

BOSTON
WASHINGTON
NEW YORK
RESTON
NEW HAVEN

www.mintz.com

*One Financial Center
Boston, Massachusetts 02111
617 542 6000
617 542 2241 fax*

*701 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
202 434 7300
202 434 7400 fax*

*666 Third Avenue
New York, New York 10017
212 935 3000
212 983 3115 fax*

*11911 Freedom Drive
Reston, Virginia 20190
703 464 4800
703 464 4895 fax*

*157 Church Street
New Haven, Connecticut 06510
203 777 8200
203 777 7111 fax*

Client Alert

April 12, 2002

BUSINESS AND FINANCE

Analyst Conflicts of Interest

On April 8, 2002, New York State Attorney General Eliot Spitzer announced that, after a 10-month investigation showed that employees of Merrill Lynch & Co. Inc. recommended stocks that they knew were probably bad investments, he had obtained a court order requiring Merrill Lynch to disclose to customers its relationship with investment banking clients and to explain its stock ratings. Spitzer has alleged that Merrill Lynch promoted the stock of certain companies, even after such stock received poor ratings from its own research analysts, because the firm wanted to keep the companies' lucrative investment banking business. Spitzer also said that the investigation is ongoing and could possibly lead to criminal charges. Various news sources recently reported that Spitzer's investigation has been expanded to include other firms, including Goldman Sachs Group Inc., Credit Suisse First Boston, Morgan Stanley Dean Witter & Co., UBS PaineWebber, Salomon Smith Barney, Bear, Stearns & Co., Lehman Brothers Holdings Inc., and Lazard Freres. In addition, various prominent individual analysts, such as Henry Blodget of Merrill Lynch and Jack Grubman of Salomon Smith Barney, have recently been the target of civil lawsuits brought by investors making claims similar to those made by Mr. Spitzer.

In light of this and similar announcements, brokerage firms would be well advised to become familiar with the recently proposed rule changes relating to research analyst conflicts of interest. The new rules will require certain written procedures and policies to be adopted. Mintz Levin has developed model policies and other written materials. Please contact Joel Papernik (212-692-6774) or Gordon Caplan (212-692-6702) in our New York office or Jonathan Kravetz (617-348-1674) in our Boston office for more information. Below for your reference is a summary of the proposed rules.¹

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934, as amended, and Rule 19b-4 thereunder, the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE) recently filed with the Securities and Exchange Commission (SEC) certain proposed rule changes relating to research analyst conflicts of interest. On March 8, 2002, the SEC published a notice to solicit

¹ As the following summary is based upon draft rule proposals that are still subject to comment and revision, the information herein should not be relied upon and no action should be taken without consultation and advice from appropriate compliance and legal advisors.

comments on the proposed rule changes.² All comments must be submitted by April 18, 2002.³

The NASD is proposing to amend its rules to establish new Rule 2711 (Research Analysts and Research Reports) to address research analyst conflicts of interest. The NYSE is proposing amendments to NYSE Rule 472 (Communications with the Public), which will impose certain disclosure requirements on members, member organizations and associated persons (which term includes any persons responsible for the making of a recommendation to purchase, sell or hold an equity security in research reports, among others) preparing research reports and making public appearances. The NYSE is also proposing amendments to NYSE Rule 351 (Reporting Requirements), which will require members and member organizations to submit to the NYSE, annually, a written attestation that the member or member organization has established and implemented written procedures reasonably designed to comply with the provisions of NYSE Rule 472.

Summary of Certain Material Provisions of NASD Proposed Rule 2711 (Research Analysts and Research Reports) and NYSE Proposed Rule 472 (Communications with the Public)⁴

With certain enumerated exceptions:⁵

Restrictions on Investment Banking Department Relationship with Research Department

- No research analyst may be subject to the supervision or control of any employee of the member's investment banking department.
- No employee of the member's investment banking department may review or approve a research report of the member before its publication.

Restrictions on Review of a Research Report by the Subject Company

- A member may not submit a research report to the subject company before its publication.

Prohibition of Certain Forms of Research Analyst Compensation

- No member may pay any bonus, salary or other form of compensa-

tion to a research analyst that is based upon a specific investment banking services transaction.

Prohibition of Promise of Favorable Research

- No member may directly or indirectly offer favorable research, a specific rating or a specific price target, or threaten to change research, a rating or a price target, to a company as consideration or inducement for the receipt of business or compensation.

Imposition of Quiet Periods

- No member may publish a research report regarding a subject company for which the member acted as manager or co-manager of: (1) an initial public offering, for 40 calendar days following the date of the offering; or (2) a secondary offering, for 10 calendar days following the date of the offering.

² See Self-Regulatory Organizations: Notice of Filing of Proposed Rule Changes by the National Association of Securities Dealers, Inc. and the New York Stock Exchange, Inc. Relating to Research Analyst Conflicts of Interest, SEC Release No. 34-45526 (File Nos. SR-NASD-2002-21; SR-NYSE-2002-09; March 8, 2002).

