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Regulatory Update: What Issuers Need to Know Concerning Rules Intended to Address Analyst Conflicts of Interest

Since the corporate scandals of 2001, regulators have focused on a variety of conflicts of interest involving investment banks and, as a result, a series of regulatory actions have been taken to address certain of these conflicts. This memorandum provides issuers and potential issuers of securities with an overview of these actions, including:

- rules issued in July 2003 by each of the NYSE and the NASD (collectively, the “SROs”), regarding research analysts conflicts of interest (the “Analyst Rules”);
- Regulation Analyst Certification (“Regulation AC”), adopted by the SEC in February 2003;
- the global settlement (the “Global Settlement”), settling enforcement actions relating to research analyst conflicts of interest brought against ten financial institutions; and
- SRO rule changes issued in April 2005 relating to analyst participation in road shows and imposing certain requirements in respect of communications about investment banking services.

I. SRO RULES

Both the NYSE and NASD have rules governing their members in relation to research analysts. Although the NYSE rules and the NASD rules may differ to some degree in their texts, the SROs intend for the Analyst Rules to operate substantially the same way.

Under the Analyst Rules, the following terms are defined as follows:

Research Analyst. The term “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.”

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Research Report. The term “research report” means a written or electronic communication which includes an analysis of equity securities of individual companies or industries and which provides information reasonably sufficient upon which to base an investment decision. A research report does not need to contain a recommendation in order to fall within the scope of the definition of a research report under the Analyst Rules.¹

Public Appearances. The term “public appearance” includes 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.

A. Restrictions on Pre-Publication Review of Research Reports (NYSE Rule 472(b) and NASD Rule 2711(b))

The Analyst Rules restrict the review of research reports prior to distribution. The Analyst Rules prohibit any review of a research report by investment banking personnel or any other employee of the member who is not directly responsible for investment research, unless such review is for the purpose of the verification of the factual accuracy of information in the report or identification of any potential conflict of interest. Any such written communication must be made through a member’s legal or compliance officer and any oral communication must be documented and made with a legal or compliance officer acting as intermediary or in a conversation conducted in the presence of such legal or compliance officer.

These provisions do not apply to members that over the previous three years, on average per year, have (i) participated in ten (10) or fewer investment banking services transactions as manager or co-manager and (ii) generated \$5 million or less in gross investment banking services revenues from those transactions.

B. Prohibition on Solicitation of Investment Banking Business (NYSE Rule 472(b)(5) and NASD Rule 2711(c)(4))

The Analyst Rules prohibit any research analyst from participating in efforts to solicit investment banking business, such as involvement in solicitation or “pitches” to prospective investment banking clients or other communications that are made for the purpose of soliciting investment banking business. The NYSE rules state that this prohibition does not apply to any communication between a research analyst, company and/or non-research personnel, if the sole purpose of which is due diligence. The NASD rule does not specify such an exception.

The original proposed rule sought to provide a disincentive for analyst involvement in pitches by prohibiting an analyst from preparing research reports on issuers with whom the analyst engaged in a pitch, while the Analyst Rules as adopted prohibit analyst involvement in all

¹ Note that the definition of research report under the Analyst Rules is limited to an analysis of equity securities, as opposed to the broader definition of research report under Regulation AC, which includes an analysis of debt or equity securities.

pitches. This prohibition is not limited to initial public offerings, as the SROs believe that the same potential conflicts exist with respect to all investment banking business.

C. Compensation of Research Analysts (NYSE Rule 472(h) and NASD Rule 2711(d))

The Analyst Rules require procedures for review and approval of the compensation of a research analyst primarily responsible for the preparation and substance of a research report at least annually by a committee that reports to the Board of Directors or a senior executive of the member. This rule only applies to those research analysts who are primarily responsible for the preparation of the substance of the research report. Research analysts who are not primarily responsible for a research report's substance, such as junior analysts who report to lead analysts, would not be covered by the compensation committee provision. No employee of a member's investment banking department may participate on this committee. The committee's function is to *review* and *approve* the research analyst's compensation. The Analyst Rules, subject to prohibitions relating to investment banking personnel having any influence or control over the compensatory evaluation of a research analyst (NYSE Rule 472(b)(1) and NASD 2711(b)(1)), do not address who may initially determine such research analyst's compensation.

