a research report certifications by the analysts who are principally responsible for

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<sup>25</sup> The prohibition on research analysts’ participation in road shows does not prohibit certain analysts’ communications that are permitted under the federal securities laws. *See* 17 CFR 230.137, 230.138 and 230.139 (research reports issued in accordance with Rules 137, 138 and 139 under the Securities Act of 1933).

<sup>26</sup> *See* NYSE Information Memo No. 02-26 (June 26, 2002), and NASD *Notice to Members* 02-39 (July 2002).

<sup>27</sup> *See* NYSE Information Memo No. 04-10 (Mar. 9, 2004), and NASD *Notice to Members* 04-18 (Mar. 2004).

<sup>28</sup> *See* Regulation Analyst Certification, Securities Exchange Act Release No. 47384 (Feb. 20, 2003), 68 FR 9482 (Feb. 27, 2003). In August 2003 and April 2005, the SEC staff issued additional guidance regarding Regulation AC in a series of questions and answers on the SEC Web site. *See* SEC Responses to Frequently Asked Questions Concerning Regulation Analyst Certification, <http://www.sec.gov/divisions/marketreg/mregacfaq0803.htm>.

preparing the report (1) that the recommendations or views expressed in the research report accurately reflect the analysts' personal views about the subject securities and issuers, and (2) whether any part of the analysts' compensation was, is, or will be directly or indirectly related to any specific recommendations or views expressed in the research report. In addition, research analysts must certify to the accuracy of statements made in public appearances and that no part of the research analysts' compensation is tied to statements made during the public appearance. If the broker-dealer does not obtain such certification by the analysts, it must disclose this fact and promptly notify its designated examining authority. The SROs continue to examine for compliance with Regulation AC.

Unlike the SRO Rules, Regulation AC applies to both fixed-income and equity research reports and the analysts who are primarily responsible for preparing those reports. Similar to the SRO Rules, Regulation AC broadly defines a "research report" as "a written communication (including an electronic communication) that includes an analysis of a security or an issuer and provides information reasonably sufficient upon which to base an investment decision."

#### **4. Enforcement Proceedings**

As the SROs engaged in rulemaking to manage and eradicate existing research conflicts, regulators brought enforcement proceedings to redress past misconduct in the area.

##### ***Merrill Lynch Settlement***

In May 2002, as part of a settlement with the New York Attorney General, Merrill Lynch agreed to adopt certain changes to its equity research and investment banking activities. Among other things, Merrill Lynch agreed to completely separate analyst compensation from investment banking, prohibit investment banking input into analysts' compensation and disclose in all research reports whether it has received or is entitled to receive any compensation from a covered company over the past 12 months.

##### ***The Global Settlement***

On April 28, 2003, the SEC, NYSE, NASD, NASAA and the New York Attorney General's Office announced that they had reached an agreement (the "Global Settlement") with ten investment banking firms settling actions alleging fraudulent or misleading research. The United States District Court for the Southern District of New York approved the Global Settlement on October 31, 2003<sup>29</sup> and an amendment to the agreement was approved in September 2004.<sup>30</sup>

The Global Settlement differs in structure from the SRO Rules. The former generally prohibits all communications between research and investment banking personnel, with certain express exceptions. In contrast, the SRO Rules permit all communications that are not expressly prohibited. But the key provisions of the Global Settlement and the SRO Rules are essentially

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<sup>29</sup> See SEC Litigation Release No. 18438, 2003 SEC LEXIS 2601 (Oct. 31, 2003).

<sup>30</sup> See 03 Civ. 2941 (WHP), 2004 U.S. Dist. LEXIS 19149 (S.D.N.Y. Sept. 24, 2004) (amendments to Addendum A).

the same; the few differences are noted below. A chart comparing the provisions is included as Exhibit D.

The common provisions include prohibitions on review and approval of research by investment banking; prohibitions on research analysts from soliciting investment banking business and participating in sales and marketing activities; requirements for the termination of coverage; general requirements that the compensation of a research analyst primarily responsible for the preparation of the substance of a research report be reviewed and approved by a member firm committee without investment banking representation that reports to the Board of Directors or the senior chief executive officer; and increased disclosure and transparency of potential and actual conflicts of interests and of issues related to the performance of research analysts, such as ratings, price targets and an explanation of the firm's rating system.

Some Global Settlement terms have not been explicitly or implicitly incorporated into the SRO Rules. For example, the Global Settlement requires that the work of the compensation committee be reviewed by an oversight committee of research management. Other Global Settlement requirements not incorporated by the SROs are physical separation between research analysts and investment banking; the requirement that research have its own dedicated legal and compliance staff; and requirements for firms to procure and make available for their clients independent research on listed companies that they cover.

Additionally, comparable SRO Rules and Global Settlement definitions differ in degree and scope. The definitions of "research reports" and "research analysts" are illustrative. The SRO Rules, for example, apply to all research reports produced by the SROs' members, irrespective of where or to whom they are distributed; however, the Global Settlement limits its definition of "research report" to communications furnished to investors in the United States. Also, the SRO Rules' definition of "research analyst" – the same as mandated by the Sarbanes-Oxley Act – is broader than the Global Settlement's definition of "Research Personnel," which is limited to those individuals whose primary job is the preparation of research reports.

The SRO staffs address in Section V whether they recommend incorporating additional Global Settlement terms into the SRO Rules or making any other conforming changes.

## **II. REGISTRATION AND QUALIFICATION REQUIREMENTS**

### **A. Series 86/87 Examinations**

As part of the Round 2 Amendments, the SEC approved rules requiring registration and qualification requirements for research analysts. The SRO Rules require an associated person<sup>31</sup> who functions as a research analyst on behalf of a member to register as such and pass a qualification examination. Those rules are intended to ensure that research analysts possess a certain competency level to perform their jobs effectively and in accordance with applicable rules and regulations. In the context of this requirement, the SRO Rules define "research analyst" as "an associated person who is primarily responsible for the preparation of the

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<sup>31</sup> See SR-NYSE-2005-24 amending the definition of "research analyst" in NYSE Rules 344.10 and 472.40 to include "associated persons." NASD rules already separately defined "associated person."

substance of a research report or whose name appears on a ‘research report,’” as that term is defined in the SRO Rules.

The SROs jointly developed and implemented the Research Analyst Qualification Examination (Series 86/87). The examination consists of an analysis part (Series 86) and a regulatory part (Series 87). Prior to taking either the Series 86 or 87, a candidate also must have passed the General Securities Registered Representative Examination (Series 7), the Limited Registered Representative Examination (Series 17), or the Canada Module of Series 7 (Series 37 or 38). Persons who were functioning as research analysts on the effective date of March 30, 2004 and submitted a registration application to NASD by June 1, 2004, had until April 4, 2005 to meet the registration requirements. There was no grandfather provision. The one-year grace period was intended to provide these analysts sufficient time to study and pass the examination without causing undue disruption in carrying out their responsibilities to their member firm and its customers.

## **B. Exemptions**

The SRO Rules provide three exemptions from the Series 86 examination. First, there is an exemption for research analysts who have passed Levels I and II of the Chartered Financial Analyst (“CFA”) examination and have either (1) completed the CFA Level II within 2 years of application or registration, or (2) functioned as a research analyst continuously since having passed the CFA Level II.<sup>32</sup> A second exemption is available to research analysts who have passed Levels I and II of the Chartered Market Technician Examination and produce only “technical research reports” as that term is defined under the SRO Rules.<sup>33</sup>

A third exemption – from both the Series 86 and Series 87 – is available to “associated persons” of a member who are employed by that member’s foreign affiliate but who produce research on behalf of the U.S. member. The SROs created this third exemption in response to requests from some members with global research operations that had difficulty ascertaining whether certain foreign research analysts whose work contributed to the member’s research report were “associated persons” who must meet the registration and qualification requirements under the SRO Rules.

To be eligible for the exemption, three primary conditions must be met: (1) a foreign analyst must comply with the registration and qualification requirements or other standards in an SRO-approved foreign jurisdiction whose regulatory scheme reflects a recognition of principles that are consonant with the SRO Rules and qualification standards; (2) the U.S. member must apply all of the other SROs rules and other member firm standards to the research produced by the foreign affiliate and foreign research analysts that qualify for, and rely upon, the exemption; and (3) the U.S. member must include a specific disclosure that the research report has been prepared in whole or part by foreign research analysts who may be associated persons of the member who are not registered/qualified as a research analyst with the NYSE or NASD, but instead have

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<sup>32</sup> See Securities Exchange Act Release No. 49464 (Mar. 24, 2004), 69 FR 16628 (Mar. 30, 2004) (order approving SR-NYSE-2004-03 and SR-NASD-2004-020).

<sup>33</sup> See Securities Exchange Act Release No. 51240 (Feb. 23, 2005), 70 FR 10451 (Mar. 3, 2005) (notice of immediate effectiveness of SR-NYSE-2005-12 and SR-NASD-2005-022).

satisfied the registration/qualification requirements or other research-related standards of a foreign jurisdiction that have been recognized for these purposes by the NYSE and NASD.

Eligibility for the exemption in no way bears upon whether the foreign research analyst is an associated person of the member. And to the extent that a member can determine that a foreign research analyst is *not* an “associated person,” there is no requirement to satisfy any of the SRO Rules, including the registration and qualification requirements.

Currently, the following jurisdictions satisfy the applicable SRO standards noted above: China, Hong Kong, Japan, Malaysia, Singapore, Thailand and the United Kingdom. The SROs only considered those jurisdictions submitted by the members that requested the exemption but agreed to consider additional jurisdictions on a case-by-case basis, as requested.<sup>34</sup>

### **C. Supervisory Requirements**

NASD has an additional rule that requires supervisors of research analysts to pass the Series 87 examination or the NYSE Series 16 Supervisory Analyst Examination. Those who oversee the *content* of research reports must have passed either the Series 87 or the Series 16 examination. A registered principal (Series 24) who has also passed either the Series 87 or the Series 16 examination must supervise the conduct of both the Series 16 Supervisory Analyst and the research analyst. The rule became effective on August 2, 2005.<sup>35</sup> NYSE Rule 472(a)(2) requires that a supervisory analyst acceptable under NYSE Rule 344 approve research reports.

### **D. Statistics**

Between April 1, 2004 and November 30, 2005, 5,599 research analysts and 418 research principals had satisfied the applicable registration and qualification requirements. The Series 86 exam was attempted 6,158 times, with an overall pass rate of 74.9%, and the Series 87 exam was attempted 8,259 times, with an overall pass rate of 89.6%. During the same period, 2,375 CFA exemptions and 34 technical analyst exemptions were granted.

## **III. EXAMINATIONS, SWEEPS AND ENFORCEMENT ACTIONS**

The SROs continue to closely examine for compliance with the SRO Rules and rigorously pursue enforcement actions for violations of these rules. The area of research analyst conflicts remains a high priority component of the SROs’ examination and enforcement programs.

### **A. NASD Summary**

#### **1. Member Regulation**

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<sup>34</sup> The SROs will notify their membership in the event additional jurisdictions are approved.

<sup>35</sup> Securities Exchange Act Release No. 50162 (Aug. 6, 2004), 69 FR 50406 (Aug. 16, 2004) (order approving SR-NASD-2004-078).

As the SRO Rules became effective, NASD's Member Regulation Department incorporated into its routine examination program an inspection for compliance with NASD Rule 2711 and SEC Regulation AC.

Between July 2002 and November 30, 2005, NASD initiated 467 examinations reviewing firms for compliance with Rule 2711 and Regulation AC. In the course of these examinations, NASD found 110 violations of Rule 2711 and 25 violations of Regulation AC. Specifically, the Rule 2711 violations have involved: (1) failure to have adequate procedures in place to supervise the activities of research analysts with respect to conflicts of interest, in violation of Rule 2711(i) (47 of 467 examinations); (2) failure to adequately comply with the disclosure requirements regarding research reports and public appearances, in violation of Rule 2711(h) (24 of 467 examinations); (3) failure to file the Annual Attestation, in violation of Rule 2711(i) (20 of 467 examinations); (4) personal trading of the subject companies' securities in the analyst's account within the restricted time period, in violation of Rule 2711(g) (10 of 467 examinations); and (5) failure to comply with restrictions on communications with the subject company, in violation of Rule 2711(c) (9 of 467 examinations).

