

**SECURITIES INDUSTRY ASSOCIATION**

**RESEARCH MANAGEMENT CONFERENCE**

October 4, 2004

**Research Analyst Independence: New Rules and Developments**

By:

**Wilmer Cutler Pickering Hale and Dorr LLP<sup>1/</sup>**

Washington, D.C.

---

<sup>1/</sup> This outline was prepared by Yoon-Young Lee, a partner at the law firm of Wilmer Cutler Pickering Hale and Dorr LLP, and Stephanie Nicolas, an associate at Wilmer Cutler Pickering Hale and Dorr LLP. The views expressed in the outline are those of the authors and do not necessarily reflect those of the panelists, their firms, companies, organizations, clients, or colleagues. This outline is for general information purposes only and does not represent legal advice regarding any particular set of facts. Unless otherwise noted, the outline speaks as of September 21, 2004. Portions of this outline have been used in other presentations.

# RESEARCH ANALYST INDEPENDENCE: NEW RULES AND DEVELOPMENTS<sup>1/</sup>

Wilmer Cutler Picker Hale and Dorr LLP  
Washington, D.C.

## I. TODAY'S ENVIRONMENT

- A. In recent years, the spate of corporate scandals and the bull market's collapse have focused attention on the role of research analysts. Concerns about research analysts' activities and perceived conflicts of interest have prompted action by Congress, the Securities and Exchange Commission ("SEC" or the "Commission"), National Association of Securities Dealers ("NASD"), New York Stock Exchange ("NYSE"), states, foreign jurisdictions, and the industry itself. A new level of investor and regulatory scrutiny is being applied to research analysts worldwide.
- B. Legal, political and regulatory pressures in the U.S. have catalyzed reform designed to improve the integrity and objectivity of research and to restore investor confidence in research reports:
1. SIA Best Practices. In June 2001, in response to questions about the integrity of research, the industry adopted a Best Practices For Research, developed by the Securities Industry Association. These best practices covered disclosures, recommendations, compensation, relationships with investment bankers and issuers, the research process, and personal trading.
  2. SRO Rules (Round I). In May 2002, the NASD and NYSE (collectively, self-regulatory organizations or "SRO"s) adopted their first round of rule changes designed to address equity research conflicts of interest relating to research reports and public appearances. See NASD Rule 2711; NYSE Rule 472; Exchange Act Release No. 45908 (May 10, 2002).
  3. Merrill Lynch Settlement. Also in May 2002, as part of a settlement with the NY State Attorney General, Merrill Lynch agreed to adopt certain changes to its equity research and investment banking activities. See In re an Inquiry by Eliot Spitzer, No. 02/401522 (NY Supreme Court, NY

---

<sup>1/</sup> This outline was prepared by Yoon-Young Lee, a partner at the law firm of Wilmer Cutler Pickering Hale and Dorr LLP, and Stephanie Nicolas, an associate at Wilmer Cutler Pickering Hale and Dorr LLP. The views expressed in the outline are those of the authors and do not necessarily reflect those of the panelists, their firms, companies, organizations, clients, or colleagues. This outline is for general information purposes only and does not represent legal advice regarding any particular set of facts. Unless otherwise noted, the outline speaks as of September 21, 2004. Portions of this outline have been used in other presentations.

County, May 21, 2002), *available at* [www.oag.state.ny.us/investors/investors.html](http://www.oag.state.ny.us/investors/investors.html).

4. *Investor Protection Principles.* In July 2002, the New York State Comptroller, North Carolina Treasurer, New York State Attorney General and California State Treasurer announced a new initiative under which financial organizations that provide investment banking services and/or are retained or used by those state officers would be strongly urged (or required) to adopt certain principles set forth in the Merrill Lynch settlement agreement (*i.e.*, the “Investment Protection Principles”). *See* Office of the NY State Attorney General Eliot Spitzer, Press Release, “Spitzer, Moore, McCall and Angelides Announce Landmark Initiative to Eliminate Wall Street Conflicts of Interest” (July 1, 2002), *available at* [www.oag.state.ny.us/press/2002/jul/jul01a\\_02.html](http://www.oag.state.ny.us/press/2002/jul/jul01a_02.html). Additional state officers (including those of New Jersey and Florida) have since adopted similar policies.
5. *Section 15D.* As part of the Sarbanes-Oxley Act of 2002, Congress enacted Section 15D of the Securities Exchange Act of 1934 (“Exchange Act”), which requires the SEC (or the SROs, upon the SEC’s authorization and direction) to adopt “rules reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearance.” *See* 15 U.S.C. § 78o-6(a); Pub. L. 107-204, 116 Stat. 745 (2002).
6. *Regulation AC.* Separate from Section 15D’s mandate, the SEC adopted Regulation Analyst Certification in February 2003. *See* Exchange Act Release No. 47384 (Feb. 20, 2003). Unlike the SRO Rules and Section 15D, Regulation AC applies to both equity and fixed income research.
7. *Global Research Settlement.* On April 28, 2003, the SEC and SROs, along with state regulators, announced a global settlement of enforcement actions against ten firms to resolve conflict of interest issues relating to equity research analysts (“Global Research Settlement”). As part of the Global Research Settlement, the ten firms agreed to an extensive set of undertakings that impose detailed changes on the firms’ equity research and investment banking activities. Those undertakings are set forth in Addendum A to their respective Final Judgments, which were entered in October 2003. Addendum A is available at [www.sec.gov/spotlight/globalsettlement.htm](http://www.sec.gov/spotlight/globalsettlement.htm). *See also* Joint Press Release, Ten of Nation’s Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Apr. 28, 2003), *available at* [www.sec.gov/news/press/2003-54.htm](http://www.sec.gov/news/press/2003-54.htm).
8. *SRO Rules (Round II).* On July 29, 2003, the SEC approved a second round of rule changes by the NASD and NYSE relating to equity research analyst conflicts of interest. These rule changes build on the earlier round

of rule changes approved by the SEC in May 2002. Some of the changes were also designed to implement the mandates set forth in Section 15D. See Exchange Act Release No. 48252 (July 29, 2003).

9. *The Bond Market Association (“Association”) Guiding Principles.* On May 19, 2004, as part of an industry initiative, the Association released the final version of 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. According to the Association, the Guiding Principles are 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. See Guiding Principles To Promote Integrity of Fixed Income Research, available at [www.bondmarkets.com/assets/files/Guiding\\_Principles\\_for\\_Research.pdf](http://www.bondmarkets.com/assets/files/Guiding_Principles_for_Research.pdf).
10. *NYSE Rule Proposal Regarding Marketing.* On April 21, 2004, the NYSE filed with the SEC proposed rule changes that would prohibit equity research analysts from participating in company- or investment banking-sponsored sales and marketing efforts (e.g., “road shows”) relating to a public offering or other investment banking services transactions. While prohibited from participating in road shows, equity research analysts still would be permitted to educate investors and employees of a firm’s sales force, provided that such communications are fair and balanced (taking into consideration the overall context in which such communications are made). The proposed rule changes, which have not been published for comment, are available at [www.nyse.com/pdfs/2004-24fil.pdf](http://www.nyse.com/pdfs/2004-24fil.pdf). [Note: The Global Research Settlement also prohibits research analysts from participating in company- or investment banking-sponsored sales and marketing efforts.]
11. *Research Settlement with Deutsche Bank Securities and Thomas Weisel Partners.* On August 24, 2004, the SEC and SROs, along with state regulators, announced a settlement of enforcement actions against Deutsche Bank Securities and Thomas Weisel Partners involving conflicts of interest between equity research analysts and investment banking. The settlements are related to the Global Research Settlement and, as part of their respective settlements, Deutsche Bank Securities and Thomas Weisel Partners agreed to an extensive set of undertakings that impose detailed changes on the firms’ equity research and investment banking activities. These undertakings are consistent with those imposed against the ten firms in the Global Research Settlement, and are available at [www.sec.gov/spotlight/globalsettlement.htm](http://www.sec.gov/spotlight/globalsettlement.htm).