The committee must, at a minimum, consider the following:

- the research analyst's individual performance, including the analyst's productivity and the quality of the analyst's research;
- the correlation between the research analyst's recommendations and the stock price performance; and
- the overall ratings received from clients, sales force, and peers independent of the member's investment banking department, and other independent ratings services.

The committee may not consider as a factor in reviewing and approving such research analyst's compensation his or her contributions to the member's investment banking business. The SRO rules do not prohibit the consideration of the revenues or results of the member firm as a whole.

The committee must document the basis upon which each such research analyst's compensation was established and provide an annual attestation to certify that the committee reviewed and approved the compensation of research analysts who are primarily responsible for the preparation of the substance of research reports and documented the basis for such approval.

D. Supervisory Analysts Personal Trading Restrictions (NYSE Rule 472(e)(5) and NASD Rule 2711(g)(6))

The Analyst Rules contain trading restrictions for research analysts that prohibit the trading of securities of companies close in time to the publication of research reports regarding an issuer, as well as trading contrary to the recommendations of the member firm.²

The Analyst Rules also extend such restrictions by prohibiting any person who supervises research analysts, or a member of a committee, who has direct influence and/or control with respect to (i) preparing the substance of research reports or (ii) establishing or changing a rating or price target of a subject company's equity securities, from effecting trades in securities of a

² The rules prohibit research analysts from taking advantage of their ability to influence the market when making their own personal transactions. The SRO rules prohibit a research analyst or household member:

- from purchasing or receiving an issuer's securities prior to its initial public offering, if the issuer is principally engaged in the same type of business as companies (or in the same industry classification) which the research analyst usually covers in research reports;
- from trading in any subject company's securities or derivatives of such securities that the research analyst follows for a period of 30 calendar days prior to and 5 calendar days after the member's publication of research reports concerning such security or a change in rating or price target of a subject company's securities; and
- from effecting trades in a manner inconsistent with the research analyst's most current recommendations.

The rules contain certain exemptions from the above restrictions, which include:

- transactions that have been pre-approved in writing by the legal or compliance department that are made due to an unanticipated significant change in personnel financial circumstances;
- the publication of research reports or change in rating, regardless of whether a research analyst or household member has traded in the subject company's securities or derivatives of such securities, due to some significant news or events regarding the subject company; provided that the publication of the research report or change in rating has been pre-approved in writing by the legal and compliance department;
- certain sale transactions by a research analyst who is new to the member organization;
- sales transactions prior to initiation of coverage of the subject company by the research analyst;
- transactions in accounts not controlled by the research analyst and for investment funds in which a research analyst or household member has no investment discretion or control, provided the interest of the research analyst or household member in the assets of the fund does not exceed 1% of the fund's assets and the fund does not invest more than 20% of its assets in securities of issuers principally engaged in the same type of business as companies (or in the same industry classification) which the research analyst usually covers in research reports; and
- transactions in a registered diversified investment company as defined under Section 5(b)(1) of the Investment Company Act of 1940.

company that are the subject of such research reports, or ratings or price target changes, without the prior approval of the member's legal or compliance personnel.

**E. Research Analyst Ownership Disclosure and Personal Trading Restrictions
NYSE Rules 472(k)(1)(iii)(b) and 472(e) and NASD Rules 2711(h)(1)(A) and
2711(g))**

The Analyst Rules require disclosure by a member in research reports, to the extent the member knows or has reason to know, and by a research analyst in public appearances, to the extent the analyst knows or has reason to know, of whether the member or any affiliate of the member, received compensation during the past 12 months from the subject company.

This requirement will be deemed satisfied if such compensation is disclosed in research reports within 30 days after the completion of the most recent calendar quarter, provided that the member has taken steps reasonably designed to identify such compensation during that calendar quarter. In addition, the member and research analyst will be presumed not to have such knowledge if the member maintains and enforces policies and procedures reasonably designed to prevent all research analysts and employees of a member with the ability to influence the substance of research reports from, directly or indirectly, receiving information from the affiliate concerning such compensation.

