

simultaneously approved comparable changes to NASD rules (new NASD Rule 2711—"Research Analysts and Research Reports"). NYSE believes that these rule amendments are the result of the SROs working to develop uniform industry rules.

The rule amendments generally restrict the relationship between research and investment banking departments and the companies that are the subject of research reports; require disclosure of a financial interest in a subject company by an analyst or a member or member organization; require disclosure of existing and potential investment banking relationships with a subject company; impose quiet periods for the issuance of research reports following the completion of a company's securities offering; restrict personal trading by research analysts in the stock of the companies covered by such analysts; and generally require extensive disclosure in research reports of certain important information to help customers monitor the correlation between an analyst's rating and the stock's price movements.

The rule amendments have been phased-in incrementally to provide members and member organizations time to develop and implement policies, procedures and systems and hire additional personnel to comply with the new requirements. The staggered implementation of the Rules began July 9, 2002, with September 9, 2002 and November 6, 2002 as the effective dates for certain specified provisions. Implementation dates for certain of the SRO rules have also been delayed for small firms. As a result of numerous interpretive requests, on June 26, 2002, the Exchange and the NASD issued a Joint Memo providing interpretive guidance to certain rule provisions.<sup>6</sup>

According to NYSE, the Exchange, together with other regulatory organizations and SROs, is currently examining members' and member organizations' research practices to determine compliance with the new SRO Rules.

According to the NYSE, some of the interpretive issues raised by the industry and the preliminary findings from the recent examinations have highlighted the need for certain additional changes to the existing SRO Rules. NYSE believes that further amendments to the SRO rules will also be required to comply with the mandate of the Sarbanes-Oxley Act of 2002

("SOA"), which requires the SEC, either directly or indirectly through SROs, to adopt not later than one year after the date of enactment of the Act (July 24, 2002), "rules reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances, in order to improve the objectivity of research and provide investors with more useful and reliable information."

According to the NYSE, certain of the disclosure requirements and prohibitions that the SOA mandates have already been adopted in the new NYSE Rules. In some cases, the SOA appears to impose more stringent requirements. The NYSE is currently analyzing the differences between the SOA and NYSE Rules, to determine the extent of additional amendments to be made.

#### *Proposed Amendments Regarding Research Analysts*

The following proposed amendments to Exchange rules governing communications with the public expand upon the recently approved rule changes. The amendments generally provide for further restrictions on research analysts' compensation and trading activities, and impose additional disclosure requirements for research reports and associated persons.

Proposed amendments to Rule 472 would further separate an analyst's compensation from investment banking influence by requiring procedures for review and approval of research analysts' compensation by a Committee that reports to the Board of Directors or a senior executive. Recently approved amendments prohibit an associated person from being compensated for specific investment services transactions.

Such a Committee, at a minimum, would consider the following factors: the associated person'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 member or member organization investment banking personnel.

Further, in determining an individual research analyst's compensation, the Committee may not consider his or her contribution to the firm's overall investment banking business. The basis for a research analyst's compensation would have to be documented and an annual attestation to the Exchange would certify that the Committee reviewed and approved each associated person's compensation and documented

the basis for such approval (Rule 472(h)(1) and (2)).

Proposed Rule 472(b)(4) will prohibit a research analyst from issuing a research report or making a public appearance concerning a subject company if the research analyst engaged in any communication with the subject company in furtherance of obtaining investment banking business prior to the time the subject company entered into a letter of intent or other written agreement with the member or member organization designating the member or member organization as an underwriter of an initial public offering by the subject company.<sup>7</sup> Prohibiting research analysts from issuing research reports or making public appearances after participating in "pitch" meetings is intended to prevent the use or promise of research as an influence or a sales and marketing tool with prospective investment banking clients of the member or member organization, and would cause subject companies to choose a prospective investment banking firm based on the merits of its underwriting capabilities, rather than its research coverage.<sup>8</sup>

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, is not subject to the prohibition. Recognizing the need for critical financial analysis of a subject company during the period an issuer is preparing to engage in a securities offering with the public, the rule allows research analysts to participate in due diligence communications. In doing so, the rule is intended to segregate legitimate research analyst duties/functions, traditionally associated with their profession, from the sales/marketing duties that they may have been called upon recently to do by their firms.

Proposed amendments to Rule 472 would prohibit the issuance of research reports by the manager or co-manager of a securities offering for fifteen (15) days prior to and after the expiration time of any "lock-up agreement" (Rule 472(f)(4)). This provision is intended to address situations where research analysts may issue positive research reports or reiterated "buy" recommendations shortly before or just after the expiration of a lock-up agreement. Through issuance or reiteration of "buy" recommendations,

<sup>7</sup> Telephone conversation between NYSE and Division Staff on December 30, 2002.

<sup>8</sup> Telephone conversation between NYSE and Division Staff on December 30, 2002.

<sup>6</sup> NYSE Information Memo No. 02-26 (June 26, 2002), and NASD Notice to Members 02-39 (July 2002).