## II. EXISTING U.S. LAWS AND REGULATIONS

### A. Sarbanes-Oxley Provision (Title V)

Sarbanes-Oxley added a new layer of federal regulation regarding research analysts by creating Section 15D of the Exchange Act, which mandates that the SEC adopt, or direct the SROs to adopt, rules “reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances... .” Section 15D(a).

Specifically, Section 15D required the SEC or the SROs to adopt by July 30, 2003, rules regarding the following areas, among others:

1. **Required Disclosures.** Rules requiring disclosure of the following in research reports and public appearances: (1) the extent to which the securities analyst has debt or equity investments in the issuer that is the subject of the public appearance or research report; (2) whether the broker-dealer or its affiliate(s), *including* the research analyst, have received *any* compensation from the subject company; (3) whether the subject company is, or was a client of the broker-dealer within the past year, and if so, the types of service provided by the broker-dealer; and (4) whether the analyst received compensation with respect to a research report based upon (among other factors) the investment banking revenues (either generally or specifically earned from the issuer) of the broker-dealer.
2. **Restrictions on Pre-Publication Approval of Research Reports.** Rules restricting the pre-publication approval or clearance of research reports by persons employed by the broker-dealer who are engaged in investment banking activities, or persons not directly responsible for investment research, other than legal or compliance staff.
3. **Supervision of Research Analysts.** Rules limiting the supervision and compensatory evaluation of analysts to officials employed by the broker-dealer who are not engaged in investment banking activities.
4. **Prohibitions on Retaliations for Negative Research Reports.** Rules prohibiting a broker-dealer and its employees who are engaged in investment banking activities from, directly or indirectly, retaliating against or threatening to retaliate against an analyst employed by that broker-dealer or its affiliates as a result of an adverse, negative or otherwise unfavorable research report that may adversely affect the present or prospective investment banking relationship of the broker-dealer with the issuer.
5. **Quiet Periods.** Rules establishing defined periods during which broker-dealers that have participated, or are to participate, in a public offering of

securities as underwriters or dealers should not publish or distribute research reports relating to those securities or such issuer.

6. **Structural and Institutional Safeguards.** Rules establishing structural and institutional safeguards within broker-dealers to assure that analysts are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of those whose involvement in investment banking activities might potentially bias their judgment or supervision.

The scope of Section 15D is limited to equity research reports and persons who are involved in the preparation of such equity research reports.

## **B. Regulation Analyst Certification**

On February 6, 2003, the SEC adopted Regulation Analyst Certification, or “Regulation AC,” which took effect on April 14, 2003. Although not specifically mandated by Sarbanes-Oxley, Regulation AC is consistent with the spirit of Section 15D. Generally, Regulation AC requires broker-dealers and certain of their associated persons (*i.e.*, “covered persons”) to: (1) include certifications by research analysts in research reports that are provided to U.S. persons in the U.S.; and (2) obtain periodic certifications by research analysts in connection with the analysts’ public appearances. *See* Regulation Analyst Certification, Exchange Act Release No. 47384 (Feb. 20, 2003).

In August 2003, the SEC staff issued additional guidance regarding Regulation AC in a series of questions and answers on the SEC website. *See* Responses to Frequently Asked Questions Concerning Regulation Analyst Certification, *available at* [www.sec.gov/divisions/marketreg/mregacfaq0803.htm](http://www.sec.gov/divisions/marketreg/mregacfaq0803.htm) (“FAQs Concerning Regulation AC”).

### **1. Scope of Regulation AC.**

- a) *Applies to broker-dealers and their “covered persons.”* Regulation AC applies to broker-dealers and their associated persons who are “covered persons.” A “covered person” is defined broadly as an associated person of a broker-dealer (*e.g.*, an investment adviser affiliate, a foreign broker-dealer affiliate, or a bank affiliate). This term, however, *excludes* an associated person if: (1) the associated person has no officers or employees in common with the broker-dealer who can influence the activities of research analysts or the content of research reports; *and* (2) the broker-dealer maintains and enforces written policies and procedures reasonably designed to prevent the broker-dealer or any of its controlling persons, officers, or employees from influencing the activities of research analysts and the content of research reports prepared by the associated person. A broker-dealer must

notify any associated person that distributes or provides research reports if the broker-dealer maintains and enforces such written policies and procedures, and whether the associated person has any officers or employees in common with the broker-dealer who could influence the activities of the analyst or the content of the analyst's research reports.

The term "covered person" also excludes investment advisers that: (1) are not registered with the SEC because of the prohibition of Section 203A of the Investment Advisers Act; *and* (2) are not registered or required to be registered with the SEC as a broker-dealer.

- b) Applies to equity and fixed income research. Unlike the NASD and NYSE rules regarding research analyst conflicts of interest that are described below, Regulation AC applies to *both* fixed income and equity research reports, and the analysts who are primarily responsible for preparing those reports. To this end, 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."
- c) Applies only to persons who are "primarily responsible" for preparing research reports. Regulation AC defines a "research analyst" as "any natural person who is primarily responsible for the preparation of the content of a research report." This definition may include persons associated with a broker-dealer who prepare and are primarily responsible for a piece of analysis that falls under the definition of "research report," even if the preparation of research reports is not a fundamental part of their job description. Regulation AC does not, however, apply to other persons involved in the preparation of a particular research report who are not "primarily responsible" for that research report. Thus, certification by junior analysts involved in the preparation of a research report is not necessary.

2. **Specific exemptions and exclusions from Regulation AC.** Regulation AC contains a number of exemptions and exclusions from the certification requirements:

- a) Third-party research distributed by broker-dealers. Regulation AC does *not* apply where a broker-dealer or covered person distributes research prepared by a third party research analyst *and*: (1) the analyst's employer does not have officers or employees in common with the broker-dealer or covered person; and (2) the

broker-dealer has written policies and procedures designed to prevent the broker-dealer, its controlling persons, officers and employees from influencing the activities of the third-party analyst and the content of the analyst's research reports.

- b) Foreign firms preparing research in accordance with Exchange Act Rule 15a-6. Regulation AC does not apply to foreign persons (*i.e.*, persons who are not U.S. persons) that: (1) are located outside of the United States; (2) are not associated with a U.S. registered broker-dealer; and (3) prepare a research report concerning a foreign security and provide it to a U.S. person in the United States in accordance with Exchange Act Rule 15a-6(a)(2).
- c) Off-shore appearances by analysts at foreign affiliates. All off-shore appearances by research analysts who are employed outside of the United States by a foreign covered person that is located outside of the United States are exempted from the public appearance provisions. [Note: For analysts who are employed by the U.S. broker-dealer or a U.S. covered person, the certification requirement extends to all public appearances, including off-shore appearances.]
- d) News media. Regulation AC does not apply to the news media. It is possible, however, that a broker-dealer or covered person could provide a research report to a media entity with the intent that it be published. In such cases, the research analyst must provide the Regulation AC certifications.

### 3. **Research Report Certifications.**

- a) General Requirements. Broker-dealers and covered persons who distribute research reports prepared by a research analyst to a U.S. person in the United States must include in those reports a statement by the research analyst: (1) certifying that the views expressed in the report accurately reflect his or her personal views about any and all of the subject securities or issuers; and (2) disclosing whether his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views in the research report.

If a research analyst cannot provide this second statement, the report must include a statement by the research analyst attesting that: (1) part or all of the analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the analyst in the research report; (2) identifying the source, amount, and purpose of such compensation; and (3) further disclosing that the compensation

could influence the recommendations or views expressed in the research report.

