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Global Research Analyst Settlement Proving Unsettling for Issuers

The much-publicized “global research analyst settlement” is rapidly reshaping the ways brokerage firms conduct business, with significant consequences for both public and pre-IPO companies.

Under the global settlement, which was entered into in response to enforcement actions brought by a number of federal and state regulators, ten leading brokerage firms agreed to severely limit interactions between equity research analysts and investment bankers. Changes are being undertaken, however, not only by the ten firms subject to the global settlement, but also by most other brokerage firms. Regulators are implementing rules that mandate key settlement terms for all brokerage firms. Non-settling firms have been voluntarily adopting additional settlement terms as industry best practices, and some of the larger brokerage firms are considering how to extend settlement principles to fixed-income securities.

We offer the following guidance for public and pre-IPO companies grappling with the effects of the global settlement on equity financings and everyday interactions with analysts and bankers.

Equity Financing Transactions

The global settlement applies to all types of equity offerings, including initial and follow-on public offerings as well as unregistered transactions such as PIPE (private investment in public equity) offerings and Rule 144A equity-related placements. Based on our initial experience, we recommend the following guidelines for companies contemplating equity financings.

1. Cultivate independent relationships with analysts.

The global settlement focuses on limiting interactions between equity research analysts and investment bankers in order to avoid even the appearance of inappropriate influence by investment banking personnel over research decisions. The settlement, for example, prohibits an analyst’s “participation” in efforts to solicit investment banking business and limits a banker’s communications with an analyst to a narrow range of specified interactions. You therefore should establish and maintain a separate line of communication with each of your analysts.

- *Expect to meet with research personnel separately from bankers.* Analysts will no longer join bankers in preparing or conducting “dog and pony shows” and other pitches. Some brokerage firms are even banning all joint conference calls and meetings among analysts, bankers and issuers (including early-stage private issuers). A private company should seek to build separate relationships with analysts earlier in the pre-IPO process in order to benefit from the analysts’ perspectives on the company and its industry. Prior to engaging a brokerage firm for a financing transaction, you should expect that the firm’s analyst will focus on conducting due diligence and discussing your business and industry, but will avoid discussing the potential transaction. If a financing is a possibility, the analyst may decline to have any contact with you until after you have given an investment banking mandate to one or more firms.
- *Obtain commitment from research management to initiate coverage.* Research management will now make all company-specific coverage decisions, with little or no input from bankers.

With planning—and some duplication of effort—companies can minimize fallout from the ongoing divorce of research from investment banking.

If you intend to engage a brokerage firm whose research department does not cover your securities, you may wish to contact research management at that firm directly to request a commitment to initiate coverage, subject to analyst diligence. Although such a commitment is permitted, neither research management nor any individual analyst may undertake to issue a favorable rating for your securities.

2. Prepare for duplicative due diligence.

Analysts who do not cover your securities will perform a diligence review in order to screen your financing for their investor clients. The diligence review will also enable the analysts to assist their firms' commitment committees. Although practices among non-settling firms may vary, analysts will most likely conduct their diligence review without the involvement of investment banking and then provide feedback to bankers in the presence of a "chaperone"—typically a member of the brokerage firm's legal or compliance staff.

- *Schedule separate management presentations.* Background presentations about your business may need to be made to analysts outside the presence of bankers. Analysts may ask questions during these separate presentations, but may not provide pointers.
- *Arrange separate third-party diligence sessions.* Your bankers may require that analysts' conversations with customers, suppliers, auditors, regulatory counsel and other key parties occur without participation by bankers. As a result, you may need to coordinate duplicative or supplemental diligence sessions for analysts and bankers.

If a financing does not involve an analyst who is initiating coverage of your securities, the diligence process is likely to remain largely unchanged from pre-settlement practice. Analysts who currently cover your securities will most likely not be brought "over the wall"—that is, informed of the pending offering—until shortly before the transaction is publicly disclosed or marketing commences.

3. Finalize the managing underwriter group as early as practicable.

You may need to identify all of the managing underwriters of your public offering at an earlier stage in the process than in the past. Previously it was possible for a co-manager to join an offering on the eve of filing a registration statement. Analysts can no longer "piggyback" on diligence procedures completed by bankers, however, and may be expected to play a more active role in commitment committee proceedings. We have already encountered situations in which a brokerage firm declined to become a co-managing underwriter because its analyst was unable to complete diligence processes prior to filing. You should engage all of your co-managers for a public offering (or, similarly, your initial purchasers in a Rule 144A offering) sufficiently early in the process to give their analysts time to complete their diligence efforts without delaying the offering timetable, particularly if you engage a brokerage firm whose analyst will be initiating coverage of your securities.

4. Understand the altered role that analysts will play in preparing and marketing offerings.

The ability of analysts to participate in the selling of securities in an offering has been significantly circumscribed. Analysts are, for example, prohibited from "participating" in road shows for financing transactions.