F. Termination of Coverage (NYSE Rule 472(f)(6) and NASD Rule 2711(f)(5))

The Analyst Rules require members to prepare a final research report prior to terminating coverage of a subject company. The final report must be made available using the means of dissemination equivalent to those it ordinarily uses to provide its customers reports on the same subject company. The final report must be comparable in scope and detail to prior research reports and must include a final recommendation or rating. The SROs have specified that a final recommendation or rating will not be required where it is impractical for the member to give a final report and/or recommendation. When a final recommendation or rating is not provided, the member must provide a rationale for termination of coverage.

**G. Quiet Periods on the Issuance of Research Reports (NYSE Rule 472(f)(1-3) and
NASD Rule 2711(f))**

Initial public offerings and secondary offerings

Under the Analyst Rules, a member may not publish or otherwise distribute research reports regarding an issuer and research analysts may not recommend or offer an opinion on an issuer's securities in a public appearance within:

- 40 calendar days following the offering date if the member acted as manager or co-manager of an issuer's initial public offering;

- 25 calendar days following the offering date if the member acted as an underwriter or dealer (other than as a manager or co-manager) of an issuer's initial public offering; or
- 10 calendar days following the offering date if the member acted as the manager or co-manager of a secondary offering.

The term "offering date" means the later of the effective date of the registration statement and the first date on which the security was offered to the public.

The 10 day black-out period for secondary offerings exempts the publishing or otherwise distributing of a research report pursuant to Rule 139 of the Securities Act of 1933 (the "Securities Act") regarding issuers with "actively-traded securities" (as defined in Rule 101(c)(1) of Regulation M of the Securities Exchange Act of 1934 (the "Exchange Act"))³ and will not prevent a research analyst from making a public appearance concerning such a company.

Waiver or termination of lock-up period

The Analyst Rules also prohibit a member that has acted as a lead manager or co-manager of a securities offering from publishing or otherwise distributing a research report, and such member's research analysts from recommending or offering an opinion on an issuer's securities in a public appearance, within 15 days prior to the expiration, waiver or termination of a lock-up agreement or any other similar such agreement. The SROs acknowledged that members serving as co-managing underwriters in an offering may not be aware of any waiver granted by the lead underwriter and noted that such issues may be dealt with by inserting appropriate notification provisions in the underwriting agreement. This rule does not apply to research reports on a subject company with "actively-traded securities" (as defined above) or to public appearances regarding such companies. The rules also provide for an exception where "significant news" necessitates reporting within the quiet periods.

H. Retaliation (NYSE Rule 472(g)(2) and NASD Rule 2711(j))

The Analyst Rules prohibit members and employees of members who are involved in the member's investment banking activities from directly or indirectly retaliating against or threatening to retaliate against any research analyst as a result of an adverse, negative or otherwise unfavorable research report written or public appearance made by the research analyst that may adversely affect the member's present or prospective investment banking relationship with the subject company of the research report. The Analyst Rules clarify that this prohibition

³ Regulation M defines "actively traded securities" as securities that have an average trading volume of \$1 million and are issued by an issuer whose common equity securities have a public float value of at least \$150 million; provided, however, that such securities are not issued by the distribution participant or an affiliate of the distribution participant. The SEC has proposed rules to increase the thresholds for actively-traded securities to adjust for inflation.

does not limit the member's authority to discipline or terminate a research analyst, in accordance with such member's policies and procedures, for any cause other than the writing of such unfavorable research report or the making of such unfavorable public appearance.

I. Registration and Continuing Education Requirements (NYSE Rules 344 and 345A; NASD Rules 1050 and 1120)

The Analyst Rules require research analysts and supervisory analysts to be registered with, qualified by, and approved by the relevant SRO. NASD Conduct Rule 1050 requires that all individuals who will work as research analysts register and pass a Qualification Exam for Research Analysts as specified by the Board of Governors. Anyone whose name appears on a report or who is primarily responsible for the content of the report is an "analyst." NASD Conduct Rule 1120 outlines a continuing education scheme on analyst regulations that is required for analysts to retain their registration. NYSE Rules 345A and 344 similarly require that analysts and those who supervise them be registered with and found acceptable by the NYSE.