Of the 135 violations of Rule 2711 and Regulation AC found to date, 27 have resulted or are expected to result in an Acceptance, Waiver and Consent, seven have resulted in a formal complaint, 18 have resulted in a compliance conference, 81 have resulted in a Letter of Caution, and two remain under investigation.

## **2. Enforcement**

As of November 30, 2005, NASD Enforcement has settled 29 cases involving Rule 2711 violations and two cases involving violations of Rule 1050, the analyst registration rule. By far, the vast majority of settled Enforcement actions have involved violations of the disclosure requirements of Rule 2711(h), encompassing over 265 research reports. Specific violations of this provision include: (1) failure to disclose ownership of shares of subject companies; (2) failure to disclose compensation for investment banking services from the subject company; (3) failure to disclose market making activity; (4) use of conditional language in making the requisite disclosures; (5) failure to provide sufficient price charts; (6) failure to disclose the distribution of buy, hold and sell recommendations; (7) failure to provide information about the valuation methods used; (8) failure to define recommendations; and (9) failure to provide disclosures required by Rule 2210.

Other settled Enforcement cases have involved such violations of Rule 2711 as (1) failure to maintain supervisory procedures pursuant to Rule 2711(i) (113 research reports); (2) communications with subject companies in violation of Rule 2711(c) (17 research reports); and (3) failure to abide by the personal trading restrictions under Rule 2711(g) (21 research reports). In addition, two cases involved analysts offering favorable research reports in exchange for compensation in violation of Rule 2711(e), and one case involved a firm's failure to provide notice of termination of coverage and issue final research reports with respect to seven subject companies, in violation of Rule 2711(f).

Sanctions in the settled Enforcement cases have included fines ranging from \$10,000 to \$50,000, disgorgement, suspensions and bars in all capacities. In addition, NASD Enforcement has settled

with two firms for failure to timely apply for research analyst designation in violation of Rule 1050. These two cases involved 56 analysts and 325 research reports, and each firm was censured and fined (one in the amount of \$100,000; the other, \$150,000).

There are currently two pending complaints against firms and a number of open investigations involving suspected violations of Rule 2711. These matters involve many of the same compliance issues discussed above, including allegations of failure to meet disclosure obligations and of transgressing the personal trading restrictions. In addition, in summer 2005, the SROs launched a joint sweep of 30 firms to review their compliance with NASD Rules 2711 and 1050 and NYSE Rule 344 in the context of research prepared on behalf of the members by foreign analysts. That review is ongoing.

### **3. Advertising**

Although members need not file research reports with NASD's Advertising Regulation Department, they do constitute "communications with the public" under NASD's advertising rules. As such, NASD's Advertising Regulation Department has conducted two sweeps since NASD Rule 2711 was implemented. In 2002, a sweep of 28 firms was conducted to determine whether firms had made a good faith effort to comply with Rule 2711 and identify any new interpretive issues that might arise. Firms were notified of any compliance shortcomings, with the expectation that those deficiencies promptly would be remedied.

In 2004, NASD's Advertising Regulation Department conducted a second sweep of the ten Global Settlement firms and specifically requested information about their equity research reports (including access to their Web sites), samples of each type of report they used and explanatory material about their ratings. As part of this second sweep, examiners revisited the spot check conducted in 2002 to determine whether firms had made revisions as indicated.

This subsequent review revealed continued deficiencies in several areas. First, some firms were unclear in describing their ratings methodology. For example, some firms failed to explain a two-pronged approach they employed to assess a sector and an individual issuer within that sector. Examiners flagged such reports for failure to comply with the clarity requirement of Rule 2711(h)(10) because the absence of clear ratings descriptions could lead to misconceptions by investors about the firm's actual view of the issuer. Second, some members failed to provide clear disclosure presentations; for example, they used complex systems of footnotes inconsistently and indefinite disclosures (*e.g.*, "may conduct investment banking"). Examiners also identified such practices as violations of Rule 2711's clarity standard. Third, some members failed to use the terms "buy," "hold," and "sell" in the ratings distribution chart, as required by Rule 2711(h)(5). Finally, some members used language that seemed to disclaim responsibility for information in the report about the member firm, including required disclosures of certain conflicts.

NASD's Advertising Regulation Department does not have authority to bring formal actions against members and thus referred to NASD Enforcement those cases where it recommended that further action be considered.

## **B. NYSE Summary**

### **1. Member Firm Regulation**

The NYSE currently has 348 members and member organizations of which 217 are conducting a public business and/or issuing research. The NYSE incorporated the SRO Rule requirements into its exam scope for routine examinations of members and member organizations by Member Firm Regulation (“MFR”), following the effective dates of the SRO Rules in 2002 and 2003.<sup>36</sup>

MFR examiners conducted a series of reviews investigating member and member organization compliance with the SRO Rules and SEC Regulation AC. Between August 2002 and October 2005, MFR conducted a total of 296 examinations.<sup>37</sup> NYSE examiners cited a total of 75 firms with a total of 271 findings for non and/or partial compliance with the SRO Rules and Regulation AC.<sup>38</sup> The findings were distributed as follows: 26 in 2002; 62 in 2003; 152 in 2004; and 31 in 2005.

Specifically, the NYSE examination findings included: (1) failure to clearly and prominently state in research reports in the proper format the disclosures required by the SRO Rules; (2) failure to adhere to the disclosure and record maintenance requirements for associated persons making public appearances; (3) failure to comply with record maintenance requirements evidencing the disclosures in connection with recommendations of securities in print media, interviews, newspaper articles or broadcasts; (4) failure to comply with restrictions on trading activities for associated persons; (5) failure to have legal or compliance personnel intermediate written communications between non-research personnel and research personnel concerning the content of research reports; (6) inclusion of price targets, rating summaries or research ratings information in a draft of a research report sent to a subject company; (7) executing changes to research reports after sending the report to a subject company without proper approval by legal and compliance; (8) allowing research analysts to work under the supervision or control of investment banking department personnel; (9) offering favorable research for business; (10) failure to maintain written procedures for compliance with the SRO Rules; and (11) failure to have a committee in place to review and approve analyst compensation.

### **2. Enforcement**

Between August 2002 and November 2005, 13 examination findings were referred to Enforcement from MFR for SRO Rule violations.<sup>39</sup> As discussed in more detail below, many of

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<sup>36</sup> Only members and member organizations that conducted a public business and/or issued research were examined for compliance with the SRO Rules.

<sup>37</sup> The breakdown of examinations was as follows: 21 firms in 2002, 85 firms in 2003, 140 firms in 2004 and 50 firms in 2005. In many instances the same firm was examined in successive years.

<sup>38</sup> Of the 271 findings, 22 involved Regulation AC. The 22 Regulation AC findings involved: failures by member organizations to maintain clear and prominent disclosures of research analyst certifications; failures to maintain records regarding public appearances of research analysts; failures to specify on the front page of reports the pages on which analyst certifications can be found; failures to have written policies and procedures to prevent inappropriate influences over research analysts; expired or missing certifications; failures with respect to terminated coverage; and missing attestations.

<sup>39</sup> There were also referrals based on findings for Rule 472 prior to its amendment.

these findings are currently the subject of NYSE Enforcement investigation/action, and many have been completed. Recently, a Hearing Panel Decision (“HPD”)<sup>40</sup> announced a disciplinary action involving violations of the SRO Rules gatekeeper provisions.<sup>41</sup> This case resulted in consent to censure and a \$150,000 fine. Additionally, a member organization has recently consented in a Stipulation of Facts and Consent to Penalty to a fine of \$1.5 million in a matter that included, among other things, having a research analyst participate in a road show, and a research analyst giving statements that were not fair and balanced.

There are a number of cases that are now under investigation by NYSE Enforcement. The cases include: research analysts selectively disclosing material non-public information; improper disclosures in research reports; research analysts trading in securities in violation of the SRO Rule blackout prohibitions; research analysts expressing opinions privately about securities they cover that were inconsistent with their published research reports; improper influence of investment banking on research compensation; lack of supervisory analyst qualifications; initiating coverage of a stock during a quiet period; violations of information barrier provisions; violations of the gatekeeper provisions; and books and records violations.

As noted above, there is also an investigation of approximately 30 firms being jointly conducted by the SROs to determine whether firms are in compliance with the requirement to register foreign research analysts who participate in the preparation of member research.

#### **IV. IMPACT OF RULES: ACADEMIC STUDIES AND MEDIA REPORTS**

Academic studies and media reports provide both empirical and anecdotal evidence regarding the impact of the SRO Rules,<sup>42</sup> and most have concluded that the rules have helped to address the conflict-of-interest issues that previously compromised the objectivity and reliability of research. Indeed, as the author of one study states:

[T]he new regulations were successful in their objectives of curbing the excessive optimism driven by the conflicts of interest . . . The distribution of recommendations is now very balanced between buy and sell recommendations . . . and the link between the presence of underwriting business and excess optimism in recommendations was removed.<sup>43</sup>

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<sup>40</sup> See Exchange HPD 04-136 (NYSE Aug. 11, 2004).

<sup>41</sup> The firm was in violation of NYSE Rule 472(b)(4), which prohibits member firms from providing a subject company with draft research reports containing the research summary, rating or price target information.

<sup>42</sup> We note that some studies and news articles refer only to the impact of the Global Settlement. Since the key provisions of the Global Settlement closely track those of the SRO Rules, we believe those studies and news articles that address the impact of the settlement terms are a fair proxy for the impact of the SRO Rules.

<sup>43</sup> Leonardo Madureira, *Conflicts of Interest, Regulations, and Stock Recommendations*, at 4 (Nov. 2004) (Working paper, Wharton School, University of Pennsylvania) (the “Madureira Study”). See also, e.g., Ohad Kadan, Tzachi Zach & Rong Wang, *Are Analysts Still Biased? The Effect of the Global Settlement and Regulation FD*, Abstract (Mar. 2005) (Working paper, John M. Olin School of Business, Washington

While many other studies and media stories similarly support the effectiveness of the SRO Rules, some contend that the impact has been minimal and that certain conflicts persist. Briefly summarized below are findings and conclusions from a survey of pertinent studies and news articles.

### ***Research Is More Balanced***

#### *(a) Changes in ratings distributions*

Several academic studies have found that the percentage of buy recommendations decreased and the percentage of sell and hold recommendations increased following adoption of the SRO Rules and Global Settlement. These ratings distribution trends suggest that research analysts are issuing more balanced stock recommendations.

For example, one study found that the percentage of buy recommendations peaked at 74% of all recommendations at the end of the second quarter of 2000 and decreased to 42% of all recommendations at the end of June 2003.<sup>44</sup> During the same period, sell recommendations increased from 2% to 17% of all recommendations, while hold recommendations increased from 24% to 41%.<sup>45</sup>

The Barber Study concludes that “taking a closer look at the trends in 2002 makes clear that [the SRO Rules]<sup>46</sup> likely did play a role in analysts’ shift away from buy recommendations.”<sup>47</sup> Indeed, the study notes that the most pronounced changes in ratings distributions occurred during the weeks leading up to the September 9, 2002 deadline for implementing the ratings distribution disclosure requirement under the SRO Rules.<sup>48</sup> The single biggest change occurred on Sunday, September 8, 2002 when buy recommendations decreased from 57% to 53% and sell recommendations increased from 8% to 11%.<sup>49</sup> Adjusting for certain factors, the authors calculate that there was a greater decrease in the percentage of buys and a greater increase in the percentage of sells and holds following implementation of the SRO Rules than otherwise would have been expected.<sup>50</sup>

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University) (the “Kadan Study”) (“the Global Settlement was effective in reducing conflicts of interests [sic] between research and investment banking departments in financial services firms”).

<sup>44</sup> Brad Barber, Reuven Lehavy, Maureen McNichols & Brett Trueman, *Buys, Holds, And Sells: The Distribution Of Investment Banks’ Stock Ratings And The Implications For The Profitability Of Analysts’ Recommendations*, at 3, 12 (Sept. 2005) (Working paper, Graduate School of Management, University of California, Davis, Ross School of Business, University of Michigan, Graduate School of Business, Stanford University and Anderson Graduate School of Management, University of California, Los Angeles) (the “Barber Study”).

<sup>45</sup> *Id.*

<sup>46</sup> While the authors refer solely to NASD Rule 2711, they state that all conclusions apply to NYSE Rule 472 as well. *Id.* at 1, n.1.

