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SEC Releases New Rules to Address Analyst Conflicts of Interest

A series of questionable practices and conflicts of interest involving securities research analysts and their reports have come to light in recent months, most notably in connection with the Enron debacle. Such conflicts can lead to greater profits for the analysts and their firms at the expense of investors generally. Even while Enron announced serious accounting errors and massive losses, and its stock price plunged, most analysts following the company gave it optimistic ratings, raising the appearance of significant conflicts. These conflicts of interest arise when analysts work for firms that have investment banking or other business relationships with issuers of the recommended securities, or when the analysts or firms own securities of the recommended issuers.

In April 2002, the Securities and Exchange Commission announced that it has begun a formal inquiry, along with the New York Stock Exchange and National Association of Securities Dealers, into potential conflicts arising from relationships between research analysts and investment banking divisions of their firms. Additional investigations are being conducted by state authorities, such as the New York Attorney General's investigation of Merrill Lynch & Co. While these inquiries and investigations continue, the SEC has adopted new and amended NYSE and NASD disclosure and conduct rules that will further regulate analysts' communications, trading activities, compensation and research ratings and mandate specific disclosure when their firms have investment banking relationships with, or when their firms own securities of, the issuers covered by the analysts.

Limits on Use and Release of Research Reports and Analyst Trading

Previously, research analysts would use their reports, particularly those that would contain favorable ratings, as a leverage point with issuers to drum up business for the investment banking divisions of the analysts' firms. For example, analysts could promise favorable ratings or threaten to downgrade ratings in return for issuers' agreements to utilize the analysts' firms in particular transactions. While this practice was likely already impermissible, under the new rules analysts will explicitly be prohibited from offering or threatening to withhold a favorable research rating or specific price target to induce investment banking business from companies.

In addition, in order to curb the practice of "rewarding" an issuer for choosing an investment banker as its underwriter by publishing favorable research, the rule changes impose "quiet periods" that bar a firm that is acting as manager or co-manager of a securities offering from issuing a report on a company within 40 days after an initial public offering (or within 10 days after a secondary offering for an inactively traded company). Critics argued that existing restrictions on research distribution were sufficient (usually a 25 day quiet period after IPOs) and that these greater restrictions will prevent the dissemination of critical information at an important time for issuers. The NYSE and NASD countered that the quiet periods allow market forces to determine the price of a security in the aftermarket, unaffected by research reports issued by firms with the most substantial interests in the offering, and that other firms will still be able to distribute research reports.

In order to reduce what the SEC and stock exchanges perceived as conflicts of interests arising when analysts trade around the time they issue research reports, new trading "black-outs" will apply to individual analysts, with limited exceptions. The rule changes bar analysts and members of their households from investing in a company's securities prior to its initial public offering if the company is in the business sector that the analysts cover. In addition, the rule changes prohibit analysts from trading securities of the

companies they follow for 30 days before and 5 days after they issue a research report about those particular companies. Analysts will also be prohibited from trading against their most recent recommendations.

Limits on Analyst Compensation and Sharing of Information

The rule changes will bar securities firms from tying analysts' compensation to specific investment banking transactions. Furthermore, if an individual analyst's compensation is based on a firm's general investment banking revenues, that fact will have to be disclosed in the firm's research reports. The SEC believes that prohibiting compensation from specific investment banking transactions will curtail a potentially major influence on research analysts' objectivity.

To further protect research analysts from influences that could impair their objectivity and independence, the rules also prohibit research analysts from being supervised by the investment banking departments of their firms. Investment banking personnel will be prohibited from discussing research reports with analysts prior to distribution, unless staff from the firm's legal or compliance department monitor those communications. Analysts will also be prohibited from sharing draft research reports with the companies covered by the reports, other than to check factual sections of the reports for accuracy, and the rules require legal or compliance personnel of the firm to receive copies of the portions of reports submitted to companies and to approve any resultant changes to ratings or price target.

New Disclosure by Analysts

The rules changes will result in a variety of new disclosure requirements (including the compensation disclosure described above) designed to alert investors about analysts' potential conflicts of interest involving their security holdings and the investment banking divisions of their firms. These new disclosures must appear or be referenced on the front page of each research report in a clear, comprehensive and prominent manner. For example, the SEC believes that requiring securities firms to disclose compensation from investment banking clients can alert investors to potential biases in their recommendations. A securities firm will be required to disclose in a research report if it managed or co-managed a public offering of equity securities for the relevant company or if it received any compensation for investment banking services from the relevant company in the past 12 months. A firm will also be required to disclose if it expects to receive or intends to seek compensation for investment banking services from that company during the next 3 months following the date of the report. Some critics have expressed concern that this disclosure could have insider trading implications by forcing research departments to disclose new relationships (albeit without specifics), thereby tipping recipients of the research reports of the possibility of acquisitions or other material activities. The SEC felt that this rule struck a fair balance between these concerns and the need for increased disclosure.

Additional disclosures designed to highlight potential analyst biases include requiring analysts to disclose in research reports if they own shares of the recommended companies and requiring firms to disclose in research reports if they own 1% or more of the covered company's equity securities as of the previous month end. Similarly, during public appearances, such as television or radio interviews, guest analysts will have to disclose if they or their firms have a position in the stock of the relevant company and also if the company discussed is an investment banking client of their firms.

Finally, to assist investors in deciding how to evaluate firms' security ratings, the rule changes require firms to clearly explain in research reports the meaning of all ratings terms they use, and this terminology must be consistent with its plain meaning. Additionally, firms must provide the percentage of all the ratings that they have assigned to buy/hold/sell categories (or whatever they call these categories, so long as they are explained!) and the percentage of investment banking clients in each category. Firms will also be required to provide a graph or chart that plots the historical price movements of the security and indicates those points at which the firm initiated and changed ratings and price targets for the company.

Conclusion

The summary above covers the most recent rules and changes designed to address conflicts of interest of securities analysts. In order to provide analysts and their firms reasonable time periods to develop and implement policies, procedures and systems to comply with the new requirements, these rules will be implemented on a staggered basis beginning in 60 days and at various times

in the next 180 days. Various state authorities, stock exchanges and the SEC continue to investigate analysts and their practices and additional enforcement proceedings will likely ensue in the coming months, along with the possibility of additional rulemaking in this area. For a more comprehensive discussion of the topics covered in this Client Advisory, please contact the lawyer at ZAG/S&W LLP with whom you regularly consult, or the undersigned.

Howard E. Berkenblit
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