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U.S. Laws and Regulations Applicable to Research Reports

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I. Introduction

This memorandum describes the approach of the U.S. Securities and Exchange Commission (the "**SEC**") in monitoring and, where appropriate, regulating the use of research reports by investment banking firms in connection with securities transactions.[1] The memorandum addresses the historical system of regulation, which continues in large measure to apply. It also examines the new initiatives taken, following a number of prominent corporate, accounting and banking scandals and a significant decline in U.S. and international capital markets, to supplement the current system in what some have dubbed the "post-Enron era".

A. U.S. securities regulation: an overview

It may be helpful to preface a consideration of the SEC's activities with a brief overview of the U.S. securities regulatory system as a whole. The SEC is undeniably the cornerstone of that system. It operates, however, solely under authority delegated to it by the U.S. legislature.[2] Furthermore, in carrying out its mission it relies heavily on so-called self-regulatory organizations ("**SROs**")[3], in particular the National Association of Securities Dealers ("**NASD**") and the New York Stock Exchange ("**NYSE**").

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1 The texts of the relevant statutes and SEC or SRO rules frequently refer to the relevant financial institutions by using technical terms defined for a specific purpose (*e.g.*, "broker-dealers" or, in the case of certain NASD rules, "members"). In the interest of simplicity, this memorandum will refer to "investment banks" or "banks". These and similar financial institutions may generally engage in securities transactions in the United States only if they are registered as brokers and/or dealers pursuant to § 15 or § 15B of the Exchange Act and will in virtually all cases also be member firms of NASD.

2 *See* Securities Act of 1933, as amended (the "**Securities Act**"), § 19; Securities Exchange Act of 1934, as amended (the "**Exchange Act**"), § 23 (rulemaking authority), §§ 21-21C (investigative and enforcement authority). Congress established the SEC through Exchange Act § 4.

3 Self regulatory organizations in the broader sense (*e.g.*, the regional educational boards that accredit universities) play an important role in many areas of American society. In U.S. securities law, however, "self regulatory organization" is a narrowly defined technical term; *see* Exchange Act § 3(26). For the purposes of this memorandum, the two most important SROs are the NYSE and the NASD. The NYSE, by far the nation's largest securities exchange, sets rules for the companies listed on, as well as for firms trading on or through, the exchange. The NASD's role is even broader. It sets rules for the Nasdaq (which is, technically, not a securities exchange) analogous to those set by the NYSE for its exchange. More importantly, it also sets the rules that govern its member institutions, the body of investment banks, brokers, dealers and traders.

The body of U.S. statutory securities law is entirely the creation of Congress. Congress has given the SEC broad powers to implement and enforce these laws, but these powers are strictly bounded by the framework of the statutes. The SEC must act on congressional mandate, and may not make rules or take enforcement actions outside the bounds of that mandate. The Sarbanes-Oxley Act of 2002 (the "**SOA**"), the centerpiece of "post-Enron" U.S. legislation, is in form typical of statutory securities law. It directs the SEC to implement certain rules (in many cases permitting the SEC to delegate some or all of this function to SROs). It leaves to the SEC broad discretion in "filling in the blanks" of the congressional mandate. However, it also directly implements a number of significant changes to the body of statutory securities law itself. If the SEC, in its rulemaking or enforcement actions, exceeds its mandate, the courts may (as they have done in the past) hold that there was no authority for the SEC action.[4]

Below the SEC stand the SROs. In their rulemaking function SROs do not act merely as private bodies adopting internal by-laws. Rather, they are also exercising public power delegated by the SEC (which must approve, and may play an active role in developing, proposed SRO rules).[5] Thus NASD and NYSE rulemaking must be understood as an integral part of the SEC's regulation of U.S. securities markets.

It is important to bear in mind that the SEC is both a regulatory and an enforcement agency. The first sections of this memorandum focus on SEC rulemaking as well as on rulemaking carried out by SROs under SEC-delegated authority, addressing both currently existing rules and proposed modifications and additions to those rules. The final section discusses recent SEC enforcement action against alleged abuse of research reports. Because new SEC regulation of research activities remains at present a work in progress, it should be noted that all such enforcement actions—even where initiated after the enactment of the SOA—are taken under existing rules.