- b) Performance-based compensation. Regulation AC does not preclude an analyst from providing otherwise permissible services to his or her firm's investment banking department, and it does not prohibit analysts generally from receiving compensation for covering issuers or for preparing research reports. Instead, it focuses on disclosure where the analyst compensation is linked to the specific recommendations or views expressed by the research analyst in the research report. Regulation AC is not intended to address compensation based on the performance of the views expressed regarding the securities discussed.

#### 4. **Public Appearance Certifications.**

- a) General requirements. When a broker-dealer distributes a research report that was prepared by a research analyst employed by the broker-dealer or a covered person to a U.S. person in the United States, the broker-dealer must make records that contain statements from the analyst certifying that: (1) the recommendations or views expressed by the analyst in public appearances during the prior quarter accurately reflected his or her personal views; and (2) no part of the research analyst's compensation was, is, or will be directly or indirectly related to any specific recommendations or views expressed in any public appearance. *These records must be made within 30 days after each calendar quarter in which the research analyst has made any public appearance.*

“Public appearance” is defined as “any participation by a research analyst in a seminar, forum (including an interactive electronic forum), or radio or television or other interview, in which the research analyst makes a specific recommendation or provides information reasonably sufficient upon which to base an investment decision about a security or an issuer.”

In its FAQs Concerning Regulation AC, the SEC interpreted its definition of “public appearance” to include password protected conference calls or Webcasts with clients to the extent that the conference call or Webcast involves a group of 15 or more persons. See SEC Responses to Frequently Asked Questions Concerning Regulation Analyst Certification, questions 12 and 13, available at [www.sec.gov/divisions/marketreg/mregacfaq0803.htm](http://www.sec.gov/divisions/marketreg/mregacfaq0803.htm). [Note: This is consistent with the SROs' definitions, discussed in Section II.C, below.]

- b) Failure to certify. If the broker-dealer does not obtain a statement by the research analyst in connection with public appearances, it must disclose in all research reports prepared by that analyst for the next 120 days that the research analyst did not provide the required certifications. In addition, the broker-dealer must promptly notify its designated examining authority of such failure to certify.
- c) Recordkeeping requirements. Records that a broker-dealer makes pertaining to public appearances pursuant to Regulation AC must be preserved in accordance with Exchange Act Rule 17a-4.

C. **NASD and NYSE Regulation Overview**. As updated by the second round of rule changes in July 2003, the SROs' rules governing equity research analyst conflicts of interest (collectively, the "Rules" or "SRO Rules") contain the following key provisions. [Note: The SROs issued joint memoranda discussing and interpreting the Rules in 2002 and 2004. See NASD Notice to Members 02-39 (June 26, 2002) and NYSE Information Memorandum 02-26 (June 26, 2002) (the "2002 Joint Memo"); NASD Notice to Members 04-18 (Mar. 9, 2004) and NYSE Information Memo 04-10 (Mar. 9, 2004) (the "2004 Joint Memo").]

1. **Promises of Favorable Research**. The Rules prohibit firms from offering or threatening to withhold favorable research, specific ratings or specific price targets as consideration or inducement for the receipt of business or compensation. See NASD Rule 2711(e); NYSE Rule 472(g)(1).
2. **Retaliation**. The Rules prohibit firms and investment bankers from retaliating (or threatening to retaliate) against analysts for adverse, negative or unfavorable reports that may adversely affect the firm's investment banking relationship with the subject company. Similarly, firms and investment bankers may not retaliate or threaten to retaliate against analysts for adverse, negative or unfavorable views expressed in public appearances that may adversely affect the firm's investment banking relationship with the subject company. See NASD Rule 2711(j); NYSE Rule 472(g)(2).
3. **Solicitations of Investment Banking Business**. The Rules prohibit analysts from participating in pitches or other efforts to solicit investment banking business. Analysts are prohibited from any communications with companies for the purpose of soliciting investment banking business. See NASD Rule 2711(c)(4); NYSE Rule 472(b)(5). The NYSE Rule specifically notes, however, that the prohibition does not apply to communications between analysts, companies and/or non-research personnel that are limited to due diligence purposes. [Note: The terms of the Global Research Settlement, discussed below, contain specific restrictions on due diligence communications.]

4. **Relationships with Investment Bankers.** The Rules prohibit members of a firm's investment banking department from supervising or controlling research analysts and from influencing or controlling compensatory evaluations of research analysts. *See* NASD Rule 2711(b); NYSE Rule 472(b)(1). [Note: The terms of the Global Research Settlement contain more specific restrictions on the structure and reporting lines of research analysts and investment bankers.]
  - a) *Small firm exception.* The Rules codify an exception from this provision for certain small firms that have limited investment banking activity. *See* NASD Rule 2711(k); NYSE Rule 472(m).
  
5. **Review of Draft Research Reports.**
  - a) *By Non-Research Personnel.* Firm personnel who are not directly responsible for research (other than legal or compliance personnel) are prohibited from reviewing or approving research reports prior to distribution, except that such non-research personnel may review a draft research report for factual accuracy or to identify conflicts of interest. Any such written communications between the research and non-research personnel must be made either through legal or compliance staff or in a transmission copied to legal or compliance staff; and any oral communications about the content of the report must be documented and made either with legal or compliance staff acting as intermediary or in the presence of legal or compliance staff. *See* NASD Rule 2711(b)(2); NYSE Rule 472(b)(2). [Note: The terms of the Global Research Settlement do not permit any review of draft research reports by investment banking personnel.]
    - (1) *Small firm exception.* The new Rules codify an exception from this provision for certain small firms that have limited investment banking activity. *See* NASD Rule 2711(k); NYSE Rule 472(m). Such firms must, however, maintain for three years, a record of any communication that but for this exemption would be subject to this rule.
  
  - b) *By Issuers.* The Rules prohibit a firm from sharing draft research reports with subject issuers other than to check sections of a draft solely to verify facts. These sections must not include the recommendation, price target, or research summary. Such communications are subject to oversight by the firm's legal and compliance department. *See* NASD Rule 2711(c); NYSE Rule 472(b)(4).

In the 2004 Joint Memo, the SROs said that firms may *not* submit a draft research report, in its entirety, to the issuer -- even if the research summary, research rating and price target have been redacted from the report. According to that memorandum, the Rules only permit submission of *sections* of a report to verify facts in those sections; redacting the research summary, research rating and price target could still enable an issuer to discern the tenor of the report and the issuer's rating or price target. *See* NASD Notice to Members 04-18 (Mar. 9, 2004); NYSE Information Memo 04-10 (Mar. 9, 2004).

6. **Termination of Research Coverage.** The Rules require firms to provide notice when they terminate research coverage of a company. In addition, the firm must make available a final research report that is comparable in scope and detail to prior research reports and contains a final recommendation or rating, unless it is impracticable to do so. If it is impracticable to produce such a final recommendation or rating, the final research report must disclose the rationale for terminating coverage. *See* NASD Rule 2711(f)(5); NYSE Rule 472(f)(5). [Note: The terms of the Global Research Settlement require disclosure of the rationale for termination in all notices of coverage termination.]
7. **Quiet Periods.** With limited exceptions for certain significant events and actively traded securities, the Rules impose the following "quiet periods" on the distribution of research reports and public appearances by research analysts regarding an issuer:
  - a) A manager or co-manager of a securities offering is barred from distributing a research report or permitting an analyst to make a public appearance regarding the issuer within 40 days after an initial public offering ("IPO") or within 10 days after a secondary offering.
  - b) Any firm that has agreed to participate or is participating as an underwriter or dealer (other than as manager or co-manager) of an IPO is barred from distributing a research report or permitting an analyst to make a public appearance regarding the issuer within 25 days after the IPO.
  - c) A manager or co-manager of a securities offering is barred from distributing a research report or permitting an analyst to make a public appearance regarding the issuer 15 days prior to or after the expiration, waiver or termination of a lockup agreement or similar agreement with the issuer or its shareholders.

