

made on equity securities. The rules contain a number of elements, including:

- A prohibition on offering favorable research to induce investment banking business;
- Structural reforms to increase analyst independence, including a prohibition on investment banking personnel supervising analysts or approving research reports;
- A prohibition on tying analyst compensation to a specific investment banking services transaction;
- Increased disclosures of conflicts of interest in research reports and public appearances by analysts;
- Restrictions on personal trading by analysts; and
- Disclosure in research reports of data and price charts showing the firm's ratings track record.

#### *B. Proposed Changes to NYSE and NASD Rules*

The proposed SRO rule changes further address research analyst conflicts of interest in connection with equity research reports, and are designed to achieve full compliance with the mandates of the SOA. The Commission provides here a general overview of the proposed rule changes. The Commission notes, in particular, that while the NASD and NYSE rules may differ to some degree in their texts, the provisions are intended to operate in substantially the same way.<sup>16</sup>

First, the proposals further separate research analyst compensation from investment banking influence. Specifically, the proposals require that a compensation committee of the broker-dealer review and approve the compensation of its research analysts that are primarily responsible for the preparation of the substance of research reports. The committee would report to the Board of Directors and may not have representation from the firm's investment banking department. Among other things, the committee would consider the analyst's individual performance (*e.g.*, quality of research product); correlation between a research analyst's recommendations and stock prices; and overall ratings from various internal or external parties exclusive of the firm's investment banking personnel. The committee may not consider a research analyst's contribution to the firm's overall investment banking business. In addition, in order to comply with the SOA, the proposals prohibit investment banking personnel influence or control

over the compensatory evaluation of research analysts.

Second, the proposed rules prohibit analysts from issuing positive research reports or reiterating a "buy" recommendation around the expiration of a lock-up agreement (sometimes called "booster shot" research reports). The proposals accomplish this by prohibiting the issuance of research reports by the manager or co-manager of a securities offering for fifteen days prior to and after the expiration of lock-up agreements.

Third, the amendments extend the current ten and forty-day quiet periods for the issuance of written research reports to communications in public appearances by managers and co-managers of initial and secondary offerings. The proposals also establish a 25-day quiet period during which broker-dealers who have agreed to participate (or who are participating) as underwriters or dealers (other than a manager or co-manager) of an issuer's initial public offering would be prohibited from publishing research reports and analysts would be prohibited from making public appearances regarding that issuer.

Fourth, the proposed rules further insulate research analysts from investment banking interests by prohibiting analysts from participating in "pitches" or other communications for the purpose of soliciting investment banking business.

Fifth, the proposed rules require that a member provide notice to customers that it is terminating research coverage of an issuer that is the subject of a research report ("subject company"). The final report must include a final recommendation or rating (unless it is impracticable to do so).

Sixth, the proposed SRO rule changes restrict the prepublication review and approval of research reports by persons not directly responsible for research. The rules also require that prepublication communications about the content of a research report between all non-research personnel and the research department be intermediated by legal or compliance staff.

Seventh, the proposals prohibit members engaged in investment banking activities from directly or indirectly retaliating, or threatening to retaliate, against a research analyst who publishes a research report or makes a public appearance that may adversely affect the member's present or prospective investment banking relationship. The SROs have clarified in the rules that the anti-retaliation provision would not preclude termination of a research analyst, in

accordance with the member's policies and procedures, for causes unrelated to issuing or distributing such adverse research or for making an unfavorable public appearance regarding the member's current or potential investment-banking relationship with the issuer.

Eighth, the proposals expand on the current SRO compensation disclosure requirements by requiring disclosure by a member in research reports, to the extent the member knows or has reason to know, and by a research analyst in public appearances, to the extent the analyst knows or has reason to know, of whether the member, or any affiliate thereof (including the research analyst), received any compensation during the past twelve months from the issuer that is the subject of the report or public appearance. The rule changes further require disclosure of whether the subject company is, or has been during the previous year, a client of the member, and if so, the types of services provided to the issuer. The types of services provided to the subject company must be described as: (1) Investment banking services, (2) non-investment banking securities-related services, or (3) non-securities services. Both the compensation disclosure and the client services disclosure provisions provide for an exception in order to prevent the disclosure of material non-public information regarding specific potential future investment banking transactions of the issuer.

Ninth, the proposed SRO rule changes also create an exception from the existing "gatekeeper" provisions of the SRO rules for certain members that engage in limited underwriting activity.<sup>17</sup> The gatekeeper provisions prohibit a research analyst from being subject to the supervision or control of any employee of a member's investment banking department, and further require legal or compliance personnel to intermediate certain communications between research and investment banking personnel.

Tenth, the proposed rules require that legal or compliance personnel pre-approve all securities transactions of persons who oversee research analysts, including the members of a committee and certain others, that have direct influence or control with respect to the preparation of research reports or establishing or changing a rating or price target of a subject company's equity securities, to the extent that the transactions involve securities of subject

<sup>16</sup> See NASD Amendment No. 3 and NYSE Amendment No. 3.

<sup>17</sup> See NYSE Rule 472(b)(1) and (3), and NASD Rule 2711(b)(1) and (3) ("gatekeeper" provisions).