<sup>47</sup> *Id.* at 13.

<sup>48</sup> *Id.*

<sup>49</sup> *Id.* at 13-14.

<sup>50</sup> *Id.* at 15.

The Madureira Study found similar results. That study looked at analyst recommendations for the period July 1995 through December 2003 and found that prior to the SRO Rules and Global Settlement, the bulk of consensus recommendations were concentrated in the strong buy and buy categories (accounting for 60% or more of the stocks in the sample) and sell recommendations were “virtually absent.”<sup>51</sup> However, from July 2002 through December 2003, “a completely different pattern emerges.”<sup>52</sup> For example, in September 2002, the fraction of stocks in the pessimistic category (sell and strong sell) jumped from 3% to approximately 20%.<sup>53</sup> The author found similar patterns with respect to initiation of coverage and ratings upgrades and downgrades, finding that brokerage houses leaned less toward optimistic ratings after the new regulations took effect.<sup>54</sup>

Both the Madureira and Kadan studies found the most decided changes in ratings distributions at firms that maintained or pursued investment banking transactions with covered companies. The Madureira Study found that, prior to the SRO Rules and Global Settlement, the presence of an underwriting business with the subject company implied a 50% increase in the odds that a new recommendation would be optimistic.<sup>55</sup> However, the study found that the effect has “largely disappeared” after the new regulations took effect.<sup>56</sup>

The Kadan Study similarly found that regulatory measures enacted to separate research from investment banking have resulted in less optimistic research by analysts whose firms had or sought investment banking business with companies the analyst covered (an “affiliated” analyst). The study found that prior to the Global Settlement, affiliated analysts generated more optimistic recommendations and long-term growth forecasts than their unaffiliated counterparts; however, those differences have now been eliminated.<sup>57</sup> Consistent with the Barber and Madureira studies, the Kadan Study found a decrease in the percentage of affiliated analysts’ buy recommendations and an increase in their hold and sell recommendations following the Global Settlement.<sup>58</sup> The authors found a similar but less dramatic shift in ratings distribution with respect to unaffiliated analyst recommendations.<sup>59</sup>

In a subsequent paper combining the Madureira and Kadan studies, the authors explained that analysts changed their behavior in an asymmetric way after adoption of the SRO Rules.<sup>60</sup>

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<sup>51</sup> Madureira Study at 17-18.

<sup>52</sup> *Id.* at 18.

<sup>53</sup> *Id.*

<sup>54</sup> *Id.* at 21.

<sup>55</sup> *Id.* at 4.

<sup>56</sup> *Id.*

<sup>57</sup> Kadan Study at 4, 26.

<sup>58</sup> *Id.* at 21-22, Table 6.

<sup>59</sup> *Id.* at 22.

<sup>60</sup> Ohad Kadan, Leonardo Madureira, Rong Wang & Tzachi Zach, *Conflicts of Interest and Stock Recommendations - The Effects of the Global Settlement and Recent Regulations*, at 25 (July 2005) (Working paper, John M. Olin School of Business, Washington University and Weatherhead School of Management, Case Western Reserve University).

Analysts now behave similarly when deciding whether to post an optimistic recommendation, and the likelihood of receiving an optimistic recommendation no longer depends on whether the analyst's firm participated in an equity offering for the subject company.<sup>61</sup> However, affiliated analysts are still reluctant to issue pessimistic recommendations for companies that have had a recent equity offering.<sup>62</sup>

One recent academic study found lesser changes in ratings distributions since the Global Settlement.<sup>63</sup> The author analyzed data for each of the ten Global Settlement firms and found that prior to the settlement, between 28.4% (in 2002) to 39.8% (in 2000) of recommendations across the ten firms carried a firm's highest rating. After the settlement, top recommendations comprised between 31.8% (in 2003) and 39% (in 2004) of all recommendations.<sup>64</sup> The percentage of the most negative recommendations decrease from a pre-settlement range of 24.1% (in 2000) to 32.4% (in 2002) to a post-settlement range of 18.8% (in 2003) and 12.8% (in 2004).<sup>65</sup> The author notes that the numbers may be explained by factors other than bias, such as analysts' accurate and unbiased expectation of investment value in the post-settlement period or the fact that analysts may intentionally have skewed their coverage post-settlement to stocks that they expect will outperform the market.<sup>66</sup>

A number of news articles buttress the conclusion that sell-side analysts are less biased after implementation of the SRO Rules and/or the Global Settlement and now are more prone to issue downgrades and sell recommendations. According to a recent article, "sell-side analysts do appear to be more discerning," noting that sell ratings, which accounted for less than 2% of the ratings published on Wall Street in 2002, were up to between 10% and 15% of the ratings at all major brokerages.<sup>67</sup> Another article reported in August 2003 that sell recommendations represented 15-25% of overall opinions, attributing the trend at least in part to adoption of the SRO Rules.<sup>68</sup> According to *The Wall Street Journal*, at one point in 2000, 95% of the stocks in the S&P 500 had no sells at all and no stock had more than one sell rating; today, only 38% are without sell recommendations, 62% have at least one sell and 9% have five sells or more.<sup>69</sup>

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<sup>61</sup> *Id.*

<sup>62</sup> *Id.* at 25-26.

<sup>63</sup> Leslie Boni, *Analyzing the Analysts After the Global Settlement*, at 5 (Aug. 25, 2005) (Working paper, University of New Mexico) (the "Boni Study").

<sup>64</sup> *Id.* at 13.

<sup>65</sup> *Id.*

<sup>66</sup> *Id.* at 14.

<sup>67</sup> Nat Worden, *Mixed Returns on Spitzer Research Settlement*, *The Street.com*, Apr. 22, 2005, <http://www.thestreet.com/markets/natworden/10218183.html>. See also Dan Ackman, *Wall Street Tries To Say 'Sell'*, *Forbes.com*, June 20, 2003, [http://www.forbes.com/2003/06/20/cx\\_da\\_0620topnews\\_print.html](http://www.forbes.com/2003/06/20/cx_da_0620topnews_print.html) (in June 2003, 43% of recommendations were buy, 46.6% were hold and 10.5% were sell, compared with June 2000, when 74.6% of all recommendations were buy and only 0.7% were sell); *Facts Without Fiction*, Crystal Research Assoc., LLC, Issue 3 (Winter 2005); *Analysts Say 'Sell' A Lot More Often*, Reuters News Service, May 18, 2003, <http://www.chron.com/disp/story.mpl/business/mym/1914061.html>.

<sup>68</sup> Andrew Leckey, *Dumping Stock Shouldn't Be Such A Hard Sell*, *Chicago Tribune*, Aug. 12, 2003, at C4.

<sup>69</sup> E.S. Browning, *Analysts Keep Misfiring With 'Sell' Ratings*, *Wall St. J.*, Apr. 11, 2005, at C1.

Some news stories also report that bias still exists, particularly at larger firms with investment banking businesses.<sup>70</sup> According to one report, the top ten Wall Street firms give a higher percentage of buy ratings – 46% versus 40% – to those companies with which they do investment banking business.<sup>71</sup> Another article reports that many firms still maintain only 0-6% sell recommendations.<sup>72</sup> Finally, one news article reports that small firms may be slightly more likely to issue buy recommendations than the Global Settlement firms.<sup>73</sup>

(b) *Correlation between recommendations and earnings forecasts*

A recent academic study attempted to measure research bias after the SRO Rules by examining the relationship between earnings forecasts and recommendation profitability across three groups of sell-side analysts: “top-tier” analysts at the top investment banks, other investment bank analysts and non-investment bank analysts.<sup>74</sup> Absent bias, the authors believe that there should be a strong correlation between accuracy in predicting earnings and profiting from following analyst recommendations since most recommendations are derived from earnings analysis. The authors further posit that bias is more likely to appear in recommendations than earnings forecasts because analysts’ reputations are tied more closely to accurately predicting earnings.

During the 1993 to 2000 period, the study found a “positive and significant association” between forecast accuracy and recommendation profitability for non-investment bank analysts, but no such relation for top-tier analysts and other investment bank analysts.<sup>75</sup> The authors suggest that this finding demonstrates that before the SRO Rules, the presence of conflicts at investment banks resulted in overly optimistic recommendations disconnected from earnings forecasts.<sup>76</sup> However, in the period following the Global Settlement and implementation of the SRO Rules, the study found such positive correlation between earnings forecast accuracy and recommendation profitability for analysts employed by top-tier investment banks, suggesting that “the increased awareness of the conflicts of interest and the regulatory changes might have had their desired effect.”<sup>77</sup>

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<sup>70</sup> See, e.g., Amey Stone, *Yes, Wall Street Research Is Better*, BusinessWeek Online, June 28, 2004, [http://businessweek.com/bwdaily/dnflash/jun2004/nf20040628\\_1253\\_db014.htm](http://businessweek.com/bwdaily/dnflash/jun2004/nf20040628_1253_db014.htm) (“some might conclude that bias still exists”).

<sup>71</sup> *Id.*

<sup>72</sup> Joseph McCafferty, *Reform of Sell-side Research is Creating A Variety of New Headaches for Corporations*, CFO Magazine, May 2003. See also Leckey, *supra* note 68.

<sup>73</sup> Susanne Craig, *Research Rules Trickle Down To Small Firms*, Wall St. J. Online, Jan. 18, 2004, <http://online.wsj.com/article/o,,SB107446466140004574,00.html>.

<sup>74</sup> Yonca Ertimur, Jayanthi Sunder & Shyam V. Sunder, *Measure for Measure: An Examination of the Association between Forecast Accuracy and Recommendation Profitability of Sell-Side Analyst* (Mar. 2005) (Working paper, Graduate School of Business, Stanford University and Kellogg School of Management, Northwestern University) (the “Ertimur Study”).

<sup>75</sup> *Id.* at 4.

<sup>76</sup> *Id.* at 2.

<sup>77</sup> *Id.* at 19.

## ***Research Is More Reliable, Accurate And Informative For Investors***

Recent studies and a number of news articles suggest that the quality of research and value to investors has improved since adoption of the SRO Rules. For example, one article reports that the “most important change for the better is in the quality of analysis . . . written commentary in stock reports is more independent, more thought-provoking, and better represents the upside and downside potential for a stock than the bubble era’s much-hyped reports.”<sup>78</sup> And in numerous interviews, portfolio managers attest to the improvement.<sup>79</sup> Another article reports that “the investment community is now benefiting from more diverse research strategies, with access to reports that are less restricted and more user-friendly.”<sup>80</sup> As discussed in more detail below, research has also become more trusted by the market and more reliable and meaningful for investors.

### *(a) Ratings reflect their plain meanings*

The SRO Rules require that ratings be consistent with their plain meanings, and several studies have concluded that ratings indeed are now truer and therefore more predictive for investors. For example, the Kadan Study found that following the Global Settlement, the price reaction in the market to buy recommendations has been “significantly more positive” and the price reaction to hold recommendations has been “significantly less negative.”<sup>81</sup> In other words, the market now accepts ratings at face value and stocks trade consistent with the plain meanings of the recommendations. According to the Kadan Study, these results suggest that buy and hold recommendations are now “more informative to investors.”<sup>82</sup> As for sell recommendations, the Kadan Study found more mixed results.<sup>83</sup> The Madureira Study also found that firms now generally seem to “mean what they say” when issuing hold and sell recommendations,<sup>84</sup> concluding that “brokerage houses no longer are disguising pessimistic recommendations as neutral ratings.”<sup>85</sup> In contrast, before the SRO Rules and Global Settlement, a hold rating often was tantamount to a sell recommendation,<sup>86</sup> which would generate far greater negative price reaction in the market than the author has found since implementation of the regulations.

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<sup>78</sup> Stone, *supra* note 70 (in the “bad old days,” research on the same company was “often barely distinguishable” among research firms).

<sup>79</sup> *Id.* See also McCafferty, *supra* note 72 (most experts expect analysts to “dig deeper into the companies they cover”).

<sup>80</sup> *Facts Without Fiction*, *supra* note 67, at 1 (noting that research is now “a competitive marketplace of versatile and diverse research providers”). See also *SIA Research Management Conference: Reflections on Two Years Since the Global Settlement*, SIA Research Reports, Vol. VI, No. 9 (Sept. 30, 2005) (“panelists agreed that there is a far greater variety of research products and services available today”).