II. REGULATION AC

Regulation Analyst Certification was promulgated by the SEC to promote the integrity of research reports and investor confidence in those reports by requiring research analysts to certify that the views expressed in the report accurately reflect his or her personal views and disclose whether or not the analyst received compensation or other payments in connection with his or her specific recommendations or views.

Certification of Research Reports

Regulation AC requires each broker-dealer, and their associated persons that are "covered persons"⁴ that publish, circulate or provide, directly or indirectly, a research report prepared by a

⁴ For purposes of Regulation AC, "covered persons" means an associated person of that broker or dealer but does not include:

- (1) An associated person:
 - (i) if the associated person has no officers (or persons performing similar functions) or employees in common with the broker or dealer who can influence the activities of research analysts or the content of research reports; and
 - (ii) if the broker or dealer maintains and enforces written policies and procedures reasonably designed to prevent the broker or dealer, any controlling persons, officers (or persons performing similar functions), and employees of the broker or dealer from influencing the activities of research analysts and the content of research reports prepared by the associated person.
- (2) An associated person who is an investment adviser:
 - (i) not registered with the SEC as an investment adviser because of the prohibition of section 203A of the Investment Adviser Act of 1940; and
 - (ii) not registered or required to be registered with the SEC as a broker or dealer.

research analyst to include in that research report a clear and prominent certification by the research analyst containing the following:

- a statement attesting that the views expressed in the research report accurately reflect the research analyst's personal views about any and all of the subject securities or issuers; and
- a statement attesting that either:
 - no part of the research analyst's compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed by the research analyst in the research report; or
 - part or all of the research analyst's compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed by the research analyst in the research report. If the analyst's compensation was, is or will be, directly or indirectly, related to the specific recommendations or views contained in the research report, the statement must identify the source and amount of such compensation and the purpose therefor and further disclose that the compensation may influence the recommendations or views expressed in the research report.

All certifications must be clear and prominent and the SEC expects them to be included on the front page of the research report or that the front page specify the page or pages on which each certification can be found.

A “research analyst” includes any natural person who is primarily responsible for the preparation of the content of a research report. This term does not include an investment adviser, such as a mutual fund portfolio manager, who is not principally responsible for preparing research reports, even if the investment adviser is a registered person of a member.

A “research report” includes any written communication (including an electronic communication) that includes an analysis of a security of an issuer and provides information reasonably sufficient upon which to base an investment decision.

Analysts' Public Appearances

Regulation AC requires broker-dealers to make and keep records related to public appearances by research analysts. If a broker-dealer, publishes, circulates or provides, directly or indirectly, a research report prepared by a research analyst or a covered person, the broker-dealer is required to make a record within 30 days after each calendar quarter in which the research analyst has made a public appearance that includes a certification by the research analyst containing:

- a statement attesting that the views expressed by the research analyst in each public appearance accurately reflected the research analyst's personal views at that time about any and all of the subject securities or issuers; and
- that no part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the research analyst in any public appearance (the "Certification").

If the research analyst is unable to provide the written Certification, the broker-dealer would then be required to disclose in all research reports prepared by the research analyst for the next 120 days that the research analyst did not provide such Certification and the reasons therefor. The 120 day disclosure period, which is longer than a calendar quarter, runs from the time the analyst notifies the broker-dealer employer that he or she is unable to provide the written Certification. The broker or dealer would then also be required promptly notify its examining authority, designated pursuant to Section 17(d) of the Exchange Act, that the analyst did not provide certification in connection with public appearances.

A "public appearance" includes any participation in a seminar, forum (including an interactive electronic forum), radio or television or other interview in which a research analyst makes a specific recommendation or provides information reasonably sufficient upon which to base an investment decision about a security or an issuer.

Liability

Regulation AC focuses on core issues of analysts' integrity: their beliefs in their recommendations and the influence of compensation on their recommendations. Regulation AC focuses on disclosure where the analyst is compensated for making a specific recommendation or rating. The SEC believes that Regulation AC is reasonably designed to prevent acts and practices that are fraudulent, deceptive or manipulative.

