Implications of New Rules Relating to Research Analysts

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The SEC recently approved significant changes to the NASD and NYSE rulesgoverning the relationship between research analysts, the investment banking departments at their firms and the companies they cover. This Internet Alert examines the rule changes, which take effect on various dates between July 9, 2002 and November 6, 2002, from the perspective of companies covered by research analysts and companies considering IPOs.

Background

The new rules, NYSE Rule 472 and NASD Rule 2711, were adopted in response to the highly publicized criticisms regarding the conflicts of interest that arise when research analysts are involved with or supervised by members of their firm's investment banking department, or when analysts or their firms directly own securities of the company that is the subject of a research report.

The NASD and NYSE intend the new rules, which are substantially identical to each other, to increase the independence of research analysts and to improve the reliability of research reports communicated to the public. The NASD and NYSE hope that the new rules will bolster public confidence in the integrity of the equity markets as a whole.

In view of the concerns raised by the recent investigations by the Attorney General's Office of New York into the retail sales practices of investment banking firms, the rule changes target certain conduct of research analysts and the investment banking departments of analysts' firms perceived to give rise to conflicts of interest. The new rules include:

- a prohibition against the supervision or control of research analysts by investment banking department personnel;

- the imposition of trading and ownership restrictions on analysts' personal portfolios; and
- a prohibition against analysts' receipt of compensation directly tied to specific investment banking transactions.

Companies should keep in mind that additional rule changes beyond those discussed in this alert may well result from the SEC's recently announced formal inquiry into research analysts or from congressional action.

Changes Relevant to Public and Pre-Public Companies

The rule changes address conduct of research analysts and their firms as related to the companies they cover. By focusing not only on research analysts and investment banks but also on subject companies, the rules are intended to provide a comprehensive approach to address analyst independence issues. The rules most relevant to public and pre-public companies are:

- a prohibition against tying favorable research ratings to an award of investment banking business (effective July 9, 2002);
- the institution of "quiet periods" to minimize the extent to which research reports published by managing underwriters can influence stock prices in the aftermarket of an IPO or certain follow-on offerings (effective July 9, 2002);
- restrictions on the review of research reports by subject companies (effective September 9, 2002); and
- mandatory disclosure by analysts and their firms of financial interests in, and interested-party relationships with, the companies they cover (effective November 6, 2002).

No Promises of Favorable Research Reports

The rule changes approved by the SEC seek to curb the practice of tying favorable research reports to obtaining a company's investment banking business by prohibiting an investment bank from offering a favorable research rating or specific price target to the company as an inducement to use the investment banking services of the research analyst's firm.

Quiet Period Rules

New rules prohibit the managing underwriters of certain equity securities offerings from publishing a research report on an issuing company during a “quiet period” following the offering. The quiet periods extend for (a) 40 days after an IPO or (b) 10 days after a follow-on offering by a company whose securities do not have an average daily trading volume of at least $1 million and a public float of at least $150 million. The quiet period rules do not apply to:

- research reports issued by any investment bank after a follow-on offering if the company’s securities are “actively traded,” meaning those securities have an average daily trading volume of at least $1 million and a public float of at least $150 million;
- research reports published by investment banking firms, including members of an underwriting syndicate, that did not serve as a manager or co-manager of the offering; and
- research reports published by any investment banking firm in response to “significant” news items or events involving the company’s earnings, operations or financial condition, provided that the investment banking firm’s legal department pre-approves the research report.

The SEC’s existing restrictions on the issuance of research reports during and shortly after public offerings remain unchanged. As a result, the quiet period rules should have a relatively limited effect on issuers. For example, SEC rules already restrict analysts from publishing research reports for 25 days after an IPO if the securities are traded on Nasdaq or an exchange. As a result, the effect of the new rule for newly public companies will be to extend for 15 days the “blackout” period applicable to research reports issued by the investment banking firms that served as managers of an IPO.