<sup>81</sup> Kadan Study at 20.

<sup>82</sup> *Id.*

<sup>83</sup> *Id.*

<sup>84</sup> Madureira Study at 3, 25-26.

<sup>85</sup> *Id.* at 25, 26. The study did, however, find some negative market reactions to hold recommendations issued by non-settling firms.

<sup>86</sup> Madureira Study at 2.

However, one recent academic study has found that investors are less responsive to analyst recommendations. The Boni Study found that market participants on average respond less to recommendation changes made by the ten settlement firms after the Global Settlement (*i.e.*, stock prices increase less on upgrades and decrease less on downgrades than they did prior to the Global Settlement).<sup>87</sup> The author notes that it is possible that retail investors react to analyst recommendations as they did before the settlement but institutional investors respond less.<sup>88</sup>

(b) *Recommendations may be more accurate and predictive of investment profitability*

Reports suggest that research has become more accurate following implementation of the SRO Rules and the Global Settlement, which served “as a wake-up call for many sell-side research professionals . . . . As a result, broker/dealers and investment banks are now paying much more attention to the accuracy of their research recommendations.”<sup>89</sup>

And there is evidence that investors who follow recommendations may be seeing improved returns. For example, the Barber Study concluded that the disclosure requirements in the SRO Rules provide investors with helpful information to assess the value of a research analyst’s recommendation and to predict profitability by investing consistent with those recommendations. The authors found that prior to the implementation of the SRO Rules, upgrades from brokers with the highest percentage of pessimistic ratings outperformed by an average of 50 basis points those brokers that tended to have a more optimistic ratings distribution.<sup>90</sup> The obverse also held true: downgrades to hold or sell from the more optimistic brokers significantly outperformed investments in stocks downgraded by brokers with more pessimistic ratings distributions.<sup>91</sup> The authors note that these differences have effectively evaporated after implementation of the SRO Rules, leading to their conclusion that the ratings distribution disclosure requirement has made research more transparent for investors.<sup>92</sup>

According to Starmine, a firm that rates analyst performance, following analysts’ advice would have had a slightly negative impact on portfolios on average in 2002; however, in 2003, it would have added 2.2 percentage points to returns.<sup>93</sup> In 2004, analysts outperformed benchmarks by

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<sup>87</sup> Boni Study at 19.

<sup>88</sup> *Id.* However, this seems inconsistent with the author’s observation that according to polls, most institutional investors said that they largely ignored analysts’ recommendation ratings prior to the Global Settlement. *Id.* at 3.

<sup>89</sup> Integrity Research Assoc. & Meghan Leerskov, *Gauging The Independent Edge*, Buyside, June 2004, at 61, 66. *See also* Stone, *supra* note 70 (quoting a senior analyst at First Call as saying that research over the prior two years “has become more objective, more original, and more accurate”).

<sup>90</sup> Barber Study at 6, 31.

<sup>91</sup> *Id.*

<sup>92</sup> *Id.* at 36.

<sup>93</sup> Stone, *supra* note 70. *See also* Daniel Gross, *The Best Stock Tips in Town - Buy When These Guys Say Buy, Not When Those Guys Say Buy*, Aug. 4, 2004, <http://slate.msn.com/id/2104760> (according to a Smith Barney study, investors who heeded consensus advice from mid-2001 through mid-2003 would have lost money, including a loss of more than 35% in the fourth quarter of 2001; however, there were two straight

1.3 percentage points.<sup>94</sup> In addition, by 2005, five of the top ten best-performing research shops were sell-side brokerages, as opposed to two years ago, when independent analysts occupied nine of the top ten spots.<sup>95</sup>

On the other hand, the Boni Study found very little change in the performance of analyst recommendations. The Boni Study found that stocks that received the strongest recommendations of settling firm analysts outperformed the S&P 500 index both before and after the Global Settlement.<sup>96</sup> The study found the same to be true for stocks that received the analysts' worst ratings and in fact, more often than not, such stocks outperformed those stocks that received analysts' strongest recommendations both before and after the Global Settlement.<sup>97</sup> In discussing these findings, the author noted that both before and after the Global Settlement, recommended stocks that outperformed the S&P 500 index did so at least in part because they are riskier investments on average.<sup>98</sup>

Some news reports also have suggested that the accuracy of research has not improved appreciably as a result of the SRO Rules. An analysis performed for *The Wall Street Journal* indicates that analysts are doing no better a job of picking stocks than they were before the research scandals.<sup>99</sup> The article reported that since 2000, "even though Wall Street supposedly has become more discriminating," stocks with large proportions of sell ratings are performing better than those with buy and hold ratings.<sup>100</sup> In 2003-2004, stocks with the most sell ratings rose 36% on average, while those with the most buys rose just over 25%.<sup>101</sup>

### ***Research Ratings Have Been Simplified***

The SRO Rules also have led to widespread adoption of simplified ratings systems. As the Madureira Study explained, the new ratings systems are simplified in terms of the number of ratings categories and the meaning among analysts is "very uniform."<sup>102</sup> Eight of the ten Global Settlement firms adopted new ratings system in 2002, and many of the next largest brokerage

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quarters of positive performance in the second half of 2003); Melissa Lee & John Metaxas, *Change Comes Slowly To Wall St. Research*, Apr. 26, 2004, <http://msnbc.msn.com/id/4816690/print/1/displaymode/1098>.

<sup>94</sup> Matt Krantz, *Analysts Deliver Better Advice*, Feb. 9, 2005, <http://www.investars.com/articles20050209.asp>; Jane J. Kim, *Stock Research Gets More Reliable*, Wall St. J., June 7, 2005, at D1.

<sup>95</sup> Worden, *supra* note 67. See also Kim, *supra* note 94 (some of the brokerage firms that were part of the Global Settlement have climbed higher in rankings of the best-performing research shops).

<sup>96</sup> Boni Study at 5.

<sup>97</sup> *Id.*

<sup>98</sup> *Id.* at 5-6.

<sup>99</sup> Browning, *supra* note 69.

<sup>100</sup> *Id.*

<sup>101</sup> *Id.*

<sup>102</sup> Madureira Study at 13. The author noted that the changes in ratings systems came about in response to the SRO Rules, which "express[ed] the regulators' concern about ratings systems that were loosely defined and perhaps not properly understood by the research's clients." *Id.* at 11.

houses began to adopt new systems around the same time.<sup>103</sup> Only one of the new ratings systems was adopted before the SRO Rules became effective in July 2002, and many came on line contemporaneous with the September 9, 2002 implementation date of the SRO Rules ratings distribution requirements.<sup>104</sup> Most large brokerage houses now use a three-tier ratings system, and every new ratings system adopted after 2001 is a three-tier system.<sup>105</sup>

Some news articles indicate that research can still be confusing for investors, since not all brokerages have adopted new ratings systems, and there is no mandated or accepted uniform ratings system for those that have them.<sup>106</sup>

### ***Conflicts Of Interest Have Been Reduced But Not Eliminated***

Numerous articles provide anecdotal evidence that the conflicts of interest arising from the close relationship of research and investment banking have been mitigated following implementation of the SRO Rules and Global Settlement. For example, one investment bank had to drop out of a large IPO in May 2005 after its top media research analyst told the firm's senior bankers that they were overpricing the shares.<sup>107</sup> In another example, analysts at two firms that launched a recent hot IPO began coverage on the stock with an "underperform" rating.<sup>108</sup>

However, a December 2004 *Newsweek* article reports that despite the regulatory changes and Global Settlement, the "big financial firms are still rife with conflicts that put their own interests, and those of big banking clients, ahead of everyone else's."<sup>109</sup> The article cites as evidence of such conflicts the fact that analysts can still meet with executives around the time they are considering which investment bankers to hire and investment banking fees continue to flow into a pool of money used to pay analysts.<sup>110</sup> Another article reports that "at some firms, banking and research were still a little too cozy" and companies looking for underwriters "still want to be sure they'll get positive research coverage once their stock is issued."<sup>111</sup> According to the article,

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<sup>103</sup> *Id.* at 11.

<sup>104</sup> *Id.* at 13; *see also* Barber Study at 14.

<sup>105</sup> Madureira at 13. The result of the change in ratings system was that many outstanding recommendations were downgraded. *Id.* at 14. More than 90% of the stocks newly rated pessimistic were rated at least neutral under the old system, and more than 40% of the stocks newly rated neutral were rated at least buy/strong buy under the old system. *Id.*

<sup>106</sup> Susanne Craig & Ann Davis, *Analyze This: Research Is Fuzzier Than Ever*, Wall St. J., Apr. 26, 2004 at C1 (ratings are not comparable across firms because the SRO rules do not require a uniform methodology).

<sup>107</sup> Andrew Ross Sorkin & Jeff Leeds, *Has Wall Street Changed Its Tune?*, June 19, 2005, <http://boycott-riiaa.com/article/17252> (stating that "[t]hroughout Wall Street, research analysts at major investment banks are increasingly showing a new sense of independence"). *See also* Joseph Nocera, *Wall Street on the Run*, June 14, 2004, [http://www.pbs.org/wsw/news/fortunearticle\\_20040614\\_02.html](http://www.pbs.org/wsw/news/fortunearticle_20040614_02.html) (reporting that there have been "plenty of stories about analysts, freed from pressure from bankers, who vetoed important underwriting deals").

<sup>108</sup> Matt Krantz, *IPO underwriters' ratings get tougher, Baidu.com hit*, USA Today, Sept. 14, 2005.

<sup>109</sup> Charles Gasparino, *The Street's Dark Side*, Newsweek (U.S. Edition), Dec. 20, 2004, at 40.

<sup>110</sup> *Id.*

<sup>111</sup> Nocera, *supra* note 107.

research continues to be used to attract banking business.<sup>112</sup> Another article suggests that “change has come more slowly to smaller securities firms.”<sup>113</sup> The article tells the story of one analyst who, after adoption of the SRO Rules, received a voice mail from a banker scolding him for a negative report and threatening that the analyst’s compensation is still determined by investment banking revenue.<sup>114</sup>

A Harvard Business School professor who has studied research analysts said in an interview that even where research is separated from investment banking, conflicts of interest persist.<sup>115</sup> These conflicts arise because (1) sell-side analysts have incentives to hype stocks to generate trading business through large institutional investors who may be clients of the brokerage firm, and (2) once a sell-side analyst has prompted an institutional client to take a large position in a stock recommended by the analyst, the analyst faces a disincentive to downgrade the stock and thereby impact the value of the client’s position.<sup>116</sup>

In addition, while the SRO Rules may have lessened the internal pressure on analysts, there have been a number of reports indicating that analysts are coming under external pressure – retaliation by issuers against analysts who have downgraded their stock.<sup>117</sup> Some say that the regulatory reforms splitting investment banking from stock research could shift the source of pressures from investment banking to the issuers.<sup>118</sup>

### ***Research Coverage Has Diminished***

Several press accounts report that the number of companies covered by research analysts has decreased since the implementation of the Global Settlement and SRO Rules. A recent report says that since 2002, 691 companies have lost analyst coverage altogether and 99% of the

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<sup>112</sup> *Id.* See also *Timing of Stock Issuance Raises Eyebrows After Upgrade*, Wall St. J., Sept. 14, 2005, at C1 (within two days after research analyst upgraded stock, employing firm won the right to lead a stock issue for the company).

<sup>113</sup> Craig, *supra* note 73.

<sup>114</sup> *Id.*

<sup>115</sup> Ann Cullen, *The Bias of Wall Street Analysts*, Oct. 18, 2004, [http://hbswk.hbs.edu/tools/print\\_item.jhtml?id=4430&t=entrepreneurship](http://hbswk.hbs.edu/tools/print_item.jhtml?id=4430&t=entrepreneurship).