*See* NASD Rule 2711(f)(1) - (4); NYSE Rule 472(f)(1) - (4).

In the 2004 Joint Memo, the SROs confirmed that the quiet periods would not apply to private placements of Rule 144A securities and Regulation S offerings. In general, the SROs stated that the quiet periods would apply only to offerings of securities that must be registered for offer or sale in the U.S. See NASD Notice to Members 04-18 (Mar. 9, 2004); NYSE Information Memo 04-10 (Mar. 9, 2004).

8. **Analyst Compensation.**

- a) *Prohibition.* The Rules prohibit firms from tying an analyst's compensation to specific investment banking transactions. See NASD Rule 2711(d); NYSE Rule 472(h).
- b) *Disclosure.* If an analyst involved in the preparation of a research report received compensation based, even in part, on the firm's general investment banking revenues, that fact must be disclosed in the research report. See NASD Rule 2711(h)(2); NYSE Rule 472(k)(1). In addition, if the analyst received compensation from the subject company in the prior 12 months, that fact must be disclosed in the analyst's research reports and public appearances. See NASD Rule 2711(h)(2); NYSE Rule 472(k)(2)
- c) *Determination of Analyst Compensation.* Compensation of analysts who are primarily responsible for the preparation of the substance of research reports must be reviewed and approved at least annually by a committee that reports to the board of directors or, if there is no board, a senior executive. The committee must consider, where applicable, individual performance, recommendation performance, and ratings from clients, sales force and other non-investment banking personnel. The committee may not consider contributions to investment banking. The Rules require documentation of the basis for compensation and prohibit investment banking representation on the committee. The firm's annual attestation to the NASD and NYSE must certify that each such analyst's compensation was reviewed, approved and documented in accordance with this provision. See NASD Rule 2711(d); NYSE Rule 472(h)(2). [Note: The Global Research Settlement imposes similar but not identical requirements on analyst compensation determinations. For example, the terms of the Global Research Settlement require that the Compensation Committee of the firm's holding/parent company (or comparable independent persons without management responsibilities) review the compensation process for research personnel on an annual basis.]

9. **Restrictions on Personal Trading.**

- a) *By Research Analysts and Household Members.* The Rules bar analysts and members of their households from investing in a company's securities prior to its IPO if the issuer is in the industry sector that the analyst covers. They also bar analysts and household members from trading any security in a manner *inconsistent with* the analyst's most recent published recommendations regarding that security (*e.g.*, selling the issuer's securities after issuing a "buy" or "hold" recommendation). In addition, the Rules impose "blackout periods" that prohibit analysts and their household members from trading any securities of an issuer that the analyst follows (or any derivative of such security) for 30 days before and 5 days after the analyst: (1) issues a research report about that issuer; or (2) changes the rating or price target of the issuer's securities. *See* NASD Rule 2711(g); NYSE Rule 472(e). [Note: Changes in earnings estimates will not trigger the blackout periods, assuming that the changes do not coincide with the issuance of a new research report or result in a change in the rating or price target for the issuer's securities.]
- b) *By Supervisors (Including Research Directors, Supervisory Analysts, and Research Committee Members).* Legal or compliance personnel must pre-approve all transactions of persons who oversee analysts to the extent such transactions involve equity securities of companies covered by those analysts. *See* NASD Rule 2711(g)(6); NYSE Rule 472(e)(5). In the 2004 Joint Memo, the SROs said they would consider a firm to have met its obligations to pre-approve a supervisor's transactions in a managed account where the supervisor has no discretion or control, provided that the firm has policies and procedures to monitor the managed account's trades. If such policies and procedures are in place, the SROs do not require legal or compliance personnel to pre-approve each transaction made within the managed account. *See* NASD Notice to Members 04-18 (Mar. 9, 2004); NYSE Information Memo 04-10 (Mar. 9, 2004).
- c) *Exceptions.* The Rules provide for certain limited exceptions that can be granted on a prior approval basis by legal or compliance personnel. Such exceptions must be granted pursuant to specific policies and procedures. *See* NASD Rule 2711(g)(2)(B) and (g)(4); NYSE Rule 472(e)(4). Written records of exceptions and the justification for exceptions must be maintained for three years. *See* NASD Rule 2711(g)(4)(c); NYSE Rule 472(e)(6).

In addition, the personal trading restrictions do not apply to transactions in registered diversified investment companies, certain other diversified investment funds, and blind trusts.

10. **Disclosure Requirements.**

- a) Application. All of the Rules' research report disclosure requirements apply to any research report that is produced and distributed by the firm. [Note: In the 2004 Joint Memo, the SROs provided specific guidance regarding these disclosures.]

In their 2002 Joint Memo, the NASD and NYSE discussed the application of the disclosure requirements to other research reports that are distributed by the firm. See NASD Notice to Members 02-39 (June 26, 2002); NYSE Information Memorandum 02-26 (June 26, 2002). In particular:

- (1) Third-party research provided through soft-dollar arrangements. The NASD and NYSE clarified that the disclosure requirements do not apply to research produced by an independent third party in accordance with a soft dollar arrangement. To the extent that the third party is itself an NASD or NYSE member firm, the third party must provide its own disclosures in the report.
- (2) Other third-party research and research of non-member affiliates. A firm that distributes research produced by a non-member affiliate or a third party (*e.g.*, a foreign broker-dealer or an investment adviser) not pursuant to a soft dollar arrangement must accompany this research with the following "Third-Party Research Disclosures," if applicable: (1) the firm's and its affiliates' ownership of the subject company's securities; (2) that the firm or its affiliates managed or co-managed a public offering of the subject company's securities in the past 12 months, received compensation for investment banking services from the subject company in the past 12 months, or expects to receive or intends to seek compensation for investment banking services from the subject company in the next 3 months; (3) that the firm was making a market in the subject company's securities at the time the research report was published; and (4) any other actual, material conflict of interest of the firm known at the time the firm distributes research report.
- (3) Independent third-party research that is "made available" to customers. The Third-Party Research Disclosures are not

required if a firm makes an independent third party's research report available to its customers upon request or through its website or a website maintained by the firm. [Note: This exclusion does not apply to third-party research reports prepared by non-member affiliates.]

b) Disclosures in Research Reports Regarding Compensation.

- (1) Investment banking compensation or activities. Firms must disclose in research reports whether they or their affiliates: (1) have managed or co-managed a public offering of securities for the company that is the subject of the report in the past 12 months; (2) have received any compensation for investment banking services from the subject company in the past 12 months; or (3) expect to receive or intend to seek compensation for investment banking services from the subject company during the next three months. *See* NASD Rule 2711(h)(2)(A)(ii); NYSE Rule 472(k)(1)(i)(a).
- (2) Non-investment banking compensation. Firms must disclose in research reports whether they received compensation for products or services other than investment banking services from the subject company in the past 12 months. In addition, a firm must disclose if the analyst or an employee who has the ability to influence the substance of the research report *knows* that an *affiliate* has received compensation for products or services other than investment banking services from the subject company in the past 12 months. Finally, a firm must disclose if it or the analyst *has reason to know* that an affiliate received such compensation in the past 12 months; firms are permitted to rely on information barriers to avoid this constructive knowledge disclosure. *See* NASD Rule 2711(h)(2)(A)(iii), (iv) and (v); NYSE Rule 472(k)(1)(i)(d)(2); 472(k)(1)(ii)(b)(2) and 472(k)(1)(iii)(a).
- (3) Client status. Firms must disclose in research reports whether the subject company is or during the prior 12 months was a client of the firm and whether the types of services provided were investment banking services, non-investment banking securities-related services or non-securities services. *See* NASD Rule 2711(h)(2)(A)(iii)(b); NYSE Rule 472(k)(1)(i)(d) and 472(k)(1)(ii)(b).
- (4) Analyst Compensation. The Rules require disclosure in research reports if an analyst involved in the preparation of the research report received any compensation from the

subject company in the past 12 months or compensation based upon, among other factors, the firm's overall investment banking revenues. See NASD Rule 2711(h)(2)(A)(i); NYSE Rule 472(k)(1)(ii)(a).

