



Research Analyst Regulation

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Brad Gude

Special Counsel

Office of Trading Practices, Division of Trading and Markets



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Historical Background

Global Settlement Cases (2003)

- In a series of settled cases, the Commission alleged that the firms engaged in acts and practices that enabled investment banking to exert inappropriate influence over analysts, which created conflicts of interest for analysts that the firms failed to manage appropriately.
- The charges, which the firms did not admit or deny included violations of Exchange Act Sections 15(c) and 17(a), Securities Act Section 17(b), various SRO rules, and state statutes.



Historical Background

Global Settlement Cases (2003)

- Specific Allegations Include:
 - Analysts supported investment banking by pitching business to prospective clients and marketing investment banking deals to institutional customers through road shows.
 - Analyst compensation was determined partly by the degree to which they assisted investment banking or their contribution to investment banking revenue.



Historical Background

Global Settlement Cases (2003)

- More Specific Allegations:
 - Investment bankers evaluated analyst performance, influencing compensation.
 - Investment bankers implicitly promised their potential clients favorable research, with analysts participating in the sales presentations.
 - Investment bankers influenced whether analysts would start or continue research coverage on existing or potential investment banking clients.



Historical Background

Other Cases

- Banc of America Securities (34-55466 (2007)): Commission alleged analysts issued false and misleading research to further investment banking interests; also that proprietary traders gained early access to research reports in violation of Sections 15(c) and 15(f) of the Exchange Act.
- Paul E. Johnson (F Sec L Rep (CCH) P93,953 (2006)): Findings of fraud based on allegations of false and misleading "Buy" recommendations on a public company that were inconsistent with his privately-held belief in violation of Exchange Act Sections 10(b) and 17(a); undisclosed ownership of pre-IPO shares in violation of Section 10(b).



Historical Background

Regulatory Responses

- Enforcement action culminating in the Global Research Analyst Settlement.
- Section 15D of the Exchange Act (Sarbanes-Oxley Act of 2002).
- Regulation AC.
- SRO (NASD and NYSE) Rules.



Global Settlement

Generally

- The SEC along with other regulators investigated the alleged undue influence of investment banking interests on the broker-dealers' analysts and their reports.
- These investigations culminated in enforcement actions and the 2003 Global Settlement among the SEC, other regulators including the SROs and the New York Attorney General's Office, and what was initially 10 broker-dealers.
- The Global Settlement required that the settling firms agree to be enjoined from violating Exchange Act Sections 15(c) and 17(a), Securities Act Section 17(b), various SRO rules, and state statutes, pay penalties, disgorgement, and provide funds for independent research and investor education.
- Structural Reforms.



Global Settlement

Overview

- Research Budget
- Physical Separation
- Coverage Decisions
- Firewalls/Information Barriers
- Communications with Investors
- Oversight Committee
- Disclosure



Global Settlement

Selected Provisions

- Analyst Participation in Education of Sales Force
 - Exception to firewall for analysts.
 - Post-mandate or in connection with certain secondary offerings.
 - Permits analyst participation separately or with the firm's equity capital markets group.
 - Cannot be jointly with issuer management or other investment banking personnel.
 - Reasonable basis.
 - Fair and balanced.



Global Settlement

Selected Provisions

- Analyst Communications with Investors Regarding Offerings.
 - Post-mandate.
 - Cannot be jointly with issuer management or investment banking personnel.
 - Reasonable basis.
 - Fair and balanced.



Global Settlement

Independent Research

- \$460m for independent research.
- Administered by independent consultants.
- Obligation to provide independent research expired July 26, 2009 for most firms.
 - Two settled later and their obligation expired March 26, 2010.



Global Settlement

Amendments

- With respect to any term [of the structural reforms] that has not been superseded [by SEC or SRO rule with the stated intent to supersede the Global Settlement] [by 31 October 2008], it is the expectation of [the parties] that the SEC would agree to an amendment or modification of such term, subject to Court approval, unless the SEC believes such amendment or modification would not be in the public interest.