<sup>116</sup> *Id.*

<sup>117</sup> Gretchen Morgenson, *You’ll Never Do Research in This Town Again*, N.Y. Times, July 31, 2005, at BU 1 (fear of retaliation from the companies they follow may explain analysts’ unreasoned optimism); Adrienne Baker, *Leader: Spitzer’s Next Challenge?* Apr. 2005, <http://ironthenet.com/feature.asp?current=1&articleID=4048> (in a survey of 732 analysts, 40% said they felt shut out by a firm after they downgraded its equity and another 6% said that companies had threatened to suspend banking relationships following a downgrade); Melissa Lee & John Metexas, *When Companies Behave Badly To Analysts*, Apr. 29, 2004, <http://msnbc.msn.com/id/4816980/print/1/displaymode/1098/>; Richard J. Wayman, *Are Analysts ‘Too’ Independent? Apparently The French Think So*, Jan. 30, 2004, <http://www.researchstock.com/cgi-bin/rview.cgi?c=bulls&rsrc=RC-20040130-F>; Deborah Solomon & Robert Frank, *‘You Don’t Like Our Stock? You Are Off The List’*, Wall St. J., June 19, 2003, at C1; *Corporate Retaliation on Analysts*, Apr. 8, 2003, <http://www.ironthenet.com/static/disclosure/USCanada/CorporateRetaliation0403.htm>.

<sup>118</sup> Solomon & Frank, *supra* note 117.

companies that have lost coverage are smaller companies with a stock market value of less than \$1 billion.<sup>119</sup> According to Reuters Research, as of January 2004, 666 companies in its database of 4,075 had been “orphaned” by sell-side analysts, while in 2002, only 85 companies were left without analyst coverage.<sup>120</sup> Of the companies that have not been orphaned, 380 are down to a pair of analysts, while 473 companies have just one.<sup>121</sup> Similarly, a recent academic study has found that the number of stocks covered by the ten Global Settlement firms has dropped an average of 14% relative to 2000 and 20% relative to 2001.<sup>122</sup> However, three of the ten firms show little change or even an increase in the number of companies they covered pre- and post-settlement.<sup>123</sup>

On the other hand, at least one article indicates that there has been no loss in coverage. In June 2004, First Call, which monitors and distributes analysts’ reports, said that as much research coverage is being generated and that 4,158 companies were being covered, down from 4,257 in June 2002.<sup>124</sup>

To the extent that coverage has diminished, some of the cutback has been attributed to the new regulatory environment, while others say that it is not clear that the new regulations are wholly to blame,<sup>125</sup> and some blame “long-term economic forces.”<sup>126</sup>

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<sup>119</sup> Susanne Craig, *Firm To Research Stock ‘Orphans’*, Wall St. J., June 7, 2005, at C3. See also SIA Research Reports, Vol. VI, No. 9, at 12 (“Panelists also agreed that there appears to be a decline in the coverage of smaller stocks (those with market capitalization lower than \$1 billion), which has a negative impact on capital formation.”); Robert Scott Martin, *Issuer-Paid Research Comes of Age*, Buyside (2005), <http://www.buyside.com/archives/2005/0501/0501fidea.asp> (64% of all publicly traded companies do not have sell-side coverage and if over-the-counter stocks are included, the number jumps to 80%); Ritu Kalra, *Paid-For Research Scores With Investors*, Reuters, July 17, 2004, [http://www.boston.com/business/articles/2004/07/17/paid\\_for\\_research\\_scores\\_with\\_investors/](http://www.boston.com/business/articles/2004/07/17/paid_for_research_scores_with_investors/) (for companies whose market capitalization is less than \$500 million, overall coverage is down by more than 35% since 2001 and nearly 60% of all publicly traded companies in the U.S. get no coverage at all); Lee & Metaxas, *supra* note 93 (Morgan Stanley cut stocks covered in North America by 26% and Merrill by 30%); Landon Thomas Jr., *Changed Smith Barney Is Thin on Analysts*, N.Y. Times, June 13, 2003, at C1 (Smith Barney discontinued coverage – at least temporarily – of close to 250 companies); McCafferty, *supra* note 72 (in 1998, 6,100 companies drew coverage from at least one analyst, but by May 2003, that number was down 30%, to 4,300).

<sup>120</sup> Marie Leone, *The Flight of The Sell-Side Analyst*, July 8, 2004, <http://www.cfo.com/printable/article.cfm/3015019?f=options>.

<sup>121</sup> *Id.*

<sup>122</sup> Boni Study at 4.

<sup>123</sup> *Id.* at 12.

<sup>124</sup> Stone, *supra* note 70 (noting that this decline may reflect the absence of IPOs and merger activity rather than research changes).

<sup>125</sup> Rachel McTague, *Goldschmid Concerned About Reduction In Broker-Dealers’ Budgets For Research*, BNA, Inc., Sept. 21, 2004.

<sup>126</sup> Martin, *supra* note 119.

## *Research Industry Has Changed*

There have been many reports that the “old research model is dead,”<sup>127</sup> although little consensus has emerged as to the new models. Summarized below are some additional reported changes in the research industry, not discussed elsewhere in this section, since the implementation of the SRO Rules and Global Settlement.

- Institutional investors are diverting equity commission dollars away from Wall Street’s traditional research to securing access to analysts and company management.<sup>128</sup>
- There has been a decrease in sell-side research staff and budgets in light of the separation of research from investment banking revenue.<sup>129</sup>
- Sell-side analysts are migrating to the buy-side/money management firms.<sup>130</sup>

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<sup>127</sup> Nocera, *supra* note 107. See also Kyle L. Brandon, *Update on Research Analysts Related Issues*, SIA Research Reports, Vol. VI, No. 5, at 8 (May 27, 2005) (to date, “sell-side firms have not come up with an answer to the question ‘what is the new business model after the global settlement?’”).

<sup>128</sup> James Langton, *Study Shows Institutions Moving Away From Wall St. Research*, July 13, 2005, <http://www.investmentexecutive.com/client/en/News/ImprimerDetail.asp?Id=29645&IdSe>.

<sup>129</sup> SIA Research Reports, Vol. VI, No. 9, at 11 (one panelist estimated that research lost half of its funding with the loss of investment banking revenues at the same time that commission revenue fell by 30%); Mara Der Hovanesian & Amy Borrus, *Can The Street Make Research Pay? In The Eliot Spitzer Era, It’s Looking More and More Like An Expensive Luxury*, Jan. 31, 2005, <http://www.capco.com/print.aspx?page=%2fpress.aspx%3fid%3d536> (research budgets at the seven biggest U.S. securities firms have fallen by more than 40% since 2000); McTague, *supra* note 125 (research budgets are down by as much as one-third at some broker-dealer firms); Leone, *supra* note 120 (the number of sell-side analysts has decreased by 15-20% over the last few years); Adam Piore, *Can Investors Get An Honest Stock Tip On (Or Off) Wall Street?*, Newsweek Int’l, Mar. 2004, <http://www.msnbc.msn.com/id/4468645> (HSBC announced that it would stop picking stocks altogether, declaring the old research model “broken”); Ann Davis, *Increasingly, Stock Research Serves The Pros, Not ‘Little Guy’*, Wall St. J., Mar. 5, 2004, at A1; Daniel Dunaief, *Analysts Abandon Wall St.*, N.Y. Daily News, Feb. 24, 2003, <http://www.nydailynews.com/business/v-pfriendly/story/61941p-57842c.html> (analysts are leaving Wall Street and research has become more bureaucratic in light of new regulations).

<sup>130</sup> Greg Crawford, *Money Managers Beefing Up Their Research Staffs; Search For New Ideas Spurs Firms Into Action*, Investment News, June 20, 2005, at 15 (money managers are beefing up their research staffs and between early 2003 and early 2005, the average research staff at U.S. buy-side institutions increased from 9.3 to 10.5 people); Bill Slocum, *Is There A Future For Wall Street Research?*, June 27, 2003, <http://www.researchstock.com/cgi-bin/rview.cgi?c=outside&rsrc=RA-20030627-F> (in-house equity analysts are being asked to cover more industries and companies than ever before); *Sell Side Gets A Boost*, June 23, 2003, <http://www.ironthenet.com/newsarticle.asp?current=1&articleID=2761> (reporting on the increased pressure on buy-side analysts to cover more industries); Paula Lace, *Sell-Side Analysts Make A Break For The Buy Side*, TheStreet.com, Mar. 5, 2003, <http://www.thestreet.com/markets/paulalace/10072239.html> (the shift to the buy-side could result in making the research industry “even more clubby”).

- Many companies are outsourcing research staff to foreign countries, such as India.<sup>131</sup>
- Research is not going to the small investor, whom the regulations were designed to protect, but to institutional investors.<sup>132</sup>
- Issuer-paid research is on the rise as a result of the loss of coverage.<sup>133</sup>

## V. REVIEW OF RULE PROVISIONS

### A. Analytical Framework for Review

The SRO staffs have conducted a section-by-section review of the SRO Rules to determine whether any additions, deletions or amendments are warranted. In evaluating each provision, the SRO staffs have been guided by several analytical touchstones. First, the SRO staffs looked to the principles that underpinned the original rule development to see if a provision is accomplishing its intended purpose. Second, the SRO staffs reviewed findings from examinations, sweeps and enforcement actions. Third, the SRO staffs considered interpretive requests and member questions. Fourth, the SRO staffs compared the rules to the provisions of the Global Settlement. Fifth, the SRO staffs considered potential gaps or overbreadth in the existing rules. Finally, the SRO staffs considered suggestions from industry groups and members.

### B. Section-by-Section Review

Set out below is a discussion of those provisions for which the SRO staffs recommend amendments or further interpretation to the rules. The SRO staffs believe that the other provisions of the SRO Rules are operating effectively and efficiently in achieving their purpose,

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<sup>131</sup> Der Hovanesian & Borrus, *supra* note 129; Davis, *supra* note 129; Khozem Merchant & David Wells, *Banks Move Analysts' Work To India*, Financial Times (London), Aug. 20, 2003, at 1.

<sup>132</sup> Davis, *supra* note 129 (“the most pioneering, market-moving research is going exclusively to big mutual funds and the private investment pools known as hedge funds”).

<sup>133</sup> SIA Research Reports, Vol. VI, No. 9, at 12 (summarizing panel discussion on the issue of “made-to-order” research tailored to meet client requests); Martin, *supra* note 119 (paid-for researchers “have taken strict measures to keep their work as independent as humanly possible”); Kalra, *supra* note 119 (portfolio managers are overcoming their skepticism of issuer-paid research, citing impressive performance and access to information on companies large Wall Street investment banks do not cover); Melissa Lee & John Metaxas, *Beware of Wall St. 'Research For Hire'*, Apr. 28, 2004, <http://www.msnbc.msn.com/id/4816907/print/1/displaymode/1098/> (current regulations are not strong enough to protect investors vis-à-vis research for hire and if an analyst is not associated with a broker-dealer, perhaps “caveat emptor” should apply); Ann Davis, *Wall Street, Companies It Covers, Agree on Honesty Policy*, Wall St. J., Mar. 11, 2004, at C1 (discussing best practices guidelines that were a joint effort between the Association for Investment Management and Research and the National Investor Relations Institute); Lynn Cowan, *Research-For-Hire Shops Growing, Seeking Legitimacy*, Wall St. J. Online, July 7, 2003, [http://online.wsj.com/article\\_print/0,,BT\\_CO\\_20030707\\_001632,00.html](http://online.wsj.com/article_print/0,,BT_CO_20030707_001632,00.html); Thomas S. Mulligan, *Ignored by Wall St., Firms Turn To Research-For-Hire Outfits; As The Fee-Based Industry Tries To Fill The Gap Left By The Withdrawal of Analyst Coverage, Some Experts Have Reservations*, Los Angeles Times, June 3, 2003; McCafferty, *supra* note 72.

and therefore no changes are recommend to those provisions at this time. In making the recommendations, the SRO staffs are mindful that consideration must be given to the mandates of Sarbanes-Oxley and that, in certain instances, implementing the recommendation may require an exemption from the SEC. The SRO staffs did not attempt to address every interpretive issue that may be outstanding and will continue to entertain interpretive requests on a case-by-case basis and to publish, as warranted, additional joint memoranda setting forth key interpretations.

## **1. Definitions**

### ***Current Rules***

The SRO Rules currently include the following defined terms:

“Public appearance” means any participation in a seminar, forum (including an interactive electronic forum), radio, television or print media interview, or other public speaking activity, or the writing of a print media article, in which a research analyst makes a recommendation or offers an opinion concerning an equity security.

“Research report” means a written or electronic communication that includes an analysis of equity securities of individual companies or industries, and that provides information reasonably sufficient upon which to base an investment decision.

“Research analyst” means 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.”