- (5) Exemption. The rules provide an exemption from the investment banking compensation and client status disclosure requirements where the disclosure would reveal material, nonpublic information regarding specific potential investment banking services transactions of the subject company. See NASD Rule 2711(h)(2)(C); NYSE Rule 472(k)(3).

- c) Compensation Disclosures in Public Appearances. Analysts must disclose in public appearances if the analyst knows or has reason to know that the firm or an affiliate received any compensation from the subject company in the past 12 months; if the analyst received any compensation from the subject company in the past 12 months; and if the analyst knows or has reason to know that the subject company is or was during the last 12 months a client of the firm and, if so, the types of services provided. See NASD Rule 2711(h)(2)(B); NYSE Rule 472(k)(2)(i)(c) and 472(k)(2)(i)(f).

The Rules provide an exemption from the investment banking compensation and client status disclosure requirements where the disclosure would reveal material, nonpublic information regarding specific potential investment banking services transactions of the subject company. See NASD Rule 2711(h)(2)(C); NYSE Rule 472(k)(3).

- d) Disclosures in Research Reports and Public Appearances of Financial Interests in Issuers. The Rules require disclosures in research reports where the analyst or a household member has a financial interest in the securities of a subject issuer, or where the analyst's firm or its affiliates beneficially own 1% or more of an issuer's equity securities. See NASD Rule 2711(h)(1)(A) and (B); NYSE Rule 472(k)(1)(i)(c) and 472(k)(1)(iii)(b). For purposes of calculating beneficial ownership, the Rules refer to Section 13(d) of the Exchange Act. Accordingly, firms should "look to the SEC to determine which affiliate holdings must be included in calculating whether firm ownership meets the 1% disclosure threshold." NASD Notice to Members 02-39 (June 26, 2002) and NYSE Information Memorandum 02-26 (June 26, 2002).

Analysts must also make these disclosures, as relevant, in public appearances where the analyst makes a recommendation or offers

an opinion concerning an equity security of an issuer. See NASD Rule 2711(h)(1)(A) and (B); NYSE Rule 472(k)(2)(i)(a) and (b).

- e) Disclosures in Research Reports and Public Appearances of Affiliations. Firms must disclose in research reports, and analysts must disclose in public appearances, if the research analyst or a household member is an officer, director or advisory board member of the subject company. This disclosure, if applicable, must state the position held by the research analyst or household member. See NYSE Rule 472(k)(1)(iii)(c) and 472(k)(2)(i)(e).
- f) Disclosures in Research Reports and Public Appearances of Any Other Actual Material Conflict. Firms must disclose in research reports, and analysts must disclose in public appearances, any other actual, material conflict of interest of the analyst or the firm of which the analyst knows or has reason to know at the time the report is distributed or the public appearance is made. See NASD Rule 2711(h)(1)(C); NYSE Rule 472(k)(1)(iii)(d) and 472(k)(2)(i)(d).
- g) Disclosures in Research Reports Regarding the Firm's Ratings and Valuations. The Rules require firms to explain clearly in research reports the meaning of all ratings terms they use, and the terminology must be consistent with its plain meaning. See NASD Rule 2711(h)(4); NYSE Rule 472(k)(1)(i)(f). Additionally, firms must disclose the percentage of all the ratings that they have assigned to "buy/hold/sell" categories and the percentage of investment banking clients in each category, and provide a graph or chart that plots the historical price movements of the subject security and indicates those points at which the firm initiated and changed ratings and price targets for the issuer. See NASD Rule 2711(h)(4),(5) and (6); NYSE Rule 472(k)(1)(i)(g) and (h). Finally, the Rules require firms to disclose the valuation methods used and an explanation of the risks associated with any price objectives. See NASD Rule 2711(h)(5) and (7); NYSE Rule 472(k)(1)(i)(e).
- h) Marketmaking Disclosure in Research Reports. Firms must disclose in research reports whether the firm is making a market in the subject company's securities at the time the research report is issued. See NASD Rule 2811(h)(8); NYSE Rule 472(k)(1)(i)(b)
- i) Records of Public Appearances. Firms must maintain records of public appearances (and information sufficient to demonstrate compliance with the disclosure requirements) for three years from the date of the public appearance. See NASD Rule 2711(h)(12); NYSE Rule Interpretation 472(k)(2)/01.

11. **Written Supervisory Procedures.** NASD Rule 2711(i) and NYSE Rule 472(c) require firms to adopt and implement written supervisory procedures reasonably designed to ensure that the firm and its employees comply with these Rules. In addition, the NYSE requires its member firms to establish written supervisory procedures relating to other communications activities (including a prior supervisory approval requirement for such activities); we understand that the NYSE has provided informal guidance that this provision is intended to cover associated persons other than research analysts. NYSE Rule 472(l).
12. **Annual Certifications.** NASD Rule 2711(i) requires that a senior officer of the firm attest annually to the NASD that the firm has adopted and implemented the relevant written procedures. NYSE Rule 351 also requires a senior officer or partner of a firm to certify that it has established and implemented procedures reasonably designed to comply with NYSE Rule 472. Both attestations must specifically certify compliance with the analyst compensation provisions of the Rules. The revised Rules harmonize the date for the NASD and the NYSE annual attestations to April 1 of each year.
13. **Registration of Research Analysts and Supervisors.**
  - (1) Registration of research analysts. The Rules create a new registration requirement for any person: (1) who is primarily responsible for the preparation of the substance of an equity “research report” (as defined below in Section II.C.14); or (2) whose name appears on such a research report. *See* NASD Rule 1050; NYSE Rule 344. [Note: The new research analyst registration requirements do not include a “grandfather” provision.]
  - (2) Registration of supervisory analysts and supervisors. Under NYSE rules, persons who are responsible for preparing or approving research reports (including non-equity reports) must pass a Supervisory Analyst Examination (*i.e.*, the Series 16). *See* NYSE Rule 344.11. Under new NASD rules, supervisors who have passed the Series 24 examination also must pass either the Series 87 or Series 16 examinations if they supervise the conduct of: (1) the research analysts described above (*i.e.*, those persons who must register pursuant to NASD Rule 1050); or (2) persons qualified as a Supervisory Analyst under NYSE rules who approve research reports on equity securities.
  - (3) Continuing education. All persons registered as research analysts, supervisory analysts, and supervisors pursuant to the new

registration requirements are required to meet continuing education requirements. *See* NASD Rule 1120; NYSE Rule 345.

- (4) *Application to fixed income and other research analysts.* The SROs confirmed in their 2004 Joint Memo that the Rules and the new registration and continuing education requirements do not apply to research analysts who only produce research on fixed income securities. In addition, these requirements do not apply to other research personnel who do not prepare reports that meet the definition of “research report” (discussed in II.C.14 below).
- (5) *Application of registration requirements to persons who are not employees of member firms.* In March and April 2004, the NASD and NYSE issued guidance regarding the application of the new registration requirements. *See* NASD Notice to Members 04-25 (Mar. 30, 2004); NYSE Information Memo 04-16 (Apr. 1, 2004).

In particular, the SROs said that an individual who prepares research for a member as a consultant *would* be subject to the registration requirements if: (1) s/he is an “associated person” of the member; and (2) his/her activities fall under the definition of research analyst under NASD Rule 1050 or NYSE Rule 344 (*i.e.*, s/he is primarily responsible for the preparation of the substance of an equity research report, or his/her name appears on such a research report). *See id.* at question 4.