B. Research reports: parallel focus on distribution and on conflicts of interest in preparation

When properly prepared and used, research reports are a valuable source of information to the capital markets. The SEC has repeatedly acknowledged the vital contributions of research to investor education and market efficiency.

Nonetheless, research reports are a subject of interest to the SEC from two distinct perspectives. First, the distribution of research reports can, under certain circumstances, be in potential conflict with one of the pillars of the U.S. securities law system: securities may be offered or sold publicly only by means of a registration statement meeting strictly defined requirements.

Secondly, regulators are concerned that research reports be prepared in a true spirit of independence. Research reports are typically produced, however, by research analysts employed by financial institutions. Unless these institutions conduct no investment banking activity—and such institutions are the exception—there is an innate conflict of interest between the analyst's role as an independent evaluator of companies and their securities, and the bank's desire to attract business from companies and make markets in securities. In

4 *See, e.g.*, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (holding that the SEC's Rule 10b-5 could not impose liability for negligent misconduct when the statutory provision under which the rule was promulgated made clear Congress's intention to penalize only intentional misconduct).

5 Exchange Act § 19 and rules thereunder.

addition, whether or not a bank engages in investment banking activities, it and its individual analysts face a potential conflict of interest in the temptation to use research reports to manipulate the market in a security for the bank's or the analyst's gain. Abuse of research runs afoul of another pillar of U.S. securities law: that investors be presented with all material facts necessary for an informed investment decision, and that material misstatements be forbidden.

With respect to the first concern, the SEC's position is long established and has generated a corresponding body of practice in the banking community. There are no indications that the SEC will revisit current doctrine in this area as a result of the events that gave rise to the SOA. By contrast, these events have spurred a major review by the SEC (and, subsidiarily, by the SROs) of currently existing conflict-of-interest regulation. Although the SOA directs the SEC to take a number of actions in this area, the SEC and the SROs had begun to revise and expand their rules even prior to the SOA's entry into force.

II. Historical and current approaches

A. SEC regulation of research distribution in connection with securities offerings

The SEC has long been concerned that research reports could be used as part of the selling effort in a securities offering. It is a fundamental principle of U.S. securities law that, absent an available exemption, securities may be offered and sold only by means of a prospectus, contained in a registration statement that satisfies the requirements of the Securities Act.[6] Given the Securities Act's very broad definitions of "offer" and "prospectus"[7], a research report used to induce interest in purchasing a security could be deemed a "defective" prospectus; such use of the report could be deemed an offering made prior to the filing of a registration statement. The penalties for either violation can be draconian. In addition, research reports typically contain statements (*e.g.*, projected financial information, target share prices) that, from concerns over potential liability, would normally never be found in a prospectus.

On the other hand, the SEC recognizes the important role of research reports in disseminating to the market information about issuers and their securities. The SEC promulgated Rule 139[8] in order to achieve a balance between these concerns. This rule provides a "safe harbor" for research reports covering an issuer or any of its securities published by members of an underwriting syndicate participating in an offering of securities by that issuer, even prior to the filing of a registration statement. In order for a syndicate member to enjoy this safe harbor, adequate information about the issuer must be publicly

6 Securities Act §§ 5, 10.

7 Securities Act §§ 2(a)(3), 2(a)(10). In marked contrast to the laws of some non-U.S. jurisdictions (as well as to non-securities related U.S. law), under the Securities Act an "offer" can be any action that might reasonably be expected to induce interest in a security. *See* Carl M. Loeb, Rhoades & Co., 38 S.E.C. 843, 1959 WL 2709 (1959) (holding that, in securities law, an offer is "not limited to communications which constitute an offer in the common law contract sense"). Similarly, a "prospectus" may be any written or otherwise recorded communication that offers (in the broad meaning of the Securities Act) a security.