### ***Recommended Changes***

The SRO staffs recommend several changes to the definitions in NASD Rule 2711 and NYSE Rule 472 to make certain interpretations express in the rule language and to circumscribe the scope of communications subject to the SRO Rules.

#### “Public Appearance”

The SRO staffs recommend amending the definition of “public appearance” to codify an interpretation consistent with SEC Regulation AC that the term applies only to appearances involving 15 or more separate investors. The SRO staffs further recommend that the definition also codify an exception to that interpretation contained in NASD *Notice to Members* 04-18 and NYSE Information Memo 04-10: that it excludes password-protected Webcasts, conference calls and similar events with 15 or more existing customers, provided that the participants previously received the most current research report or other documentation that includes the disclosures required by the SRO Rules and that the research analyst making the appearance corrects or updates any disclosures that are inaccurate, misleading or no longer applicable.

#### “Research Report”

The SRO staffs recommend several amendments to the definition of “research report.”

First, the SRO staffs suggest codifying the various exceptions to the definition set forth in the two joint interpretive memoranda.<sup>134</sup> These exceptions essentially parallel those in SEC Regulation AC and the Global Settlement and are set forth below:

- reports discussing broad-based indices, such as the Russell 2000 or S&P 500 index;
- reports commenting on economic, political or market (including trading) conditions;
- technical or quantitative analysis concerning the demand and supply for a sector, index or industry based solely on trading volume and price;
- reports that recommend increasing or decreasing holdings in particular industries or sectors or types of securities;
- statistical summaries of multiple companies' financial data and broad-based summaries or listings of recommendations or ratings contained in previously-issued research reports, provided that such summaries or listings do not include any narrative discussion or analysis of individual companies; and
- notices of ratings or price target changes that do not contain any narrative discussion or analysis of the subject company, provided that the member simultaneously directs the readers of the notice as to where to obtain the most recent research report on the subject company that includes the disclosures required by the rule, and the notice does not refer to a research report that contains materially misleading disclosure, such as where the disclosures are outdated or no longer applicable.

In addition, the SRO staffs recommend codifying two other exceptions to the definition of "research report" contained in the March 2004 Joint Memorandum and SEC Regulation AC. These exceptions exclude certain communications even if they include information reasonably sufficient upon which to base an investment decision or a recommendation or rating of individual securities or companies:

- any communication delivered to fewer than 15 persons; and
- periodic reports, solicitations or other communications prepared for current or prospective investment company shareholders (or similar beneficial owners of trusts and limited partnerships) or discretionary investment account clients that discuss individual securities, provided that such communications discuss past performance or the basis for previously made discretionary investment decisions.

Second, the SRO staffs recommend explicitly excluding from the definition sales material regarding registered investment companies and direct participation programs ("DPPs"). Since investment companies and DPPs are "equity securities" as defined in Section 3(a)(11) of the Securities Exchange Act of 1934, related sales material that contains an analysis of those

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<sup>134</sup> See NASD *Notices to Members* 02-39 (July 2002) and 04-18 (Mar. 2004) and NYSE Information Memos 02-26 (June 26, 2002) and 04-10 (Mar. 9, 2004).

securities and information sufficient upon which to base an investment decision technically is covered by the definition. Yet sales material regarding investment companies is already subject to a separate regulatory regime, including NASD Rule 2210, NYSE Rule 472 and SEC Rule 482, and all advertisements and sales literature regarding investment companies and DPPs must be filed with the NASD Advertising Regulation Department. Moreover, the SRO staffs do not believe that the conflicts underpinning the SRO Rules are manifest to the same extent with respect to research on investment companies and DPPs.

Third, the SRO staffs recommend codifying a longstanding interpretation that communications that constitute prospectuses under the Securities Act of 1933, including free-writing prospectuses as defined under the SEC's recent Securities Offering Reform rules,<sup>135</sup> are not considered "research reports," even if they meet the definitional elements. Such prospectuses facilitate differing purposes from research reports and are subject to a separate comprehensive regulatory scheme.

#### "Research Analyst"

Several industry members have urged the SROs to amend the definition of "research analyst" to exclude any member personnel who are not principally engaged in the preparation or publication of research reports – a limitation contained in the Global Settlement. The SRO Rules, in accordance with the mandates of Sarbanes-Oxley, are constructed such that the author of a communication that meets the definition of a "research report" is a "research analyst," irrespective of his or her title or primary job. This prevents firms from circumventing the rules by redirecting through other channels, such as registered representatives or traders, potentially biased research that is not subject to the SRO objectivity safeguards.

The SRO staffs believe it is important to maintain such communications as research reports subject to the rules and those principally responsible for their preparation as research analysts. However, the SRO staffs recommend consideration of a limited exemption from the registration requirements for non-research personnel that produce research reports. The SRO staffs believe that the registration and qualification requirements were intended for those individuals whose principal job function is to produce research, while the balance of the SRO Rules are intended to foster objective analysis of equity securities and transparency of certain conflicts and to provide beneficial information to investors.

## **2. Restrictions on Investment Banking Department Relationship with Research Department**

### ***Current Rules***

The SRO Rules permit investment banking and other non-research employees, other than legal and compliance personnel, to review a research report before publication only to verify the factual accuracy of information in the report or identify a potential conflict of interest. The rules further require that an authorized legal or compliance official act as intermediary for all such permissible communications.

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<sup>135</sup> Securities Offering Reform, Securities Act Release No. 8591 (July 19, 2005), 70 FR 44722 (Aug. 3, 2005).

### ***Recommended Changes***

The SRO staffs recommend eliminating the provision that permits pre-publication review of research by investment banking and other non-research personnel, other than by legal and compliance. The SRO staffs believe that review of facts in a report by investment banking personnel is unnecessary in light of the numerous other sources available to verify factual information and only raises concerns about the objectivity of the report. Such review may invite pressure on a research analyst from investment banking personnel that could be difficult to monitor.<sup>136</sup>

The SRO staffs note that such factual review is not permitted under the terms of the Global Settlement. Moreover, legal and compliance can adequately perform a conflict review without sharing draft research reports with investment banking personnel.

### **3. Restrictions on Solicitation of Investment Banking Business**

#### ***Current Rules***

The SRO Rules prohibit research analysts from participating in efforts to solicit investment banking business, including pitch meetings with prospective clients.

#### ***Recommended Changes***

This provision, which mirrors language in the Global Settlement, strikes at a core conflict that can compromise research analysts' objectivity when they and their research are utilized to win business rather than provide dispassioned analysis. While the SRO staffs believe this provision is operating effectively, some members have asked for additional guidance regarding references to research analysts and research in pitch books and related meetings. The SRO staffs note that the SEC has provided interpretive guidance to the parallel provisions of the Global Settlement and concluded that it would be inconsistent with the purpose of the solicitation ban to include in a pitch book or related presentation materials any information regarding an analyst employed by a firm or an analyst's views. The SRO staffs generally agree with that guidance and intend to address this area in more detail in a future interpretive memorandum.

### **4. Restrictions on Sales and Marketing Activities**

#### ***Current Rules***

The SRO Rules prohibit research analysts from participating in road shows related to investment banking services transactions and from engaging in any communications regarding investment banking services transactions with current or prospective customers in the presence of investment banking personnel or company management. Investment banking personnel also are prohibited from directing a research analyst to engage in sales or marketing efforts or to engage in any communication with a current or prospective customer related to investment banking transactions.

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<sup>136</sup> See, e.g., Craig, *supra* note 73.

## ***Recommended Changes***

This provision, which is substantially the same as a comparable provision in the Global Settlement, seeks to address potential conflicts of interest during the period that firms market securities offerings for issuers. While the SRO staffs believe this provision is operating effectively, some members have asked for additional guidance on whether research analysts can listen to or view an investment banking or company-sponsored road show or other presentation to investors or the analysts' sales force.

The SRO staffs note that the SEC has provided interpretive guidance on the parallel provision of the Global Settlement and concluded that it would not be inconsistent with this provision to permit research analysts to listen to ("listen-only" mode, not identified as being present), or view a live Webcast of a road show or other widely attended presentation to investors or the sales force, so long as access is from a remote location (*i.e.*, not at the same address as investment banking, investors or the sales force). The SEC has further stated that if the road show or other widely attended presentation to investors or the sales force is conducted at the firm's offices, research personnel may listen-in from the same address as investment banking, investors or the sales force, but may not be in the same room as investment banking, investors or the sales force. The SRO staffs generally agree with that guidance and intend to address this area in more detail in a future interpretive memorandum.

### **5. Restrictions on Publishing Research Reports and Public Appearances**

#### ***Current Rules***

The SRO Rules set forth, in accordance with the mandates of Sarbanes-Oxley, "quiet periods" during which a member is prohibited from publishing or otherwise distributing a research report and a research analyst is prohibited from making a public appearance. These quiet periods apply in two circumstances: (1) after a public offering of securities and (2) before and after the expiration, waiver or termination of a lock-up agreement entered into by a member with a subject company that restricts the sale of securities by that company or its shareholders.

With respect to the former, the SRO Rules establish different quiet periods depending on whether the offering is an IPO or secondary offering and whether the member acted as manager or co-manager. A member that acted as a manager or co-manager of an IPO may not publish or otherwise distribute research for 40 calendar days following the date of the offering; all other members that participated as an underwriter or dealer in the offering are subject to a 25-day quiet period. A ten-day quiet period applies only to the manager and co-manager of a secondary offering.

The rules contain an exception that permits publication and distribution of research or a public appearance concerning the effects of "significant news or a significant event on the subject company" during the quiet period. The SRO staffs have interpreted this exception to apply only to news or events that have a material impact on, or cause a material change to, a company's operation, earnings or financial condition. Another exception to the secondary offering quiet period permits publication or distribution of research pursuant to SEC Rule 139 regarding a subject company with "actively-traded securities" as defined in SEC Regulation M.

## ***Recommended Changes***

The SRO staffs recommend several changes to the quiet periods surrounding public offerings and lock-up expirations. In some cases, the SRO staffs offer alternative recommendations to address these issues.

### *(a) Quiet periods following public offerings of securities*

The SRO staffs recommend unifying the IPO quiet periods for all underwriters and dealers participating in the offering and tying them to the SEC's rules regarding publication and distribution of research. As such, the SRO staffs recommend amending the rules to apply a 25-day quiet period to managers, co-managers, underwriters and dealers that participate in an IPO, unless publication or distribution of the report or the public appearance is permitted by SEC rule or interpretation.

The lengthier quiet period for managers and co-managers was intended to allow other voices to publicly analyze and value a subject company before managers and co-managers – those members vested with the greatest interest in seeing the stock price of the subject company go up – weighed in with their reports and public appearances. At the time this provision was enacted, it had been commonplace for managers and co-managers to initiate coverage with a positive rating on a company they just brought public, irrespective of whether the stock price had already risen well beyond the public offering price.

However, the SRO staffs recently have observed more circumstances where managers and co-managers have been neutral or even negative with their initial post-quiet period report based on price appreciation or other factors. Accordingly, the SRO staffs believe that the objectivity safeguards of the SRO Rules and the certification requirement of SEC Regulation AC have obviated the need for a longer quiet period for managers and co-managers than other underwriters and dealers participating in an IPO. The SRO staffs also believe the change would promote more information flow to investors and consistency with SEC regulations.

For some of the same reasons, the SRO staffs also recommend eliminating the quiet periods following a secondary offering. Coupled with the protections of SEC Regulation AC and other SRO Rule provisions, the SRO staffs believe that repeal of this provision would advance the SEC's purpose in its Securities Offering Reform rules to expand the ability of issuers to release more information regarding their prospects and financial condition, without sacrificing the reliability of the research. Along those lines, the existing SRO Rules already provide exceptions for research reports on issuers with "actively-traded securities" as defined in SEC Regulation M.