Accordingly, Regulation AC is not intended to impose new liability. Regulation AC does not alter or affect any other existing obligation under the federal securities laws for research analysts or broker-dealers. Even without Regulation AC, analysts may still be found to have violated the anti-fraud provisions of the federal securities laws if they make baseless recommendations or recommendations that they disbelieve. Regulation AC is not intended to create duties under Section 10(b) of the Exchange Act.

Existing NASD and NYSE Rules

Regulation AC is intended to complement other rules governing conflicts of interest disclosure by research analysts, including the Analyst Rules. The scope of Regulation AC is broader however than the scope of the current SRO rules in that Regulation AC covers debt as well as equity securities.

III. THE GLOBAL SETTLEMENT

In April 2002, the SEC, the SROs and state securities regulators undertook a joint investigation into allegedly improper influence of investment banking upon the securities research of brokerage firms. As a result of this joint investigation, the SEC, the New York State Attorney General, the North American Securities Administrators Association, the NYSE and the NASD entered into the Global Settlement with ten brokerage firms,⁵ in which the ten firms agreed to pay a total of \$875 million in penalties. In addition, the settlement included undertakings by the firms to adopt a broad range of structural reforms in the manner in which they provide research. Some of these undertakings are similar to the SRO rules, while others go much further.

As part of the global settlement, the subject firms agreed to:

- a physical separation of research and investment banking departments to prevent flow of information between the two groups (not required by the Analyst Rules);
- the determination of the research department's budget by senior management without input from investment banking and without specific revenues derived from investment banking (not required by the Analyst Rules);
- the determination of research analysts' compensation and evaluation of their job performance without regard to investment banking revenues or input from investment banking personnel;
- the making of all company-specific, termination-of-coverage decisions by research management (not required by the Analyst Rules);
- prohibit research analysts from participating in efforts to solicit investment banking business;
- the creation of "firewalls" between investment banking and research;

⁵ The ten brokerage firms that entered into the global settlement were: Bear Stearns & Co., Inc., Credit Suisse First Boston LLC, Goldman, Sachs & Co., Lehman Brothers Inc., J.P. Morgan Securities Inc., Merrill Lynch, Morgan Stanley & Co., Incorporated, Citigroup Global Markets, Inc., UBS Warburg LLC and U.S. Bancorp Piper Jaffrey, Inc.

- a commitment on the part of the firms to furnish independent research to customers for a period of five years (not required by the Analyst Rules); and
- a requirement to disclose publicly their research analysts historical ratings and price target forecasts.

IV. 2005 Changes

In April 2005, the SEC approved SRO rule changes that to a certain extent overlap with the Global Settlement, but apply to all SRO member firms. These changes:

- prohibit analysts from participating in road shows related to an investment banking transaction or otherwise communicating with customers in the presence of investment banking personnel or company management about an investment banking transaction, in effect prohibiting three-way conversations among analysts, customers and investment banking as well as those involving research, customers and issuers;
- prohibit investment banking personnel from directing analysts to engage in marketing efforts with customers relating to investment banking transactions; and
- require that all communications (whether written or oral) from analysts to customers or internal personnel relating to investment banking services be fair, balanced and not misleading, taking into consideration the overall context of the communication.

V. Pending Actions

In August 2002, the NYSE and the NASD, at the request of the SEC, established an IPO Advisory Committee to address abusive practices in the IPO process, such as spinning, unlawful “quid pro quo” arrangements, inequitable imposition of penalty bids and allocations based on agreements to pay excessive commissions. The Committee in May 2003 proposed 20 recommendations, including various proposals for SRO action. The NYSE and the NASD have rulemaking proposals pending before the SEC responding to the recommendations directed at the SROs.

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This memorandum is not intended to provide or constitute legal advice, and no legal or business decision should be based on its contents. Any questions concerning the foregoing should be addressed to members of the Paul Weiss Securities Group (see below). In addition, memoranda on related topics may be accessed under Securities Group publications on our website (www.paulweiss.com).

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