

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-51593; File Nos. SR-NYSE-2004-24; SR-NASD-2004-141)

April 21, 2005

Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc. and the National Association of Securities Dealers, Inc. to Prohibit Participation by a Research Analyst in a Road Show Related to an Investment Banking Services Transaction and to Require Certain Communications about an Investment Banking Services Transaction to Be Fair, Balanced and Not Misleading

**I. INTRODUCTION**

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act” or “Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> on April 22, 2004 the New York Stock Exchange (“NYSE” or the “Exchange”), and on September 20, 2004, the National Association of Securities Dealers, Inc. (“NASD”), filed with the Securities and Exchange Commission (“SEC” or “Commission”) proposed rule changes including proposals to prohibit participation by a research analyst in a road show related to an investment banking services transaction and to require certain communications about an investment banking services transaction to be fair, balanced and not misleading. On February 11, 2005, NYSE filed Amendment No. 1 to its proposed rule change, which replaced the original rule filing in its entirety. On February 4, 2005, NASD filed Amendment No. 1 to its proposed rule change, which replaced the original rule filing in its entirety.<sup>3</sup> The proposed rule changes, as amended, were published for comment in the Federal Register

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> On March 9, 2005, NASD filed with the Commission Amendment No. 2 to its proposed rule change, which clarified that Amendment No. 1 replaced the original filing in its entirety.

on March 17, 2005.<sup>4</sup> The comment period expired on April 7, 2005. The Commission received one comment letter in response to the Notice, which supported the proposed rule changes.<sup>5</sup> This order approves the proposed rule changes, as amended.

## **II. BACKGROUND**

On May 10, 2002, the Commission approved rule changes filed by the NYSE and NASD (the “SROs”) governing research analyst conflicts of interest.<sup>6</sup> Those rules took considerable steps towards promoting greater independence of research analysts and significantly enhanced the disclosure of actual and potential conflicts of interest to investors.

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (“SOA”), which required, among other things, that the Commission, or upon authorization and direction of the Commission, a registered securities association or national securities exchange, adopt rules governing analyst conflicts.<sup>7</sup> Certain of the SOA’s mandates were satisfied by NASD and NYSE rule provisions existing at the time of the enactment of the SOA. Other of the SOA’s mandates necessitated amendments to the then existing rules. Thus, the Commission directed the NASD and NYSE to amend

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<sup>4</sup> See Securities Exchange Act Release No. 51358 (March 10, 2005), 70 FR 13061 (the “Notice”).

<sup>5</sup> See Letter to Jonathan G. Katz, Secretary, Commission, from the Ohio Public Employees Retirement System (April 1, 2005).

<sup>6</sup> See Securities Exchange Act Release No. 45908, 67 FR 34968 (May 16, 2002) (the “Round I” rules).

<sup>7</sup> See Pub. L. 107-204, 116 Stat. 745 (2002). The SOA amended the Exchange Act by adding Section 15D. See 15 U.S.C. 78a et seq.; 15 U.S.C. 78o-6.

their analyst conflicts rules to fulfill the mandates of the SOA.<sup>8</sup> The Commission approved these rules on July 29, 2003.<sup>9</sup>

In the order approving the Round I rules, the Commission directed the SROs to prepare a report on the operation and effectiveness of the rules by November, 2003. The Commission later postponed requiring the SROs to submit the report in light of the SOA and the approval of the Round II rules.<sup>10</sup> The Round II rules have now been fully implemented since April 26, 2004 and the SROs have been instructed to jointly submit a report on the operation and effectiveness of all of the analyst rules by November 4, 2005.<sup>11</sup> It is possible that the report may indicate additional areas for rulemaking.

On April 28, 2003, the Commission, along with other regulators, announced a global settlement of enforcement actions against certain investment firms that followed joint investigations by regulators of allegations of undue influence of investment banking interests on securities research at brokerage firms.<sup>12</sup> The Global Settlement was approved by the court on October 31, 2003. On September 24, 2004, the court approved

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<sup>8</sup> See Letter from Annette Nazareth, Director, Division of Market Regulation, Commission, to Mary Schapiro, Vice Chairman and President, Regulatory Policy and Oversight, NASD, and Richard Grasso, Chairman and Chief Executive Officer, NYSE (March 13, 2003).

<sup>9</sup> See Securities Exchange Act Release No. 48252, 68 FR 45875 (August 4, 2003) (the “Round II” rules).

<sup>10</sup> Id.

<sup>11</sup> See Letter from Annette Nazareth, Director, Division of Market Regulation, Commission, to Mary Schapiro, Vice Chairman and President, Regulatory Policy and Oversight, NASD, and Richard Ketchum, Chief Regulatory Officer, NYSE (April 8, 2005).