### *(b) Quiet periods around releases of lock-up agreements*

The NASD staff recommends eliminating the quiet periods around the expiration, waiver or termination of a lock-up agreement, provided members include an additional statement as part of their SEC Regulation AC certification – or, alternatively, a separate certification – for research issued during such periods. The quiet periods surrounding lock-up releases are intended to prevent abusive "booster shot" reports by members to raise the stock price of a company just before previously locked-up shares become freely saleable into the market by a company or its major shareholders. While the SRO staffs continue to share the concern expressed by the former

Acting Chair of the SEC<sup>137</sup> that these periods pose heightened concerns about biased research, the changes to internal structure of investment banks and the other safeguards imposed by the rules appear to the NASD staff to have addressed these concerns, and have obviated the need for a quiet period that inhibits the flow of information to the marketplace. Moreover, the NASD staff believes that practical limitations inhibit effective administration of the provision. Most notably, the SRO Rules do not require lock-up agreements, and the SROs often have no jurisdiction over parties to them, including the subject company and its non-member shareholders. The SROs therefore cannot always be the arbiter of whether certain facts constitute, for example, a waiver or termination of a lock-up – a significant impediment to the SROs’ ability to enforce this provision.

The NASD staff notes that under no circumstances are overly optimistic reports acceptable, whether or not they occur around the expiration of a lock-up. To that end, the SRO Rules require a reasonable basis for any recommendation or price target and the valuation method used to determine a price target, while SEC Regulation AC requires certification that any such recommendation or price target be genuinely held. Accordingly, the NASD staff believes an effective alternative to the quiet periods would be to require that members include under Regulation AC, or separately, an additional certification to having a bona fide reason for issuing research within 15 days before and after a lock-up expiration.

On the other hand, the NYSE staff believes that the quiet period surrounding the expiration, termination or waiver of a lock-up agreement should be maintained but perhaps reduced from the current 15-day period to a five-day period. The NYSE staff believes that the regulatory concerns that precipitated the promulgation of the prohibitions are still present. That is, the NYSE staff is concerned that, absent a quiet period around the release of lock-up agreements, member firms may issue “booster shot” reports that are intended to raise the stock price of a company just before locked-up shares become freely saleable into the market by a company or its major shareholders. The NYSE staff believes that, while the certification requirement of SEC Regulation AC may have obviated the need for a longer quiet period for managers and co-managers than other underwriters and dealers participating in an IPO, it does not support the elimination of quiet periods around the release of lock-up agreements.

With respect to operational issues, the NYSE staff observes that the comments and concerns initially made at the time of the rule proposal have not materialized. In this regard, there have not been instances when the NYSE staff has found co-managers to have inadvertently published research in violation of the quiet periods surrounding the waiver of lock-up agreements granted by lead managers.<sup>138</sup>

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<sup>137</sup> Unger Testimony, *supra* note 5, at 229, 235.

<sup>138</sup> The NYSE/NASD IPO Advisory Committee made the following recommendations: (1) require prospectuses to include a clear description of lock-up agreements and whether the underwriter expects to grant exceptions relating to hedging or other transactions; and (2) require improved disclosure regarding exemptions by an underwriter to an IPO lock-up agreement, by mandating that underwriters notify issuers prior to granting any exemption to a lock-up, and require issuers to file a current report on Form 8-K at least one business day prior to the time the insider commences the transaction, and also that prior to the transaction, the lead underwriter announces the exemption by broad communications to the investment community through a major news service. *See also* Securities Exchange Act Release No. 50896 (Dec. 20,

Moreover, the NYSE staff notes that while the NYSE may not have jurisdiction over some of the participants to such agreements (*e.g.*, the company and its shareholders), it does retain jurisdiction over its member organizations that can issue research and as such can limit the potential for any untoward conduct by maintaining this prohibition.

Lastly, the NYSE staff notes the recent strength of the IPO market<sup>139</sup> and that such offerings generally contain lock-up agreements. Accordingly, it believes that at this juncture it is appropriate to maintain a form of prohibition absent some compelling empirical data/evidence to the contrary.

(c) *Exceptions to quiet periods*

As noted above, the rules contain an exception that permits publication and distribution of research or a public appearance concerning the effects of “significant news or a significant event on the subject company” during the quiet period. The SRO staffs have interpreted this exception to apply only to news or events that have a material impact on, or cause a material change to, a company’s operations, earnings or financial condition and that generally would trigger the filing requirements of SEC Form 8-K. The SROs have not interpreted the exception to include earnings announcements absent some other significant news or significant event because it was felt that they generally are not a causal event or news items that materially affects a company’s operations, earnings or financial condition.

The NYSE staff believes that exceptions to quiet periods should be consistent with SEC requirements for the filing of Forms 8-K. In this regard, Item 2.02 (Results of Operations and Financial Conditions) of Form 8-K requires, in part, a filing of such form if a registrant makes any public announcement or release (including any update of an earlier announcement or release) disclosing material non-public information regarding its results of operations or financial condition. Accordingly, the NYSE staff recommends including an announcement of earnings as an exception to the quiet periods as it will be consistent with SEC requirements and maintain a flow of potentially sensitive information to the market and investors in a timely manner.<sup>140</sup> The NYSE staff also believes that an announcement of a change to earnings will, in all likelihood, be accompanied by an announcement of some type of causal events. Further, earnings announcements and guidance are necessary pipelines of information for research analysts to support the basis of their investment recommendations.

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2004), 69 FR 77804 (Dec. 28, 2004) (notice of filing of proposed NYSE Rule 470 and NASD Rule 2712 which would codify, in part, the above recommendations) (SR-NYSE-2004-12 and SR-NASD-2003-140).

<sup>139</sup> In 2005, there have been 61 IPOs so far that have listed on the NYSE. In 2004, there were 69 NYSE-listed IPOs. Further, in a recent *Wall Street Journal* article, it was noted that “there are 115 initial public offerings of stock valued at \$20.9 billion waiting to price in the U.S. in 2006, according to data from deal tracker Dealogic LLC.” Lynn Cowan, *IPO Market Looks Strong in 2006*, *Wall St. J.*, Dec. 19, 2005, at C4.

<sup>140</sup> The SEC recognized the importance of timely dissemination of information to the marketplace in its recent amendments to Form 8-K in which it shortened the filing deadline to four business days after the occurrence of an event triggering the disclosure requirements of the form. *See Securities Act Release No. 8400 and Securities Exchange Act Release No. 49424* (Mar. 16, 2004), 69 FR 15594 (Mar. 25, 2004).

The NASD staff does not believe it is necessary to revise the quiet period exceptions to include any event that triggers the filing of a Form 8-K. The NASD staff continues to believe that earnings announcements are not causal occurrences that, in and of themselves, connote significant news or significant events that materially impact a subject company's financial condition or operations. Moreover, in the NASD staff's experience, abolition of the quiet periods around releases of lock-up agreements would largely obviate the need to expand the "significant news" exception. These issues have arisen mainly because an earnings announcement has occurred or will occur within 15 days of the expiration, waiver or termination of a lock-up agreement. As noted above, the NASD staff further believes that abolition of the quiet periods around releases of lock-up agreements would increase information flow to the marketplace.

## **6. Restrictions on Personal Trading by Research Analysts**

### ***Current Rules***

NASD Rule 2711(g) and NYSE Rule 472(e) generally restrict the trading of securities by "research analyst accounts."<sup>141</sup> Specifically, NASD Rule 2711(g) and NYSE Rule 472(e) prohibit any research analyst account from:

- purchasing or receiving any securities before the issuer's initial public offering if the issuer is principally engaged in the same types of business as companies that the research analyst follows;
- purchasing or selling any security issued by a company that the research analyst follows, or any option or derivative of such a security, for a period beginning 30 days before and ending five days after the publication of a research report concerning the company or a change in a rating or price target of the company's securities; and
- purchasing or selling any security or option or derivative of such a security in a manner inconsistent with the analyst's most recent recommendation.

The rules include exceptions to these trading restrictions for certain trades that:

- are due to unanticipated significant changes in an analyst's personal financial circumstances;
- occur within the 30-day/five-day trading blackout around the publication of a report if the report is issued due to a significant news event;

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<sup>141</sup> NASD Rule 2711(a)(6) defines the term "research analyst account" to include any account in which a research analyst or member of the analyst's household has a financial interest, or over which the analyst has discretion or control, other than an investment company registered under the Investment Company Act of 1940. The term does not include a "blind trust" account that is controlled by a person other than the research analyst or household member and neither the analyst nor any household member knows of the account's investments or investment transactions. Although NYSE Rule 472 does not employ the term "research analyst account," the trading restrictions of NYSE Rule 472(e) and NASD Rule 2711(g) are coterminous. *See* NYSE Rule 472.40.

- occur within 30 days after an analyst initiates coverage of a company;
- involve shares of diversified registered investment companies; and
- involve interests in an investment fund over which neither the analyst nor a household member has any investment discretion or control, the research analyst accounts collectively own no more than 1% of the fund's assets, and the fund invests no more than 20% of its assets in securities of issuers principally engaged in the same types of business as companies that the analyst follows.

NASD Rule 2711(g) and NYSE Rule 472(e) also require legal or compliance personnel to pre-approve all trades of persons who oversee research analysts to the extent such trades involve equity securities of subject companies covered by the analysts they oversee.

### ***Recommended Changes***

Members have suggested the SROs make two principal changes to the personal trading restrictions. First, members have urged the SROs to expand the exceptions to the personal trading restrictions to include any investments in funds not controlled by the research analyst or member of his or her household, regardless of whether the fund is registered as an investment company and regardless of its holdings. Second, some members that wish to go beyond the SRO Rules and ban ownership of securities covered by their analysts have asked the SROs to provide a means for those analysts to divest their holdings without violating the blackout period and trading against recommendation prohibitions.

The SRO staffs generally agree with these comments and therefore recommend the following changes to the exceptions to the SRO Rules' personal trading restrictions.

First, the SRO staffs recommend revising the exceptions to the personal trading restrictions for investment funds. The current rules do not apply the personal trading restrictions to investments in diversified registered investment companies and funds that meet certain percentage-of-assets tests. The SRO staffs recommend that the personal trading restrictions instead not apply to investments in any fund so long as neither the analyst nor a member of his or her household is aware of the fund's holdings or transactions other than through periodic shareholder reports and sales material based on such reports, and provided that the research analyst account owns no more than 1% of the assets of the fund.

This would simplify the ability of analysts to invest in mutual funds, variable insurance products and hedge funds that do not disclose their holdings other than through periodic reports or sales material based on such reports. The SRO staffs believe that absent discretion or control of an account or the contemporaneous knowledge of the account's transactions, a minimal investment by a research analyst will not tempt the analyst to compromise research objectivity to benefit the account.

Second, the SRO staffs recommend creating an exemption for firms that voluntarily choose to prohibit their analysts from owning shares of the companies they cover. The exemption would allow such a firm to adopt policies that permit research analysts to divest their holdings in an

orderly and controlled way with the oversight of the firm's legal and compliance personnel. The SRO staffs permitted firms to allow their analysts to divest their holdings in the same manner when the rule first became effective by delaying for a certain time period implementation of the personal trading restrictions for firms that wished to ban ownership. With the recommended change, the rule would allow firms that adopt ownership bans to implement the same divestiture procedures regardless of when they adopted such a policy.

## **7. Disclosure Requirements**

### ***Current Rules***

NASD Rule 2711(h) and NYSE Rule 472(k) impose a number of disclosure requirements on member research reports and research analyst public appearances in which the analyst makes a recommendation or offers an opinion concerning an equity security. The rules require specific disclosures of conflicts of interest, including where the member firm, the research analyst or a member of the analyst's household has a financial interest in the subject company's securities or the member or its affiliates have received compensation from the subject company. The rules also require a number of non-conflicts related disclosures in research reports, including the meanings of ratings used in the member's rating system, the distribution of buy, hold, and sell ratings assigned by the member, and a price chart that plots the assignment or changes of the analyst's ratings and price targets for the subject company against the movement of the subject company's stock price over time.

### ***Recommended Changes***

The SRO staffs have found that these required disclosures promote transparency and provide important information to enable investors to assess the value of the research in making their investment decision. However, the SRO staffs are concerned that the sheer volume of the disclosures may obscure the overall message that the disclosures are attempting to convey: that the member or research analyst faces conflicts of interest with respect to the subject company. This problem is compounded by the fact that many members include additional disclosures required by other jurisdictions, as well as sometimes lengthy disclaimers for their own purposes. The SRO staffs believe that it would be more effective and useful to investors to know immediately whether the member firm or research analyst producing the research report is conflicted, while providing the reader the means to learn more about these conflicts if he or she chooses to do so.