In addition, an analyst employed by a foreign broker-dealer affiliate of a member *would* be subject to the registration requirements if: (1) the analyst is an “associated person” of the member; and (2) the member uses that analyst’s research reports or distributes them in the U.S. in accordance with SEC Rule 15a-6. *See id.* at question 7.

[Note: The NASD defines “associated person” to include: (1) a natural person who is registered or has applied for registration under the NASD rules; and (2) a sole proprietor, partner, officer, director, or branch manager of a member, or other natural person occupying a similar status or performing similar functions, or a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member (whether or not any such person is registered or exempt from registration with the NASD). *See* NASD By-Laws, Art. 1(dd).]

14. **Key Terms: Application of the Rules to Member Firms and Their Associated Persons.** Among the most scrutinized aspects of the SRO Rules have been the definitions of “research report,” “research analyst”

and “public appearance.” These definitions are critical because they determine which persons and what types of communications are subject to the Rules. In the 2004 Joint Memo, the SROs also discussed situations where they would consider a research report produced by a third party to be a product of a member firm and, thus, subject to the Rules. These interpretations have been criticized by industry participants because of their far-reaching consequences, particularly with respect to firms that operate on a global basis.

- a) Research Report. The definition of “research report” in the SRO Rules was amended in Round II to conform to the definition of “research report” in Section 15D. In particular, the definition of “research report” is no longer limited to reports that include a “recommendation.” Research report is defined as 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.” NASD Rule 2711(a)(8). *See also* NYSE Rule 472.10(2) (which has a substantially identical definition).

In the 2002 Joint Memo discussing and interpreting NASD Rule 2711 and NYSE Rule 472, the SROs stated that they generally do not consider any of the following communications to be research reports:

- (1) Reports discussing broad-based indices, such as the Russell 2000 or S&P index, that do not recommend or rate individual securities.
- (2) Reports commenting on economic, political or market conditions that do not recommend or rate individual securities.
- (3) Technical analysis concerning the demand and supply for a sector, index or industry based on trading volume and price.
- (4) Statistical summaries of multiple companies’ financial data (including listings of current ratings) that do not include any narrative discussion or analysis of individual companies’ data.
- (5) Reports that recommend increasing or decreasing holdings in particular industries or sectors but that do not contain recommendations or ratings for individual securities.
- (6) Notices of ratings or price target changes that do not contain any narrative discussion or analysis of the company, provided that the firm simultaneously directs the readers of the notice as to where they may obtain the most

recent research report on the subject company that includes the disclosures required by the SRO Rules.

- (7) An analysis prepared by a registered representative for a specific customer's account.
- (8) Internal communications that are not given to customers.

*See* NASD Notice to Members 02-39 (June 26, 2002); NYSE Information Memorandum 02-26 (June 26, 2002).

In their 2004 Joint Memo, the SROs reaffirmed that they generally would not consider the above-listed communications to be "research reports." The SROs also agreed with the additional categories of communications that the SEC described as outside the scope of "research report" for purposes of Regulation AC. In particular, these communications are:

- (9) An analysis prepared for a specific person or a limited group of fewer than 15 persons.
- (10) Periodic reports or other communications prepared for investment company shareholders or discretionary investment account clients discussing past performance or the basis for previously made discretionary investment decisions.

*See* NASD Notice to Members 04-18 (Mar. 9, 2004); NYSE Information Memo 04-10 (Mar. 9, 2004).

The SROs specifically declined, however, to exclude all technical and quantitative analysis from the definition of "research report." Specifically, in the 2004 Joint Memo, the SROs stated that many research reports typically labeled "quantitative" by members "can and do raise conflicts concerns" because "not all mathematical models are inherently objective." *Id.* Nevertheless, the SROs acknowledged that certain quantitative models may sufficiently guard against any potential conflicts of interest to render them outside the definition of a "research report" and that "reports generated by formulas that are generally free of subjective inputs from an employee of a member may fall outside the definition of research report." *Id.* Any such determinations, however, must be considered on a case-by-case basis.

- b) *Research analyst.* The definition of "research analyst" turns on the definition of "research report" because "research analyst" is an "associated person who is primarily responsible for, and any associated person who reports directly or indirectly to such a

research analyst in connection with, the preparation of the substance of a research report, whether or not any such person has the job title of ‘research analyst.’” NASD Rule 2711(a)(5). *See* also NYSE Rule 472.40 (defining “research analyst” as “a member, allied member, or employee of a member or member organization primarily responsible for, and any person who reports directly or indirectly to such research analyst in connection with, the preparation of the substance of a research report whether or not any such person has the job title of ‘research analyst.’”).

In the 2004 Joint Memo, the SROs confirmed that persons such as salespeople, traders, and other non-research personnel who do *not* hold the title of “research analyst” and do *not* work in a firm’s research department, nevertheless, may be “research analysts” for purposes of the Rules if they are primarily responsible for preparing the substance of communications that meet the definition of “research report.” *See* NASD Notice to Members 04-18 (Mar. 9, 2004); NYSE Information Memo 04-10 (Mar. 9, 2004).

- c) *Public appearance.* The term “public appearance” is defined to include “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.” NASD Rule 2711(a)(4). *See* NYSE Rule 472.50 (which has a substantially identical definition).

In the 2002 Joint Memo, the SROs noted that the term “public appearance” includes an analyst’s participation in a conference call or Webcast that is open to the public in which the analyst makes a recommendation or offers an opinion concerning an equity security. *See* NASD Notice to Members 02-39 (June 26, 2002) and NYSE Information Memorandum 02-26 (June 26, 2002).

In the 2004 Joint Memo, the SROs endorsed the SEC’s interpretation of the term “public appearance” for purposes of the Rules, stating that an appearance by a research analyst before a group of 15 or more separate persons will be regarded as a “public appearance.” *See* NASD Notice to Members 04-18 (Mar. 9, 2004); NYSE Information Memo 04-10 (Mar. 9, 2004). [Note: The SROs would not require an analyst to make the disclosures required for public appearances in a password protected web-cast, conference call or similar event with more than 15 existing customers (*e.g.* individuals or entities), provided: (1) all of the call participants previously received the most current research report or other documentation that included the required disclosures; and (2)

the research analyst making the public appearance corrects and updates any disclosures in the research report that are inaccurate, misleading or are no longer applicable. If representatives of the media attend the public appearance, the analyst must make the required disclosures. *See id.*]

d) *Member v. Third-Party Research Reports.* In the 2004 Joint Memo, the SROs stated that -- in certain situations -- they would consider research reports prepared by third parties to be products of a member firm for purposes of the Rules. According to that memorandum, a third-party research report may be considered a report of a member firm if either:

- (1) A “research analyst (as defined by the SRO Rules) associated with a member is involved in producing the research report” (*e.g.*, the research report is prepared by a research team that includes at least one person who meets the definition of “research analyst” and is an “associated person” of the member); or
- (2) The report “appears to be a product of a member” (*e.g.*, if a member issues a “globally branded” research report *or* the member adapts, alters or distributes a research report produced by an affiliate or an independent third party in such a way that an investor reasonably could believe it to be the product of the member). [Note: For purposes of this interpretation, the 2004 Joint Memo defines a “globally branded” report as one that “refers to the use of a single marketing identity that encompasses the member and its affiliates.”]

*See* NASD Notice to Members 04-18 (Mar. 9, 2004); NYSE Information Memo 04-10 (Mar. 9, 2004).

In determining whether a research report is that of a member firm (and, thus, subject to the Rules), the SROs have said that “it is irrelevant to the analysis where a report is distributed - domestically or internationally - or to whom it is distributed, or on which market the subject company’s securities are traded.” *Id.* Not surprisingly, the SROs’ interpretations regarding third-party research have been criticized by industry participants because of their potentially far-reaching, unprecedented consequences, particularly for firms with global research operations.

