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*18. Restrictions and Disclosure Requirements Regarding Firms'
and Analysts' Conflicts of Interest,*

Speech by Mr. Edward A. Kwalwasser

*Group Executive Vice President – Regulation, New York Stock Exchange,
United States of America*

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**“Restrictions and Disclosure Requirements Regarding
Firms’ and Analysts’ Conflicts of Interest”**

In adopting amendments to its communications rules, the Exchange proposes sweeping changes in the way member organizations, their investment-banking departments and research analysts manage and disclose conflicts of interest between their investment-banking and research activities.

These amendments are designed to restore investor confidence in a process that is critical to the equities markets. The measures reflect a self-policing approach consistent with strong self-regulation. The proposed changes have been developed in collaboration with NASD Regulation (“NASDR”) at the initiative of the Securities and Exchange Commission (“SEC”). While highly beneficial for the integrity of the markets, they undoubtedly will also result in increased costs and administrative burdens for member organizations. The amendments were approved by the SEC on May 8, 2002. However, there will be a continuing review of this area which may result in additional amendments to our rules.

These amendments are precipitated by a series of events that have eroded investor confidence in the equities markets and called into question the current ways in which these conflicts of interest are managed and disclosed.

BACKGROUND: During 2000 and 2001, the stock-market decline and negative news articles brought regulatory scrutiny to the issue of research analysts’ conflicts of interest as well as to the adequacy of disclosure of those conflicts in communications to the public that recommend securities. The SEC expressed particular concern with analysts and others who make stock recommendations during TV interviews. The SEC had additional concerns about written communications in which disclosures were vague and buried in hedge clauses or footnotes.

At the same time, the NYSE and NASDR began working on proposed amendments to their rules governing communications with the public (NYSE Rule 472 and NASD Rule 2210) to strengthen the disclosure requirements.

In June 2001, the Securities Industry Association’s (“SIA”) Ad Hoc Committee on Analysts Integrity issued new guidelines for research analysts entitled “Best Practices for Research.” These best practices, which do not have the effect of rules of the SEC or self-regulatory organizations (“SROs”), suggested prohibitions on linking analysts’ compensation to investment banking deals, on analysts’ trading against their own securities recommendations, and on approving research by investment banking departments and subject companies. The guidelines also recommended disclosure of ownership positions in securities of companies that research analysts cover.

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During June and July 2001, the House Committee on Financial Service's Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises held hearings on the "sources and ramifications of analysts conflicts of interest" and on the adequacy of disclosures in communications to the public. The report of these hearings deemed the SIA best practices to be inadequate as a means of eliminating and/or mitigating the systemic conflicts of interest confronting analysts and the biased research attributable to such conflicts. The Subcommittee concluded that rulemaking would be a more effective way to deal with these issues.

In November 2001, the NYSE and NASDR established a joint SRO/industry committee to elicit industry comment on a joint rule proposal on communications with the public developed to address Congress' concerns. The NYSE and NASDR also received comments and guidance from the SEC on the joint proposal. The joint proposal also incorporates, as rules, many of the SIA best practices.

Summary of Rule Amendments

Amendments to Rule 472 place the following prohibitions and/or restrictions on Investment Banking, Research Department and Subject Company Relationships and Communications:

- Research Department personnel or others engaged in preparation of research reports may not be subject to supervision or control of Investment Banking Department (Rule 472(b)(1)).
- Research reports may not be subject to review or approval prior to distribution by Investment Banking Department (Rule 472(b)(1)).

Exception for written and oral communication, intermediated through Legal or Compliance Department, to verify accuracy of information and to identify potential conflicts of interest (Rule 472(b)(2)(i) and (ii)).

- Member organizations may not submit research reports to subject companies prior to distribution (Rule 472(b)(3)).

Exception for review of sections of draft excluding research summary, research rating or price target to verify facts, provided Legal or Compliance receives complete draft prior to submission to subject company (Rule 472(b)(3)(i)).

After submission to subject company, any changes in proposed rating or price target must be justified by Research Department, and receive prior written authorization from Legal or Compliance Department (Rule 472(b)(3)(ii)).

- Subject company may not be notified of ratings change until after close of trading in principal market one business day prior to the announcement change (Rule 472(b)(3)(iii)).

Amendments to Rule 472 prohibit and/or restrict the following in connection with associated persons preparing research reports:

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- Prohibits compensation linked to specific investment banking services transactions (Rule 472(h)).
- Prohibits ownership positions (including purchasing or receiving pre-IPO shares) if issuer principally engaged in same type of business or industry classification as companies which associated person covers in research reports (Rule 472(e)(1)).
- No trading in recommended securities thirty (30) days prior to and five (5) days after issuance of research reports, changes in rating or price target (Rule 472(e)(2)).
- Prohibition on trades contrary to most current recommendation (Rule 472(e)(3)).