<sup>12</sup> The terms of the settlement are available at <http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf> (“Global Settlement”).

amendments to the Global Settlement, which, among other things, amended the Addendum to provide additional, more specific guidelines relating to analyst communications with members of a settling firm's sales force and prospective investors in the context of certain investment banking transactions, and were intended to avoid research analysts becoming, or being perceived as, part of the investment banking team or otherwise promoting a particular transaction.<sup>13</sup>

#### **A. Current NYSE and NASD Rules Governing Disclosure of Conflicts of Interest**

The SROs' research analyst conflicts of interest rules were designed to foster greater public confidence in securities research and to protect the objectivity and independence of securities analysts. The rules contain a number of elements, including:

- Structural reforms to increase analyst independence, including a prohibition on investment banking personnel supervising analysts or approving research reports and limiting the compensatory evaluation of analysts to officials employed by the broker or dealer who are not engaged in investment banking activities;
- A prohibition on tying analyst compensation to a specific investment banking services transaction;
- Restrictions on personal trading by analysts;
- A prohibition on retaliation by members and employees of members involved with investment banking activities against analysts as a result of an adverse, negative, or otherwise unfavorable research report or public appearance; and
- A prohibition on offering favorable research to induce investment banking business.

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<sup>13</sup> The SROs note that the proposed rule changes are similar in certain aspects to provisions found in the Global Settlement. The SROs have stated that the proposed rule changes have not been proposed for the purpose of conforming to the Global Settlement, or addressing differences between the Global Settlement and SRO rules. Rather, the SROs believe that the proposed rules are appropriate in that they would facilitate the goal of more objective and reliable research.

## **B. Proposed Changes to NYSE and NASD Rules**

The proposed SRO rule changes further define the types of communications that are inappropriate for research analysts and investment banking personnel. Thus the rules further insulate analysts from investment banking pressure, thereby promoting the integrity of, not only research reports and public appearances, but all communications by research analysts to customers as well as internal personnel. The Commission provides here a general overview of the proposed rule changes.

First, the proposals would prohibit a research analyst from directly or indirectly participating in a road show related to an investment banking services transaction, or otherwise communicating with customers in the presence of investment banking personnel or company management about an investment banking services transaction. Therefore, such “three-way” communications between research, customers and banking, as well as those involving research, customers and issuers, are prohibited.

Second, the proposals would prohibit investment banking personnel from directly or indirectly directing a research analyst to engage in sales and marketing efforts or other communications with a current or prospective customer related to an investment banking services transaction.

Finally, the proposals would require that research analyst written and oral communications relating to an investment banking services transaction with a current or prospective customer or with internal personnel, must be fair, balanced and not misleading, taking into consideration the overall context in which the communication is made. Thus, the proposals preserve the ability of research analysts to educate investors and internal personnel about investment banking services transactions, provided such

communications are fair, balanced and not misleading, considering the overall context in which the communication is made.

### **III. DISCUSSION**

The Commission received one comment letter on the proposed rule changes, which supported the approval of the proposals. After careful review, the Commission finds, as discussed more fully below, that the proposed rule changes, as amended, are consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to the NYSE and NASD.<sup>14</sup> In particular, the Commission believes that the proposals are consistent with Sections 6(b)(5) and 6(b)(8) of the Exchange Act,<sup>15</sup> and Sections 15A(b)(6) and 15A(b)(9) of the Exchange Act.<sup>16</sup>

Section 6(b)(5) requires, among other things, that the rules of an exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of free trade, to remove impediments to and perfect the mechanism of a free and open market, and to protect investors and the public interest. Section 6(b)(5) also requires that the rules of an exchange not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers. Section 6(b)(8) of the Exchange Act prohibits the rules of an exchange from imposing any burden on competition not necessary or appropriate in furtherance of the purposes of the statute.

Section 15A(b)(6) requires that the rules of a registered national securities association be designed to prevent fraudulent and manipulative acts and practices, to

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<sup>14</sup> See 15 U.S.C. 78c(f).

<sup>15</sup> 15 U.S.C. 78f(b)(5) and (b)(8).

<sup>16</sup> 15 U.S.C. 78q-3(b)(6) and (b)(9).

promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. Section 15A(b)(9) requires that the rules of an association not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Section 3(f) of the Exchange Act directs the Commission to consider, in addition to the protection of investors, whether approval of a rule change will promote efficiency, competition, and capital formation.<sup>17</sup> In approving the proposed rule changes, the Commission has considered their impact on efficiency, competition, and capital formation.

The Commission believes the rule changes, as amended, promote the independence of research analysts and the objectivity of the views analysts communicate to customers and internal personnel.

**A. Prohibition on Research Analyst Participation in Road Shows and Certain Three-way Communications [NASD Rule 2711(c)(5) and NYSE Rule 472(b)(6)(i)]**

The proposals prohibit research analysts from participating in road shows related to investment banking services transactions, or otherwise communicating with customers in the presence of investment banking personnel or company management about an investment banking services transaction.

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<sup>17</sup> 15 U.S.C. 78c(f).