To accomplish this result, the SRO staffs recommend amending the rules to require that, in lieu of publication in the research report itself, member firms disclose their conflicts of interest related to research reports by including a prominent warning on the cover of a research report that such conflicts of interest exist, together with information on how the reader may obtain more detail about these conflicts on the member's Web site. A member would then be required to include detailed conflicts information on its Web site. The SRO staffs believe that this disclosure system would be more effective to warn the reader of such conflicts than the current system of disclosing all conflicts in the back of the report.

The SEC has considered using this approach elsewhere to disclose the existence of conflicts of interest to investors. For example, the SRO staffs understand that in its mutual fund point-of-sale disclosure proposal,<sup>142</sup> the SEC staff found that most investors only want to know about whether a conflict exists, rather than receiving quantitative or lengthy disclosure about the precise nature of those conflicts. For that reason, the SEC has proposed requiring a “Yes/No” disclosure of whether a dealer receives revenue sharing or pays differential compensation with respect to the sale of mutual funds. The SEC would require that more detailed disclosure about the nature of any conflicts be provided separately on a mutual fund’s Web site.

Similarly, in commenting on the SEC point-of-sale disclosure proposal, the NASD Mutual Fund Task Force recommended Internet delivery of point-of-sale documents and prospectuses, a recommendation that NASD supports.<sup>143</sup> The Task Force argued that Internet delivery would enable investors to obtain the level of disclosure that they wanted in electronic form.

The SRO staffs believe that the research analyst conflict of interest rules similarly lend themselves to a more targeted means of disclosure. The SRO staffs therefore suggest amending the SRO Rules to require conflicts of interest disclosure along the lines of the SEC’s point-of-sale proposal and NASD’s Internet delivery recommendations for mutual fund related disclosures. This disclosure requirement would ensure that investors obtain prominent disclosure that a research-related conflict exists, and would permit investors to find additional information about the conflict on the member’s Web site. It is possible that a similar approach could be used for disclosure of conflicts in public appearances, as long as the existence of such conflicts is clearly communicated.

The SRO staffs generally do not believe that vague, so-called “health warnings” that conflicts of interest “may or may not” exist are useful or effective. In this regard, the SRO Rules would still require disclosure based on actual conflicts of interest, rather than the possibility of such conflicts.

The SRO staffs do not recommend Web site disclosure for the non-conflicts related disclosures, such as the meanings of the member’s ratings and the price chart showing the subject company’s price movements against the analyst’s assignments of ratings and price targets. The SRO staffs believe that these disclosures provide useful information that should be readily available to investors, particularly since they would not be encompassed by the recommended conflict warning on the cover of the report.

Finally, the SRO staffs recommend the inclusion of non-substantive, technical changes to certain disclosure requirements in order either to codify past SRO interpretations of the rules or to clarify the rules’ intent. For example, a research report is required to disclose the meanings of ratings used in the member’s ratings system only if the report actually includes a rating of the subject company. Similarly, a price chart is not required for reports that do not include a rating or price target. In addition, the SRO staffs recommend including the disclosure requirements for third-party research reports, which are discussed in NASD *Notices to Members* 02-39 (July

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<sup>142</sup> Securites Act Release No. 8544 (Feb. 28, 2005), 70 FR 10521 (Mar. 4, 2005).

<sup>143</sup> Report of the Mutual Fund Task Force: Mutual Fund Distribution (Mar. 2005), [http://www.nasd.com/web/groups/rules\\_regs/documents/rules\\_regs/nasdw\\_013690.pdf](http://www.nasd.com/web/groups/rules_regs/documents/rules_regs/nasdw_013690.pdf).

2002) and 04-18 (Mar. 2004) and NYSE Information Memos 02-26 (June 26, 2002) and 04-10 (Mar. 9, 2004), in the SRO Rules' text.

## **8. Prohibition on Retaliation Against Research Analysts**

### ***Current Rules***

The SRO Rules currently prohibit any member and any employee of a member who is involved with the member's investment banking activities from directly or indirectly retaliating against a research analyst as a result of an unfavorable research report or public appearance that may adversely affect the member's current or prospective investment banking relationship with a subject company.

### ***Recommended Changes***

The SRO staffs believe that under no circumstances is retaliation appropriate against a research analyst who expresses his or her truly held beliefs about a subject company. As such, the SRO staffs recommend amending this provision to extend the retaliation prohibition to all employees, not just those involved in investment banking activities.

## **9. Prerequisites for the Research Analyst Qualification Examination**

### ***Current Rules***

As detailed in Section II, the SRO Rules require an associated person who functions as a research analyst on behalf of a member to register as such and pass the Research Analyst Qualification Examination (Series 86/87) or qualify for an exemption. Prior to taking either the Series 86 or 87, a candidate also must have passed the General Securities Registered Representative Examination (Series 7), the Limited Registered Representative Examination (Series 17), or the Canada Module of Series 7 (Series 37 or 38).

The SRO staffs believe it is important for those functioning as research analysts to be familiar with general industry rules and practices, particularly those of registered representatives, who are a primary source for distributing research. The SRO staffs believe that the topics on the Series 7 and other eligible prerequisite examinations further develop a sensitivity in research analysts to the interests of public customers who are the end users of their work product. The SRO staffs note that a committee of research analysts who were consulted in the development of the Series 86/87 examination program unanimously recommended that research analysts be required to pass the Series 7 in addition to a more job-specific research analyst qualification examination.

### ***Recommended Changes***

Several industry members have asked the SROs to consider eliminating the Series 7 or alternative prerequisite exam. These firms argue that research analysts should only be tested on job-specific requirements, and that relevant topics on the Series 7 examination should instead be imported to the Series 86/87 examinations. The SRO staffs recommend considering this suggestion, as well as the possibility of substituting for the Series 7 prerequisite a new Capital Market Professional Examination that is being developed jointly by NASD, the NYSE and

regulators in the United Kingdom. While the content of the latter examination has not yet been precisely determined, it is anticipated that the concepts tested may provide an adequate foundation of general industry rules and practices for research analysts. The SRO staffs will be better situated to evaluate this alternative once the new examination has been fully developed and approved by the SEC.

## C. Other Issues

### 1. **Fixed-Income Research**

On May 19, 2004, The Bond Market Association (“BMA”) issued its “Guiding Principles to Promote the Integrity of Fixed Income Research,” which are voluntary principles designed to help firms manage potential conflicts of interest that may arise in their fixed-income research activities.<sup>144</sup> According to the BMA, its Guiding Principles were designed to recognize the significant differences between fixed-income research and equity research, as well as the important differences in research regarding individual fixed-income asset classes.

The SRO staffs do not believe it is appropriate at this time to codify any of these principles or amend the SRO Rules to extend their provisions to fixed-income research. Instead, the SROs are monitoring the extent to which firms have adopted the BMA Guiding Principles and will consider further rulemaking after assessing the effectiveness of voluntary compliance. Meanwhile, the SRO staffs believe that the anti-fraud statutes, as well as existing SRO rules, such as NASD Rule 2110’s requirement that members “observe high standards of commercial honor and just and equitable principles of trade” and similar obligations under NYSE Rules 401 and 476(a)(6), can reach any egregious conduct involving fixed-income research.

### 2. **Issuer Retaliation**

As noted above, the source of analysts’ conflicts was not limited solely to their investment banking relationships, but also included pressure stemming from issuer retaliation. Issuer retaliation can consist of limiting an analyst’s access to company management or participation in conference calls, and interfering with other company relationships (such as by prohibiting the analyst’s firm from managing an issuer’s pension plan). The SRO Rules have insulated analysts from internal pressures from investment banking personnel by prohibiting retaliation by a member against a research analyst for issuing an unfavorable research report that adversely affects a firm’s investment banking relationship with an issuer. The prohibition against investment banking personnel’s supervising or controlling analysts or participating in the determination of analyst compensation also protects the analyst from retaliation by the investment banking department.

Protection from retaliation by an issuer rather than the investment bank is a more difficult problem to solve. The issue could be addressed through listing standards. However, the NYSE does not believe amendments to its listing standards and its limited ability to enforce such standards by delisting is practicable. In this regard, issuer retaliation, unlike other prohibited

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<sup>144</sup> See Guiding Principles To Promote Integrity of Fixed Income Research, May 2004, [http://www.bondmarkets.com/assets/files/Guiding\\_Principles\\_for\\_Research.pdf](http://www.bondmarkets.com/assets/files/Guiding_Principles_for_Research.pdf).

firm conduct, is very fact specific, qualitative rather than quantitative in nature and difficult to evaluate and discern with absolute certainty.

Accordingly, the NYSE would like to see the practical impact of the CFA/NIRI “Best Practice Guidelines Governing Analyst/Corporate Issuer Relations” which it has endorsed and communicated to its listed companies.<sup>145</sup> It will continue to monitor the impact of such Best Practices and will continue to engage the SEC in dialogue to explore other practical ways to address this issue.

### 3. Foreign Regulatory Initiatives

In addition to the SROs, regulators in such jurisdictions as the United Kingdom,<sup>146</sup> Canada,<sup>147</sup> Japan,<sup>148</sup> and Australia<sup>149</sup> have implemented or proposed research analyst conflict of interest rules in some form. Organizations such as the International Organization of Securities Commissions (“IOSCO”) also have issued guidelines and best practices for their members.<sup>150</sup> And the European Union Forum Group (“EU”) released a set of recommendations involving research analyst conflicts to be included in a directive targeting market abuse and promoting uniform regulations among the different European Union securities markets.<sup>151</sup>

These regulatory models share a common goal of reducing bias in the production and dissemination of research. At the same time, the various initiatives by these regulatory groups demonstrate that there are a number of approaches to eliminating research analyst conflicts: some organizations, like IOSCO and the EU, recommend best practices but do not impose

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<sup>145</sup> The NYSE recently issued a letter to its listed companies encouraging them to consider implementing CFA/NIRI Best Practice Guidelines Governing the Relationship between Analysts and Corporate Issuers. *See* letter dated October 11, 2005 from Richard G. Ketchum, Chief Regulatory Officer, NYSE, to Exchange Listed Companies.

<sup>146</sup> Regulations by the Financial Services Authority, “Discussion Paper No. 15” and “Consultation Paper 171,” July 2002 and December 2003, respectively.

<sup>147</sup> Report issued by Securities Industry Committee on Analyst Standards, which was established by the Toronto Stock Exchange, the Investment Dealers Association (“IDA”) and the Canadian Venture Exchange. The report, entitled “Setting Analyst Standards: Recommendations for the Supervision and Practice of Canadian Securities Industry Analysts” was released in November 2001. IDA “Policy 11, Analyst Standards,” was issued in June and December 2002.

<sup>148</sup> Japanese Securities Dealers Association, “Rules for Handling Analysts’ Reports,” January 2002, revised January 2003.

<sup>149</sup> Securities Institute of Australia and the Securities and Derivatives Industry Association, “Best Practices Guidelines for Research Integrity,” November 2001.

<sup>150</sup> IOSCO is an international organization whose members cooperate to promote high standards of regulation to protect investors and ensure that markets are fair, efficient and transparent. In September 2003, the Technical Committee of IOSCO issued a Statement of Principles to guide securities regulators and others in addressing the conflicts of interest securities analysts may face. These principles are combined with certain more specific measures designed to eliminate or manage analysts’ conflicts of interest. The Statement of Principles can be found at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD150.pdf>.

<sup>151</sup> This group issued a Report and the “Market Abuse Directive” to implement a uniform system of regulation to handle market abuses in the European Union. The Market Abuse Directive was first issued in December 2002.

regulations, while the SRO Rules and rules promulgated by the other regulators take a more prescriptive approach. These diverse regulatory models sometimes result in differing requirements that can pose challenges for firms with global research operations.

The SRO staffs support ongoing discussions with their members and international regulatory groups to promote the most effective and efficient means to manage research analyst conflicts of interest and to ensure reliable and objective research throughout the world.

## **VI. CONCLUSION**

The SRO staffs believe that the SRO Rules have been effective in helping to restore integrity to research by minimizing the influences of investment banking and promoting transparency of other potential conflicts of interest. Evidence also suggests that investors are benefiting from more balanced and accurate research to aid their investment decisions. The SRO staffs believe that certain changes to the SRO Rules would further improve their effectiveness by striking an even better balance between ensuring objective and reliable research on the one hand and permitting the flow of information to investors and minimizing costs and burdens to members on the other.