Exceptions to prohibitions for:

a significant unanticipated change in the personal financial circumstances pre-approved by Legal or Compliance Department (Rule 472(e)(4)(i));

thirty (30) and five (5) day blackout period for issuance of research reports, change in rating or price target attributable to significant news or events regarding subject company pre-approved by Legal or Compliance Department (Rule 472(e)(4)(ii));

sale transactions for associated persons new to member or member organization within thirty (30) days of employment (Rule 472(e)(4)(iii)) or being assigned responsibility of preparing research reports (Rule 472(e)(4)(iv));

transactions in accounts not controlled by associated person, e.g., investment funds (Rule 472(e)(4)(v)), or registered investment company (Rule 472(e)(4)(vi)).

Amendments to Rule 472 place the following prohibitions and/or restrictions on members or member organizations:

- Publishing of research reports within forty (40) calendar days of completion of an initial public offering (Rule 472(f)(1) and (2)).
- Publishing of research reports within ten (10) calendar days following completion of secondary offering.

The prohibition to secondary offerings shall not apply to research reports issued under Securities Act Rule 139 regarding issuers whose securities are actively traded, as defined in Securities Exchange Act Rule 101(c)(1) of Regulation M.

Exception to forty (40) day and ten (10) blackout period for a research report issued due to significant news or events about issuer pre-approved by Legal or Compliance Department (Rule 472(f)(3)).)

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- Prohibition on offering favorable research to companies as consideration or inducement for business (Rule 472(g)).

Amendments to Rule 472 would impose requirements on members, member organizations, and associated persons preparing research reports to disclose the following in written communications and public appearances:

All required disclosures must be clear, comprehensive and on the first page of a research report or must reference reader to page in which it is found (Rule 472(k)(2)).

- If, as of the last day of the month before the publication or appearance (or the end of the second most recent month if the publication or appearance is less than ten (10) calendar days after the end of the most recent month), the member or member organization or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company. (Rule 472 (k)(1)(i)(A)). The member or member organization must make the required beneficial ownership computation no later than ten (10) calendar days after the end of the prior month.
- Associated person's or household member's financial interest in subject company (Rule 472(k)(1)(i)(B)).
- Any actual, material conflict of interest of member or member organization which the associated person knows or has reason to know at time of issuance of a research report or public appearance (Rule 472(k)(1)(i)(C)).
- If the member or member organization or its affiliates: a) has managed or co-managed a public offering of equity securities for the subject company in the past twelve (12) months; b) has received compensation for investment banking services from the subject company in the past twelve (12) months; or c) expects to receive or intends to seek compensation for investment banking services from the subject company in the next three (3) months (Rule 472(k)(1)(ii)).
- Whether associated person or household member is officer, director, or advisory board member of recommended issuer (Rule 472(k)(1)(iii)).

Proposed amendments to Rule 472 would require the following disclosures specific to research reports:

All required disclosures must be clear, comprehensive and on the first page of a research report or must reference reader to page in which it is found (Rule 472(k)(2)).

- associated person preparing research report receives compensation, based in part, on member's or member organization's investment banking revenue (Rule 472(k)(2)).
- whether member or member organization makes a market in subject company's securities at time of issuance of research report (Rule 472(k)(2)(i)).

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- valuation methods used (price objectives must have reasonable basis and include discussion of risk) (Rule 472(k)(2)(ii)).
- meanings of all ratings used by member or member organization in its rating system (Rule 472(k)(2)(iii)).
- percentage of all recommended securities in “buy, “sell”, or “hold” categories, and percentage of subject companies that are investment banking services clients for each category, at time of recommendation (Rule 472(k)(2)(iv)).
- chart of subject company’s stock price performance and references to assignment and/or change in rating or price target (Rule 472(k)(2)(v)).

When a member or member organization distributes a research report covering six (6) or more subject companies for purposes of the disclosures required in paragraph (k) of this Rule, such research report may direct the reader in a clear and prominent manner as to where they may obtain applicable current disclosures in written or electronic format.

Amendments to Rule 351 would require members and member organizations to submit to the Exchange, annually, a letter of attestation signed by a senior officer or partner, that the member or member organization has established and implemented written procedures reasonably designed to comply with the provisions of Rule 472 (Rule 351(f)). See also Rule 472(c) for requirement to establish written procedures.