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NASD PROPOSES RULE REGARDING RESEARCH ANALYST CONFLICTS OF INTEREST

The NASD has filed with the SEC a proposed rule change to establish NASD Rule 2711, which is intended to address research analyst conflicts of interest that arise when research analysts recommend securities in public communications. The proposed Rule is also intended to improve the objectivity of research and provide investors with more useful and reliable information when making investment decisions.

The SEC has indicated that the Rule could be implemented in as little as two months. The SEC, in the meantime, is encouraging analysts and firms to abide by the proposed changes on a voluntary basis.

The proposed Rule generally would:

- help to rebuild the “Chinese wall” between research and investment banking;
- prohibit analysts from receiving compensation directly tied to investment banking fees;
- require analysts to disclose, both in research reports and public appearances, any financial relationship with companies they analyze;
- make ratings more understandable to investors; and
- place trading and ownership restrictions on analysts’ personal portfolios.

I. Investment Banking Department Relationship with Research Department

A. Supervision and Control

The Rule would prohibit a firm’ s investment banking department from supervising or controlling any member of the research department. The Rule would permit the investment banking department and/or the subject company to review research reports prior to publication only in limited circumstances.

Investment banking personnel would be able to review a research report to check for factual accuracy or for any potential conflicts of interest. For all such

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communications between investment banking personnel and research personnel, an authorized legal or compliance officer of the investment bank would be required to act as an intermediary or be copied on the communications. Oral communications would have to be documented. Communications not related to a research report would not require an intermediary.

A subject company would be able to review a research report to check for factual accuracy, provided the draft does not contain the research summary, the research rating or the price target, and a complete copy of the draft is submitted to the legal or compliance department. If the analyst decides to make changes to the proposed rating or price target after review by the subject company, the analyst would first have to receive written approval from the legal or compliance department. Drafts and final versions of the report would have to be retained for three years.

B. Analyst/Firm Compensation

The Rule would prohibit an investment bank from tying analyst compensation to specific investment banking transactions.

The Rule would require the following to be disclosed in research reports:

- if the analyst receives compensation based, in part, upon the firm's investment banking revenues (which reflects the recognition that analysts will participate in the due diligence efforts for initial public offerings and may be compensated for overall performance, including services to the investment banking division); or
- if the firm or its affiliates received compensation from the subject company within the previous 12 months or if they reasonably expect to receive compensation from the subject company within the three months following the publication of the report.

As disclosure would have to be definitive, conditional language such as disclosure that a firm "may have" received compensation will be insufficient. In addition, as disclosure would be required in respect of the receipt of compensation, and not the nature of the transaction that gave, or will give, rise to the compensation, there would be no risk of disclosure of non-public transactions.

In addition, if the analyst recommends a security in a public appearance, the analyst must disclose if he knows or has reason to know that the issuer is a client of the firm or one of its affiliates. Public appearances would include seminars, forums (including interactive electronic forums), radio or television interviews and any other public activity in which an analyst makes a recommendation or offers an opinion concerning an equity security. This would include a public conference call in which an analyst expresses an opinion on an equity security. For this purpose, an issuer would be deemed a "client" of a firm if the firm or its affiliates received compensation from the issuer within the previous 12 months or reasonably expect to receive compensation from

the issuer within the next three months. If the analysts does not know or have a reason to know that the issuer is a client, for example in the context of a non-public transaction as to which the analyst is not “over the wall,” no disclosure would be required.

II. Promises of Favorable Research

The Rule would expressly prohibit firms from offering favorable research, a specific rating or a specific price target, or threatening to make any change in the foregoing, to induce business.

III. Quiet Periods

The Rule would require quiet periods during which any firm acting as manager or co-manager of a securities offering would be prohibited from issuing a report on a company within 40 days after its initial public offering or within 10 days after a follow-on offering. Such firm could issue research concerning the effects of significant news or a significant event during such periods, provided the legal and compliance department authorizes publication. The NASD asked for comment on whether the quiet period should extend to public appearances.

Note that the proposed quiet periods would exceed the quiet periods imposed under the securities laws.

IV. Analysts’ Personal Trading

The Rule would prohibit an analyst or a member of the analyst’s household from purchasing or receiving an issuer’s securities prior to its initial public offering if the analyst issues research reports respecting companies that are in the same business as the issuer. In addition, neither the analyst nor a household member would be able to trade in securities issued by companies followed by the analyst for a period beginning 30 days prior to, and ending five days after, the date of issuance of a research report or change in the research rating or price target for the subject company’s securities. Finally, neither the analyst nor any household member would be allowed to effect trades inconsistent with the analyst’s most current recommendations.

Certain exceptions to these trading prohibitions would apply, including the following:

- trades that are precleared by the firm’s legal or compliance department and that are made because of significant personal financial circumstances;
- a sale of all of the company’s securities held by an analyst within 30 days after the analyst began following such company (if permitted by the member firm); and
- a purchase or sale fewer than 30 days before the publication of a new research report or change in the rating or price target of an equity security where such publication or change is precleared by the firm’s legal or compliance

department and is prompted by significant news or events about the subject company (if permitted by the member firm).

V. Disclosures of Firm/Analyst Ownership of Securities

A firm would be required to disclose in research reports and an analyst would be required to disclose in public appearances if the analyst or a household member has a financial interest in the securities of the subject company or if, as of 5 business days before the publication or appearance, the firm or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company. The firm and the analyst would be required to also disclose any other actual, material conflict of interest of either the firm or the analyst which the firm or analyst knows or has reason to know at the time of the issuance of the research report or public appearance.

VI. Other Disclosures

The Rule would require that the following disclosures, which must be clear, comprehensive and prominent, be made on the front page of the research report or the front page must refer to the page on which the disclosures may be found:

- the valuation methods used (any price objective must have a reasonable basis and include a discussion of risks);
- whether the firm is making a market in the subject securities at the time the research report is issued;
- whether the analyst or a household member is an officer, director or advisory board member of the subject company;
- the meaning of all ratings used by the firm in its rating system;
- the percentage of all securities that the firm recommends an investor “buy”, “hold” or “sell”, as well as the percentage of companies in each of these categories for which the firm has provided investment banking services within the previous twelve months. The information would have to be current as of the end of the most recent calendar quarter (or the second most recent calendar quarter if the publication date is less than 15 calendar days after the most recent calendar quarter); and
- a price chart that maps the price of a stock over time and indicates points at which an analyst assigned or changed a rating or price target. The information in the price chart would have to be current within the same time frames noted above.

VII. Supervisory Procedures/Reporting Requirements

A firm would be required to adopt written supervisory procedures reasonably designed to ensure that the firm and its employees comply with the proposed rules. A

firm's senior officer would be required to attest annually to its regulatory body that it has established and implemented procedures reasonably designed to comply with the proposed rules.

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This memorandum provides only a general overview of the proposed rule change and is not intended to provide or constitute legal advice, and no legal or business decision should be based on its contents. We will supplement this memorandum when the proposals are made effective.

Any questions concerning the foregoing should be addressed to members of the Paul Weiss Securities Group (see below). In addition, memoranda on related topics may be accessed under Securities Group publications on our web site (www.paulweiss.com).

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