³ Persons submitting comments must file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. All submissions should refer to File Nos. SR-NASD-2002-21 and SR-NYSE-2002-09. Copies of all submissions will be available for inspection and copying in the SEC's public reference room and at the principal offices of the NASD and the NYSE.

⁴ This summary combines the fundamental aspects of both rule proposals and should not be read as a complete restatement of either proposal. Your attention is directed to the text of the actual proposals, which may be read on the SEC's website (see <http://www.sec.gov/rules/sro/34-45526.htm>). Though there is significant overlap between the rules proposed by the NASD and the NYSE, the SEC noted that there are differences in the text of the proposals and specifically requested comment on whether there are any differences that would present compliance or interpretive issues.

⁵ Some examples of the numerous exceptions to the proposed rules: (i) rules prohibiting investment banking employees or subject companies from approving research reports contain exceptions allowing research reports to be reviewed for factual accuracy; (ii) rules prohibiting a member from trading in recommended subject company securities contain exceptions allowing transactions that are pre-approved by the member's legal or compliance department and that are made due to unanticipated significant changes in personal financial circumstances; and (iii) rules prohibiting a member from issuing research reports regarding a subject company for which the member has recently acted as manager or co-manager of an initial public offering or secondary offering contain exceptions for research reports that are issued due to significant news or events (provided that such research reports are pre-approved in writing by the member's legal or compliance department).

Restrictions on Personal Trading by Research Analysts

- No research analyst account (which term includes any account in which a research analyst or member of the research analyst's household has a beneficial interest, or over which such analyst or household member has discretion or control) may purchase or receive any securities before the subject company's initial public offering if the subject company is principally engaged in the same types of business as companies that the research analyst follows.
- No research analyst account may purchase or sell any security issued by a company that the research analyst follows, or any option on or derivative of such security, for a period beginning 30 calendar days before and ending five calendar days after the publication of a research report concerning the company or a change in a rating or price target of the company's securities.
- No research analyst account may purchase or sell any security or any option on or derivative of such security in a manner inconsistent with the research analyst's recommendation as reflected in the most recent research report published by the member.

Disclosure Requirements

- A member must disclose in research reports and a research analyst must disclose in public appearances: (A) whether the research analyst or a member of the research analyst's household has a financial interest in the securities of the subject company,

and the nature of the financial interest; (B) whether, as of five business days before the publication of the research report or the public appearance, the member or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company; and (C) any other actual, material conflict of interest of the research analyst or member of which the research analyst knows or has reason to know at the time of publication of the research report or at the time of the public appearance.

- A member must disclose in research reports if: (i) the research analyst principally responsible for preparation of the report received compensation that is based upon the member's investment banking revenues; and (ii) the member or its affiliates received compensation from the subject company within twelve months before, or reasonably expects to receive compensation from the subject company within three months following, publication of the research report.
- A research analyst must disclose in public appearances whether the analyst knows or has reason to know that the subject company is a client of the member or its affiliates.
- A member must disclose in research reports and a research analyst must disclose in public appearances whether the research analyst or a member of the research analyst's household serves as an officer, director or advisory board member of the subject company.
- A member must define in its research reports the meaning of each rating used by the member in its rating system. The definition of each rating must be consistent with its plain meaning.
- Regardless of the rating system that a member employs, a member must disclose in each research report the percentage of all securities rated by the member to which the member would assign a "buy," "hold/neutral" or "sell" rating.
- In each research report, the member must disclose the percentage of subject companies within each rating category ("buy," "hold/neutral" or "sell") for whom the member has provided investment banking services within the previous twelve months.
- A member must present in any research report concerning an equity security on which the member has assigned any rating for at least one year, a line graph of the security's daily closing prices; such graph must cover the period that the member has assigned any rating or a three-year period, whichever is shorter.
- A member must disclose in research reports the valuation methods used to determine a price target. Price targets must have a reasonable basis and must be accompanied by a disclosure concerning the risks that may impede achievement of the price target.
- A member must disclose in research reports whether it was making a market in the subject company's securities at the time that the research report was published.

- The disclosures described above must be presented on the front page of research reports or the front page must refer to the page on which disclosures are found. Disclosures and references to disclosures must be clear, comprehensive and prominent.

Supervisory Procedures

- *Each member subject to these rules must adopt and implement written supervisory procedures reasonably designed to ensure that the member and its employees comply with the provisions of these rules, and a senior officer of such a member must attest annually to the NASD and/or NYSE, as applicable, that it has adopted and implemented those procedures.*

Proposed NASD Rule 2711 and proposed NYSE Rule 472, if enacted, may significantly impact certain current industry practices. Members and member organizations are strongly encouraged to comment on the proposed rules and to immediately begin planning for the adoption of written policies and procedures to ensure compliance.

If you would like further information about the topic covered in this Alert, or any Business and Finance issue, please contact the Mintz Levin attorney who ordinarily handles your legal affairs, or one of the attorney authors listed below:

Joel I. Papernik
212 692 6774
jpapernik@mintz.com

Gordon R. Caplan
212 692 6702
gcaplan@mintz.com

Jonathan Kravetz
617 348 1674
jkravetz@mintz.com