Global Settlement

Amendments, cont.

- 3 August 2009: Settling firms file motion to modify the Global Settlement.
- 15 March 2010: Court approved all but one of these modifications.
 - Did not permit change to allow unchaperoned discussions between research and investment banking regarding market trends.



Exchange Act Section 15D

Generally

- Required SEC or SROs (upon the authorization and direction of the SEC) to enact rules reasonably designed to address conflicts of interest that can arise when analysts recommend equity securities in research reports and public appearances.
- “[I]n order to improve the objectivity of research and provide investors with more useful and reliable information.” Exchange Act Section 15D(a).



Exchange Act Section 15D

Specific Requirements

- Quiet Periods.
- Appropriate informational partitions.
- Restrict Pre-publication Review.
- Limit Supervision and Compensatory Evaluation of Analysts by Investment Banking.
- Disclosures.



Regulation AC

- Adopted February 2003.
- The views expressed by the analyst accurately reflect that analyst's personal views about the subject securities or issuers.
- No part of the analyst's compensation is directly related to the specific recommendation/view of the report (or specific disclosures detailing this compensation if the analyst is compensated in this way).



SRO Rules

Generally

- Primarily NASD Rule 2711 and NYSE Rule 472.
- Stem from proposals in 2002 by the SROs to help improve objectivity and transparency in research.
- Certain research on equity securities only.
- Application: Members of the SRO.



SRO Rules

General Provisions

- Internal controls (e.g. NASD Rule 2711(b)-(d)).
- Prohibition on Promise of Favorable Research (e.g. NASD Rule 2711(e)).
- Quiet Periods (e.g. NASD Rule 2711(f)(1)-(4)).
- Restrictions on Research Analyst Personal Trading (e.g. NASD Rule 2711(g)).
- Disclosures (e.g. NASD Rule 2711(h)).
- Exception for members (i.e., broker-dealers) who have only a small amount of investment banking transactions or revenues (e.g. NASD Rule 2711(k)).



SRO Rules

Quiet Periods

- IPOs
 - Manager/co-manager: 40 days after the date of the offering.
 - Other participating underwriters/dealers: 25 days after the date of the offering.
- Secondary Offerings
 - 10 days after the date of the offering (manager/co-manager only).
- Lock-ups
 - 15 days prior to and after the expiration, waiver or termination of the agreement (manager/co-manager only).
- Exceptions
 - Significant News and Events.
 - Actively-traded securities.



SRO Rules

Selected Analyst Prohibitions

- Analysts are prohibited from participating in efforts to solicit investment banking business, including participation in pitches.
- Analysts are also prohibited from directly or indirectly:
 - (A) participating in a road show related to an investment banking services transaction; and
 - (B) engaging in any communication with a current or prospective customer in the presence of investment banking department personnel or company management about an investment banking services transaction.
- (B) has been interpreted to also prohibit joint appearances by analysts and company management when educating the broker-dealer's staff.



SRO Rules

Ongoing Developments

- FINRA Regulatory Notice 08-55 (Oct. 2008).
- FINRA Regulatory Notice 11-11 (Mar. 2011).
- FINRA Regulatory Notice 11-41 (Sep. 2011).



GAO Report

“Additional Actions Could Improve Regulatory Oversight of Analyst Conflicts of Interest.”

- Issued 12 January 2012 and was required under the Dodd-Frank Act.
- “Research suggests reforms were associated with improvements in analyst recommendations, but other effects were mixed.”
- Recommendation:
 - “To help ensure that investors consistently are protected from potential conflicts of interest between analysts and investment bankers employed by the same broker-dealers, the Chairman of the SEC should direct the appropriate divisions or offices to formally assess and document in a recommendation whether any of the Global Settlement’s remaining terms should be codified.”