NASD believes that by prohibiting research analyst participation in road shows, the proposed rule change will further reduce the pressure on research analysts to give an overly optimistic assessment of a particular transaction. Further, NYSE believes that the proposed provisions to prohibit analysts from engaging in any communication regarding investment banking services with current or prospective customers in the presence of investment banking personnel or company management also will reduce the pressure on research analysts to give overly optimistic assessments of investment banking services transactions.

We believe that it is appropriate that the SROs prohibit research analysts from participating in road shows, as well as from engaging in communications with investors in the presence of investment banking personnel or issuer management. In addition, we believe that the prohibition on research analyst communications with customers in the presence of investment banking or company management will guard against research analysts being, or being perceived as, part of the sales and marketing team for a transaction, rather than as independent sources of information.

We also note that the Round II rules included a prohibition on research analyst involvement in efforts to solicit investment banking, which were designed to further the goals of research objectivity and investor confidence by eliminating all participation by research analysts in solicitation efforts, which could suggest a promise of favorable research in exchange for underwriting business.

Likewise, the proposed prohibition on research analyst participation in road shows would seek to provide for greater analyst objectivity and guard against analysts becoming part of the investment banking team for a transaction. The Commission finds

that the rule changes to prohibit research analyst involvement in road shows related to investment banking transactions and three way communications between research, customers, and issuers or investment banking personnel, are consistent with the Exchange Act, particularly Sections 6(b)(5), 6(b)(8), 15A(b)(6), and 15A(b)(9).

**B. Investment Banking Directed Communications with Customers [NASD Rule 2711(c)(6) and NYSE Rule 472(b)(6)(ii)]**

The proposals would prohibit investment banking department personnel from directing a research analyst to engage in sales or marketing efforts and any other communication with a current or prospective customer about an investment banking services transaction.

NASD believes this proposal is important to eliminate attempts by investment banking personnel to pressure a research analyst to engage in communications related to an investment banking services transaction, thereby further insulating research analysts from influences that could affect their objectivity. Further, the NYSE believes the proposal preserves the traditional function of research analysts (providing analysis of securities and transactions), while placing further limitations on the ability of investment banking personnel to influence and/or compromise the objectivity of research analyst analyses. The NYSE believes that it is important for investor protection that research analyst views be objective, unbiased, and not the result of pressure on an analyst.

The Commission believes it is appropriate for the SROs to prohibit investment banking personnel from directing research analysts to engage in sales and marketing efforts or to engage in customer communications relating to an investment banking services transaction. We believe that these provisions will further insulate research analysts from investment banking pressure by cutting off the ability of investment banking

personnel to directly, or indirectly (e.g. through other parties), direct research analysts to engage in sales or marketing efforts, or otherwise communicate with customers about a transaction. Thus, we believe the proposals would promote analyst objectivity and independence and find that the proposed rules are consistent with the Exchange Act, particularly Sections 6(b)(5), 6(b)(8), 15A(b)(6), and 15A(b)(9).

**C. Fair and Balanced Requirement** [NASD Rule 2711(c)(7) and NYSE Rule 472(b)(6)(iii)]

The proposed rule changes require that all research analyst communications (written and oral) with current or prospective customers or with internal personnel relating to an investment banking services transaction, must be fair, balanced and not misleading, taking into consideration the overall context in which the communications are made.

NASD believes that the primary role of a research analyst is to provide unbiased analysis of companies and transactions and to value securities accurately. Therefore, NASD and NYSE note that the proposed rule changes permit research analysts to educate investors and member personnel about a investment banking services transactions, so long as such permissible communications to investors and internal personnel are fair, balanced and not misleading, taking into account the overall context in which such communications are made. Thus, NYSE notes that, while the proposed rule should insulate research analysts from potential undue influence of investment bankers and company management, it would not interfere with legitimate activities.

The Commission believes that the SRO proposals are designed to promote the objectivity and independence of research analysts by explicitly requiring that all research analyst written and oral communications with customers, as well as with internal firm

personnel, must be fair, balanced and not misleading, considering the context of the communications. These requirements build on existing SRO standards for research analyst communications with the public and provide additional safeguards for research communications with personnel within the broker-dealer.<sup>18</sup> The Commission further believes that the SROs' determination to require that such communications be fair, balanced and not misleading is consistent with Sections 6(b)(5), 6(b)(8), 15A(b)(6) and 15A(b)(9).

#### **D. Implementation**

The SROs suggest that the proposed rule changes become effective 45 days after approval by the Commission and the Commission believes that this is reasonable.

#### **IV. CONCLUSION**

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act,<sup>19</sup> that the proposed rule changes (SR-NYSE-2004-24; SR-NASD 2004-141), as amended, are approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>20</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>18</sup> See NASD Rule 2210 (“Communications with the Public”) and NYSE Rule 472 (“Communications with the Public”).

<sup>19</sup> 15 U.S.C. 78s(b)(2).

<sup>20</sup> 17 CFR 200.30-3(a)(12).