

where the research analyst is no longer employed by the same firm.²⁷

Commenters also noted that the proposed provisions referred to the signing of a letter of intent, or other written agreement, in determining the date the firm received an investment-banking mandate. They argued that letters of intent are not common industry practice and, therefore, should not be used as evidence of the receipt of a mandate.²⁸

The proposals also provided that the prohibition would not apply to "due diligence communications" between the research analyst and the subject company, the sole purpose of which is to analyze the financial condition and business operations of the subject company. Commenters requested clarification as to the meaning of "due diligence communications" and several suggested specific language or parameters.²⁹

After considering commenters' concerns, the SROs modified their proposals in Amendment No. 3 to provide for an outright prohibition on research analyst participation in "pitches" for investment banking business or other communications with companies "for the purpose of soliciting investment banking business."³⁰ While the original proposals sought to provide a disincentive for analyst involvement in pitches by prohibiting an analyst from preparing research reports on issuers with whom the analyst engaged in a pitch, the amended proposals take the approach of prohibiting analyst involvement in pitches.

The NASD believes that this amendment will not only promote regulatory consistency, but will also further the goals of research objectivity and investor confidence by eliminating all participation by research analysts in solicitation efforts, which could suggest a promise of favorable research in exchange for underwriting business.³¹ Because the SROs believe that the same potential conflicts exist with respect to solicitation of all investment banking business, the amendment is not limited to initial public offerings.³²

The final amendments also address commenters' concerns regarding what communications are permissible for

research analysts. The SROs note that certain activities are traditionally associated with research functions within a multi-service securities firm, and are separate from the solicitation activities of concern that analysts may have recently been called upon to engage in by their firms.³³ For example, the NASD notes that the proposed amendment would not curtail research analysts from performing activities traditionally associated with research functions that do not involve solicitation of investment banking business, such as helping to screen potential investment banking clients.³⁴ The NYSE also recognizes the need for critical financial analysis of a subject company, during the period after the receipt of an investment banking mandate by the member while an issuer is preparing to engage in a securities offering to the public.³⁵ By prohibiting analyst participation in pitches and other activities involving the solicitation of investment banking business, the final amendments also avoid the implementation issues associated with the initial proposals.

The amended proposals further insulate research analysts from investment banking interests, while addressing commenters' concerns regarding vagueness, by clarifying the parameters of the kind of activities the rule is designed to address. The SROs note that the prohibition on analysts' involvement in solicitations of investment banking business is intended to support the prohibition on promising favorable research as a marketing tool to prospective investment banking clients of members, and is designed to encourage issuers to choose an investment banking firm based on the merits of the firm's underwriting capabilities.³⁶

In our view, it is appropriate for the SROs to prohibit analyst involvement in pitches or other communications by research analysts that are made for the purpose of soliciting investment banking business. The Commission believes that the rules address concerns regarding analyst objectivity and independence from investment banking

interests while permitting research analysts to provide certain services to their firm that several commenters viewed as valuable. The Commission also finds that the rules relating to research analyst involvement in solicitations for investment banking business are consistent with the Exchange Act, particularly Sections 6(b)(5), 6(b)(8), 15A(b)(6), and 15A(b)(9).

B. Compensation of Research Analysts [NYSE Rule 472(h) and NASD Rule 2711(d)]

The rule proposals reinforce the separation of research analyst compensation from investment banking influence by requiring procedures for review and approval of a research analyst's compensation by a committee that reports to the Board of Directors or a senior executive of the broker-dealer. No employee of a member's investment banking department may participate in the committee. At a minimum, the committee must consider the following factors: the research analyst's individual performance (e.g., quality of research product), the correlation between a research analyst's recommendations and stock prices, and overall ratings from various internal (other than investment banking) or external parties.

Further, in reviewing and approving an individual research analyst's compensation, the committee may not consider his or her direct contribution to the firm's overall investment banking business. The basis for a research analyst's compensation would have to be documented and the committee must provide an annual attestation to certify that the committee reviewed and approved the compensation of research analysts who are primarily responsible for the preparation of the substance of research reports³⁷ and documented the basis for such approval.

Several commenters expressed concern regarding the compensation committee provisions and suggested alternatives.³⁸ One commenter believed that the ban on consideration by a compensation review committee of contributions to the firm's investment banking business should not preclude considering contributions to the extent that they benefit investors.³⁹ Other commenters asked for clarification that a member's overall profitability may be considered in determining a research

³³ *Id.*

³⁴ See NASD response to Comments.

³⁵ See NYSE Amendment No. 3.

³⁶ Promising favorable research to companies as an inducement for business is currently explicitly prohibited by NASD Rule 2711(e) and NYSE Rule 472(g). In addition, according to the SROs, promising favorable research to companies as an inducement for business would constitute a violation of just and equitable principles of trade. See Securities Exchange Act Release No. 45526 (March 8, 2002), 67 FR 11526 at 11539 (March 14, 2002) (Notice of SRO rules approved by the Commission in May 2002 approval order).

²⁷ See Adams *et al.* letter; SIA March 10th letter; SunTrust letter; and Wilmer March 11th letter.

²⁸ See SIA March 10th letter and Wilmer March 11th letter.

²⁹ See Adams *et al.* letter; SIA March 10th letter; Stifel letter; and Wilmer March 11th letter.

³⁰ The Global Settlement also prohibits research analyst involvement in "pitches."

³¹ See NASD Response to Comments.

³² See NASD Response to Comments and NYSE Amendment No. 3.

³⁷ The research analyst who is primarily responsible for the preparation of the substance of a research report is often referred to as the "lead" analyst. The Commission notes that a research report may have more than one lead analyst.

³⁸ See SIA March 10th letter, Stifel letter, and Weiss letter.

³⁹ See SIA March 10th letter.