### III. GLOBAL RESEARCH SETTLEMENT

#### A. Overview

1. On April 28, 2003, the SEC and SROs, along with state regulators, announced a global settlement of enforcement actions against ten firms to resolve conflict of interest issues relating to equity research analysts and investment banking. The final agreement was entered on October 31, 2003. Penalty payments and contributions totaled \$1.4 billion. As part of the Global Research Settlement, the ten firms agreed to an extensive set of undertakings that impose detailed changes on the firms' equity research and investment banking activities. Those undertakings are set forth in Addendum A to their respective Final Judgments, which were entered in October 2003. Addendum A is available at [www.sec.gov/spotlight/globalsettlement.htm](http://www.sec.gov/spotlight/globalsettlement.htm).
2. Almost one year later, on August 24, 2004, the SEC, SROs, and state regulators announced a settlement of enforcement actions against Deutsche Bank Securities and Thomas Weisel Partners involving conflicts of interest between equity research analysts and investment banking. The settlements are related to the Global Research Settlement and, as part of their respective settlements, Deutsche Bank Securities and Thomas Weisel Partners agreed to an extensive set of undertakings that impose detailed changes on the firms' equity research and investment banking activities. These undertakings are consistent with those imposed against the ten firms in the Global Research Settlement, and are available at [www.sec.gov/spotlight/globalsettlement.htm](http://www.sec.gov/spotlight/globalsettlement.htm).
3. Because the Global Research Settlement is a court-issued injunction and not regulatory rulemaking, its terms apply only to the settling firms. Regulators have indicated, however, that comparable rulemaking for the rest of the industry may follow (except for the independent research component). In addition, state regulators and other third parties are looking to the terms of the Global Research Settlement to define a set of "best practices" to supplement the SRO Rules. *See, e.g.,* News Release, Treasurer Angelides Announces Tough New Requirements for Investment Banks That Do Business With State of California (May 8, 2003), *available at* [www.treasurer.ca.gov/news/releases/2003/2003508ips.pdf](http://www.treasurer.ca.gov/news/releases/2003/2003508ips.pdf).

#### B. Structural and Organizational Provisions

1. **Reporting lines.** Research and investment banking must be separate units with entirely separate reporting lines within the firm. The head of research may report to or through a person or persons to whom the head of investment banking also reports, provided that such person or persons have no direct responsibility for investment banking or investment banking activities. *See* Addendum A at I.1.

2. **Physical Separation.** Research and investment banking must be physically separated. Such physical separation must be reasonably designed to prevent the intentional and unintentional flow of information between research and investment banking personnel. *See* Addendum A at I.4.
3. **Dedicated Legal/Compliance Staff.** Research must have its own dedicated legal and compliance staff. Such designated legal and compliance persons may be a part of the firm’s overall compliance/legal infrastructure. *See* Addendum A at I.2.
4. **Separate Research Budget.** Research budget and allocation of research expenses must be determined exclusively by firm senior management (excluding investment banking personnel). Such determinations must be made without input from investment banking and without regard to specific revenues or results derived from investment banking, although revenues and results of the firm as a whole may be considered. On an annual basis, the audit committee of the firm’s holding or parent company (or comparable independent persons without management responsibilities) must review the research budgeting and expense allocation process. *See* Addendum A at I.3.
5. **Compensation of Research Personnel.** Compensation of research personnel must be determined exclusively by research management and the firm’s senior management (but not including investment banking personnel) pursuant to specific principles and factors. Among other things, investment banking must have no input into compensation decisions, and compensation may not be based (directly or indirectly) on investment banking revenues or results, although compensation may relate to the revenues or results of the firm as whole. For “primary analysts” (*i.e.*, analysts who are primarily responsible for the preparation of the substance of a research report), a significant portion of their compensation must be based on quantifiable measures of the quality and accuracy of the analyst’s research. On an annual basis, the compensation committee of the firm’s holding or parent company (or comparable independent persons without management responsibilities) must review the compensation process for research personnel. *See* Addendum A at I.5.
6. **Evaluations of Research Personnel.** Evaluations of research personnel must not be conducted by, nor may there be input from, investment banking personnel. *See* Addendum A at I.6.
7. **Oversight Committee.** An oversight committee (which cannot include investment banking representation) must review ratings changes and material changes in price targets, conduct periodic reviews of research reports, and monitor the overall quality and accuracy of research reports. *See* Addendum A at I.12.

C. **Firewalls Between Research Analysts and Investment Bankers**

1. The Global Research Settlement generally prohibits all interactions and communications between analysts and investment banking personnel except in the following seven, specifically-described instances, that are set forth in Section I.10 of Addendum A:
  - a) Discussions involving proposed transactions/candidates for transactions, and market or industry trends, conditions, or developments. Investment banking personnel may seek the views of research personnel about the merits of a proposed transaction, a potential candidate for a transaction, or market or industry trends, conditions or developments. These inquiries and the research analyst's response must be made through research management (or an appropriate designee) or conducted in the presence of internal legal or compliance staff. Research personnel also may initiate communications with investment banking personnel relating to market or industry trends, conditions or developments, provided that they: (1) are made through research management (or a designee) or in the presence of internal legal or compliance staff; and (2) are consistent in nature with the types of communications that an analyst might have with investing customers. No communications between research and investment banking personnel may be made for the purpose of having research personnel identify specific potential investment banking transactions.
  - b) Participation in commitment committee meetings. At the request of a firm's commitment committee (or subgroup thereof), research personnel may communicate their views about a proposed transaction or potential candidate for a transaction to the committee in connection with its review of such transaction or candidate. Investment banking personnel working on the transaction may participate in these discussions, provided that the research personnel have an opportunity to express their views outside the presence of such investment banking personnel.
  - c) Review of disclosure documents. Research personnel may assist firms in confirming the adequacy of disclosures in offering or other disclosure documents for a transaction based on their communications with the company and other vetting conducted outside the presence of investment banking personnel. If research personnel communicate their views to investment banking personnel, such communication must be made in the presence of internal legal or compliance staff, or counsel on the transaction.

- d) Assisting equity capital markets with pricing and structuring offerings. After a firm receives an investment banking mandate, or in connection with a block bid or similar transaction, research personnel may: (1) communicate with personnel in the firm's equity capital markets group ("ECM") (which group's principal job responsibility is the pricing and structuring of transactions) regarding the structuring and pricing of the transaction and participate with ECM in the preparation of internal-use memoranda and other efforts to educate the sales force; and (2) provide to ECM personnel other information obtained from investing customers relevant to the pricing and structuring of the transaction.
  - e) Widely-attended conferences. Research personnel may attend or participate in a widely-attended conference attended by investment banking personnel or in which investment banking personnel participate, provided that the research personnel do not participate in activities otherwise prohibited by Addendum A.
  - f) Widely-attended firm meetings. Research and investment banking personnel may attend or participate in widely-attended firm or regional meetings at which matters of general firm interest are discussed. Research and investment banking management may attend meetings or sit on firm management, risk or similar committees at which general business and plans (including those of investment banking and research) and other matters of general firm interest are discussed. Research and investment banking personnel may communicate with each other regarding legal or compliance issues, provided that internal legal or compliance staff is present.
  - g) Non-investment banking and non-research communications. Communications between research and investment banking personnel that are not related to investment banking or research activities may take place without restriction.
2. Unlike the Global Research Settlement, the SRO Rules do not generally prohibit analyst interactions with banking personnel. Instead, they restrict or prohibit those specific types of interactions that are most likely to raise potential conflicts of interest, and they contain general principles that require firms to manage or prevent other interactions between analysts and bankers that raise potential conflicts.
3. As a result of the differing approaches underlying the SRO Rules and the Global Research Settlement, many contacts between research analysts and investment banking personnel that are permissible under the SRO Rules are prohibited under the Global Research Settlement -- even if those communications serve an important business purpose and any potential

conflicts can be managed effectively (e.g., through chaperoning procedures).