The quiet periods are intended to permit market forces to determine the aftermarket price of a security uninfluenced by positive research reports from the investment banking firms with the most substantial economic interests in the offering. The exception for follow-on offerings by “actively traded” companies reflects the view that these types of positive research reports are less likely to influence an aftermarket for a larger, seasoned issuer. The NASD and NYSE expect that the quiet periods will minimize the perception that a managing underwriter has the ability to reward a company for investment banking business by issuing a favorable research report immediately following the completion of an offering.

Company Review of Research Analysts Reports

The new rules prohibit research analysts and their firms from submitting drafts of research reports to subject companies for review, except for purposes of verifying facts. This provision is intended to protect analysts from influences that otherwise could taint the objectivity and independence of their reports. Similarly, the new rules bar investment banking departments from reviewing research reports prior to distribution of such reports to the public, except for purposes of fact checking and identification of conflicts of interest.

When an analyst does share a research report with a company prior to publication, the analyst must do so only under the supervision of the firm's legal and compliance departments. In addition, the new rules prohibit the analyst from including in that draft report the analyst's research summary, research rating or price target. If the research analyst changes his or her rating, price target or recommendation after sharing the report with the company, the analyst must provide written justification for the change to the firm's legal or compliance department which then must authorize the change. Research analysts are also prohibited under the new rules from informing companies about changes in a rating or recommendation until after the market closes on the business day prior to announcing the rating recommendation to investors.

While Regulation FD has already caused companies to be more vigilant in their disclosures to analysts, including by curtailing the practice of reviewing analyst reports, the new rules will similarly cause analysts to reevaluate the level and types of contact analysts have with the companies they evaluate. For example, investment banking firms may reconsider the extent to which they will involve research analysts in road show meetings and other aspects of a company's capital-raising efforts.

Mandatory Public Disclosure Requirements

An analyst must disclose during public appearances regarding a subject company, and a firm must disclose in research reports, whether:

- the analyst or any member of his or her household has a financial interest in the securities of the recommended company;
- the firm beneficially owns 1% or more of any class of the subject company's common equity securities, as measured at the end of the previous month (or the end of the

second most recent month if the publication or appearance is less than ten calendar days after the end of the most recent month);

- an analyst or any member of his or her household is an officer, director or advisory board member of the company; and
- any other actual, material conflicts of interest of the analyst or firm exist of which the analyst knows or has reason to know at the time the research report is issued or the public appearance is made.

In addition, a firm must disclose in research reports if:

- the firm managed or co-managed a public offering of equity securities for the subject company;
- the firm received compensation for investment banking services from the subject company in the past 12 months, or reasonably expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months; and
- the research analyst principally responsible for the preparation of the report received compensation based on the firm's investment banking revenues.

Finally, an analyst must disclose in public appearances if he or she knows or has reason to know that the subject company is a client of the analyst's firm.

Companies should be mindful of the potential for inadvertent disclosure of non-public transactions by investment banking firms complying with the new disclosure rules. To reduce the risk of any inadvertent disclosure of non-public transactions, the rules do not require disclosure of the specific amount of compensation that the firm received, or expects to receive, from the investment banking services, or even the type of transaction from which the fees were earned.

Limitations on Purchases by Analysts of Subject-Company Securities

Although the new rules do not prohibit analysts from investing in the securities of subject companies, the new rules do impose restrictions on the timing of those purchases. In addition, a number of firms have enacted even broader internal policies which prohibit analysts from holding securities in the companies they cover.

Among other trading restrictions, the new rules prohibit an analyst, or anyone in the analyst's household, from purchasing or receiving an issuer's pre-IPO securities if the analyst covers the same types of business as the pre-IPO issuer. By barring analyst ownership of pre-IPO shares in subject companies, the new rules reduce the incentive for analysts to publish overly favorable research on subject companies. In addition, the new rules prohibit analysts and members of their households from trading in subject-company securities for 30 days prior to, and five days after, publication of research reports on subject companies or announcements of changes in rating or price targets of subject-company securities.

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