- *Expect less help from analysts in drafting offering documents.* In the past, drafting sessions provided a company with an opportunity to benefit from an analyst's views of the company's industry and business. The role of analysts in the drafting process varied widely, from simply answering bankers' questions to attending drafting sessions where the analysts actively assisted in positioning the company and revising disclosure. Under the global settlement, an analyst may assist in "confirming the adequacy" of disclosure in your prospectus or other offering documents, but may not comment on these documents in the presence of bankers unless counsel or a member of the brokerage firm's compliance department also is present. Uncertainty about the nature of this

"chaperoning," as well as general caution about interactions between analysts and bankers, seems to have chilled analyst participation in drafting sessions to date.

- *Prepare your road show presentation without help from analysts.* Prior to the global settlement, analysts often played a key role in helping companies prepare road show presentations, particularly in IPOs. Analysts can no longer review or comment on draft road show slides; they may read, but not comment on, the final slide deck. Analysts may continue to make "balanced" presentations about the company at sales force teach-ins, but those presentations must be separate from management's presentations. Analysts also may continue to assist in preparing internal-use sales memoranda, although some brokerage firms currently are limiting analyst involvement and having their bankers prepare the sales memoranda (incorporating analyst models). Analysts may not attend road show presentations or "dry runs" of those presentations, although management may make a special presentation solely for analysts.
- *Outperform on the road show.* While road show presentations always have been critical to the marketing of public offerings and many PIPE and Rule 144A placements, those presentations often were supplemented and supported by the sales activities of analysts. The global settlement has eliminated the ability of banking to direct analysts to initiate contacts with prospective investors. Analysts may no longer participate in road show presentations by company management during an offering, although they still may take part in one-on-one meetings with potential investors and provide banking with feedback from those conversations. Road show presentations are likely to play an even more important role in post-settlement offerings, and you should work closely with (a) investment banking, to ensure that your road show presentation communicates your key messages and value proposition effectively and (b) equity capital markets, to ensure the presentation reaches a sufficient group of investors. Be aware, however, that neither you nor the bankers may provide analyst models to prospective investors.

5. Adopt a policy addressing "spinning."

"Spinning" occurs when a brokerage firm allocates shares in "hot" IPOs—that is, IPO shares that trade at a premium when secondary trading begins—to directors and executive officers of investment banking clients as an inducement for future investment banking business. Contemporaneously with the global settlement, the settling brokerage firms voluntarily agreed to prohibit spinning. In September 2003, regulators proposed rules that would prohibit allocations by any brokerage firm to executive officers and directors of a company if that firm either received compensation from the company for investment banking services during the preceding twelve months or expects to receive—or intends to seek—any such compensation in the following three months.

It will be difficult, however, for brokerage firms to compile the data necessary to track all allocations that could constitute spinning. In order to avoid actual or perceived conflicts of interest, we recommend that you adopt a policy specifically addressing the spinning of IPO shares to your directors and executive officers by investment banks with which you conduct, or may conduct, business.

Non-Transactional Interactions

The global settlement affects companies, including pre-IPO companies, even when they are not involved in financings. We recommend taking the following measures.

1. Cultivate independent relationships with your bankers.

Staying in regular contact with your bankers will be more useful than ever. Historically, analysts often played a significant role in helping bankers and companies identify transaction opportunities, especially for unregistered financings such as Rule 144A and PIPE offerings. Analysts are no longer permitted to suggest potential transactions to bankers or to refer potential transactions to bankers. Your bankers probably will not be aware of conversations you have with your analysts. You should remain in regular contact with your bankers to update them about your business and plans so that they can help you identify appropriate market opportunities. As noted above, although you can meet separately with your analysts, you may no longer be able to meet

simultaneously with your analysts and bankers, for example, at investor conferences or in social interactions. In addition, bankers are no longer permitted to participate in "non-deal" road shows and periodic educational meetings organized by an analyst.

2. Facilitate coverage by independent research firms.

Under the global settlement, the settling firms are required to spend an aggregate of $432.5 million over the next five years to make "independent" research available to their customers from firms that do not conduct any investment banking business or provide competing brokerage services. This initiative, together with the considerable adverse publicity about past conflicts involving analysts at brokerage firms, is likely to result in the increased stature and importance of independent research firms. You should be responsive to requests for information from independent research firms and seek to cultivate positive relationships with independent analysts.

3. Mind the gap between research and banking.

Avoid actions that might lead to a violation of the principles underlying the global settlement.

- *Express concerns about coverage directly to your analyst or research management.* Bankers are not permitted to serve as conduits for your comments about coverage issues.
- *Address all questions and comments about investment banking transactions to your bankers.* Expressions of concern to analysts about investment banking transactions may be perceived as a threat to withhold investment banking business pending some action (such as a rating upgrade) by the analyst. The result could be counterproductive, as analysts seek to avoid any perception of inappropriate influence.

Conclusion

We expect practices to continue to develop as settling and non-settling brokerage firms interpret and implement the global settlement and regulatory authorities codify the settlement's key terms and principles. We are monitoring these developments and would be pleased to discuss with you the changes you should expect as the full ramifications of the global settlement unfold.

– Mark L. Johnson

– Gregory M. Woods

If you are interested in basic background information about the settlement, please see **http://www.sec.gov/news/press/2003-54.htm**, which provides access to a press release issued by regulators to announce the key terms and principles of the global settlement.

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