**D. Additional Restrictions on Research Activities**

**1. Research Coverage.**

a) *Coverage Decisions.* Investment bankers are prohibited from having any input into company-specific coverage decisions, and investment banking revenues or potential revenues cannot be considered in making company-specific decisions. These restrictions do not apply to “category-by-category” decisions. *See* Addendum A at I.7.

b) *Termination of Coverage.* As with the SRO Rules, decisions to terminate coverage must be announced, and the firm must issue a final research report that is comparable to prior reports (to the extent practicable). The Global Research Settlement requires disclosure of the firm’s rationale for the decision to terminate coverage in any notice of coverage termination. *See* Addendum A at I.8.

**2. Prohibition on Soliciting Investment Banking Business.** As with the SRO Rules, research analysts are prohibited from participating in the solicitation of investment banking business. *See* Addendum A at I.9.

**3. Prohibition on Participation in Road Shows.** Research analysts are prohibited from participating in company-sponsored or investment banking-sponsored road shows relating to a public offering or other investment banking transaction. *See* Addendum A at I.11(a).

**4. Investment Banking-Directed Marketing Efforts.** Investment bankers are prohibited from directing research analysts to engage in marketing or selling efforts to investors with respect to public offerings or other investment banking transactions. *See* Addendum A at I.11(b).

**E. Disclosure/Transparency Provisions**

1. In addition to SRO disclosures, the settling firms must disclose in research reports and in any summary or listing of recommendations or ratings, disclosures as to potential conflicts of interest and the availability of independent research. *See* Addendum A at II.1.

2. The settling firms must make information regarding research coverage, ratings, price targets, EPS forecasts, and explanations of ratings publicly available and updated quarterly. *See* Addendum A at II.2.

**F. Provision of Third-Party Research**

1. The settling firms are required to provide to their customers in the U.S. third-party research free of charge for 5 years. Each firm must contract with no fewer than three independent research providers and must appoint an independent consultant to oversee procurement of third party research for covered companies. (Covered companies include any issuer of common stock or equivalents listed on a U.S. national securities exchange or quoted in Nasdaq and covered in the firm's research reports. Covered companies also include certain non-U.S. companies. Independent research providers may not perform investment banking business of any kind and may not provide brokerage services in competition with the relevant firm.) *See* Addendum A at III.
2. The settling firms must adopt measures designed to assure that with respect to any solicited order for a U.S. customer in a security covered by independent research, the customer is informed of the availability of independent research. Firms must also adopt procedures to assure that trade confirmations and account statements sent to such a customer will reflect the ratings (if any) contained in the firm's own research report and in any independent research available through the firm. *See* Addendum A at III.

**G. Defined Terms**

1. **Research Report** - means "any written (including electronic) communication that is furnished by the firm to investors in the U.S. and that includes an analysis of the common stock, any security convertible into common stock, or any derivative thereof, including American Depositary Receipts (collectively, "Securities"), of an issuer or issuers and provides information reasonably sufficient upon which to base an investment decision." It excludes various categories of communications that parallel the exclusions adopted by the SROs for purposes of the SRO Rules and by the SEC for purposes of Regulation AC. *See* Addendum A at I.1.e.

The Global Research Settlement diverges notably from the definition "research report" in the SRO Rules and Regulation AC by excluding "an analysis prepared for a current or prospective investing customer or group of current or prospective investing customers by a registered salesperson or trader who is (or group of registered salespersons or traders who are) not principally engaged in the preparation or publication of research reports" even if such analysis contains information reasonably sufficient upon which to base an investment decision. The most comparable exclusion provided by the SROs and SEC are for communications limited to a group of fewer than 15 persons.

2. **Research personnel** - are defined as “all firm personnel engaged principally in the preparation and/or publication of research reports, including firm personnel who are directly or indirectly supervised by such persons and those who directly or indirectly supervise such persons, up to and including research management.” Addendum A at I.1.d. By focusing on the principal responsibilities or activities of a person, this definition is significantly narrower than the definitions of “research analyst” in the SRO Rules and Regulation AC, which capture any person who is responsible for or involved in the preparation of the substance of a *single* research report.
3. **Investment Banking** - means “all firm personnel engaged principally in investment banking activities, including the solicitation of issuers and structuring of public offering and other investment banking transactions. It also includes all firm personnel who are directly or indirectly supervised by such persons and all personnel who directly or indirectly supervise such persons, up to and including Investment Banking management.” Addendum A.I.1.c.

#### **H. Application**

1. All of the Global Research Settlement terms apply to equity research reports prepared and furnished by the U.S. broker-dealer or any affiliate (other than certain investment adviser affiliates) to U.S. investors that relate to:
  - a) A U.S. company or
  - b) A non-U.S. company whose “principal equity trading “ market is in the U.S.

Certain terms also apply to equity research reports that are *furnished* to U.S. investors but not prepared by the firm and that relate to such companies. In addition, the disclosure requirements apply to certain reports that relate to a non-U.S. company for which the U.S. market is not the principal equity trading market. *See* Addendum A at II.3.

2. This means the activities of non-U.S. analysts covering or co-covering a U.S. company or a company whose principal trading market is in the U.S. may be subject to the requirements of the Global Research Settlement. Accordingly, for firms that must comply with the Global Research Settlement, it may be necessary to implement structural reforms in international offices.

#### IV. FIXED INCOME RESEARCH VOLUNTARY INITIATIVE

- A. On May 19, 2004, as part of an industry initiative, The Bond Market Association (the “Association”) released the final version of 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. These Guiding Principles set forth a suggested framework of principles that firms can use as a reference point in creating policies and procedures appropriate for their fixed income research activities. *See* Guiding Principles To Promote Integrity of Fixed Income Research, *available at* [www.bondmarkets.com /assets/files/Guiding\\_Principles\\_for\\_Research.pdf](http://www.bondmarkets.com/assets/files/Guiding_Principles_for_Research.pdf).
- B. Specifically, the Guiding Principles recommend the following:
1. Firms should promote the integrity of fixed income research and the ability of fixed income research analysts to express their own independent views by: (1) establishing prohibitions on promising favorable fixed income research and on retaliation against research analysts for research that may adversely affect a firm’s investment banking or sales and trading interests; and (2) ensuring decisions regarding fixed income research coverage are made by research department personnel.
  2. Supervisory and management structures should insulate fixed income research analysts from review, pressure and control by investment banking personnel. This includes structuring reporting lines so that research analysts are not controlled or supervised by investment banking personnel, preventing investment banking personnel from performing or having input into evaluations, and maintaining physical separation where appropriate.
  3. Firms should take measures to prevent inappropriate influence by non-research department personnel and issuers over the content of fixed income research reports and the timing of their publication.
  4. Fixed income research analysts should be compensated in a manner designed to promote their independence.
  5. Firms should impose personal trading restrictions on fixed income research analysts to manage potential conflicts of interest.
  6. Firms and fixed income research analysts should inform investors of potential conflicts of interest that may affect fixed income research.
  7. Fixed income research analysts should not act as marketers or solicitors of investment banking services.
  8. Firms should manage potential conflicts of interest relating to their trading desks and the publication of fixed income research, including establishing a prohibition on improperly trading securities and related derivative

securities ahead of fixed income research reports, and disclosing potential conflicts of interest relating to the trading desk.

9. Trader commentary, trading ideas and other analyses produced by trading desk personnel must be clearly identified as such, and as separate and distinct from research produced by the fixed income research department.
10. Firms should allocate sufficient supervisory resources to promote the integrity of the fixed income research process, including establishing written policies and procedures and providing periodic training to research analysts, research managers and investment banking personnel.

[Note: The Association acknowledges that modifications to the Guiding Principles may be necessary and appropriate for different types of fixed income research because research for different asset classes present different potential for conflicts of interest.]