8 17 C.F.R. § 230-139 (1995) ("**Rule 139**").

available.[9] In addition, the syndicate member must, prior to its involvement in the (proposed or active) offering, have published research concerning the issuer "with reasonable regularity in the ordinary course of business."[10] Furthermore, any recommendation by the research analyst contained in the report published under the safe harbor must be no more favorable than the recommendation contained in the most recent report published by the syndicate member prior to its involvement in the offering.[11]

In addition to formal SEC rulemaking, a body of "best practices" has developed within the U.S. banking community to address the potential conflict between the registration principle of the Securities Act and the legitimate use of research reports. Thus banks assisting an issuer in a securities offering typically adhere to internal rules calling for "restricted periods" and "blackout periods" during which publication of research covering the issuer is limited or banned outright. These codes of practice are, obviously, of greatest importance in cases where the Rule 139 safe harbor is unavailable. It is important to understand that these practices are the result of private initiatives by banks in consultation with their legal advisors. SEC rules neither prescribe blackout periods nor grant a safe harbor for their use. Nevertheless, given their long establishment, it is fair to conclude that the SEC tacitly regards these practices as an appropriate response to its concerns. It is interesting to note that NASD and NYSE have borrowed from these unofficial best practices in their "post-Enron" rulemaking aimed at reducing potential research-related conflicts of interest; see below, § III.C.

B. SEC and SRO approaches to analyst conflicts of interest

The SEC, NASD and NYSE have all been long aware of the potential for conflicts of interest in research activities. Prior to the events of the early 2000s, however, these regulators lacked tools designed to prevent and punish many of the specific practices that gave rise to these conflicts. The SEC relied chiefly on the so-called general antifraud provisions of the securities laws. The SROs did require certain disclosures concerning financial interests of banks in the issuers covered by their research analysts. These disclosures were, however, relatively minimal. The NASD and NYSE standards were inconsistent with each other. The NASD rule required no disclosures concerning individual analysts; the NYSE rules did require such disclosures, but in an extremely weak form. Perhaps most importantly, both sets of rules failed entirely to address structural pressures that could subject analysts to powerful conflicts of interest. The SEC's proposed new rules and the SRO's new rules (which are already in effect) represent a dramatic change to this approach; see below, §§ III.B.,C.

1. SEC regulation of analyst conflicts of interest

In one sense it would be accurate to claim that the SEC has not had (and, pending the final promulgation of the rules discussed below in § III.B., still does not have) any rules addressing conflicts of interest in the use of research. This claim is indeed accurate, but misleading. It is true that there has to date been no body of rules directly addressing analyst conflicts. Nevertheless, in the antifraud provisions of the securities laws the SEC has long

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[9] Rule 139(a). Essentially, the issuer satisfies this informational requirement if it has filed reports with the SEC under the Exchange Act for at least one year prior to the publication of the research report. Under certain circumstances, this period may be shortened with respect to foreign private issuers.

[10] Rule 139(b)(1)(i).

[11] Rule 139(b)(3).

had a powerful weapon against (among many others) banks and analysts that use research to manipulate markets or otherwise gain an improper private advantage.

Chief among these weapons are Exchange Act § 10 and the SEC's Rule 10b-5 thereunder.[12] Together, these provisions make it unlawful to use any "manipulative or deceptive device", to "make any untrue statement of a material fact or to omit to state a material fact", or to "engage in any … fraud or deceit" in connection with any securities transaction.

Rule 10b-5 is in no way limited to research activities, nor do most SEC enforcement actions based on the rule involve analysts or the research activities of their employers. Indeed, a literal reading of the rule might conclude—incorrectly[13]—that research activities (which may not at first sight appear to have any connection with a securities transaction) do not fall within the rule's purview. This is not the case, as a review of the enforcement actions described in § IV below makes clear. The antifraud provisions of the securities laws empower the SEC to take determined, and at times devastating, action against analysts and banks that use research in a manner that violates those provisions.

What the antifraud provisions do *not* do is require banks to adopt structures intended to discourage conflicts of interest from arising in the first place. Nor do they impose on banks and analysts the duty to make public disclosure of facts that could indicate potential conflicts. The latter is a particularly notable omission, given the SEC's guiding philosophy that "sunshine is the best disinfectant". The SEC does use prohibitions and enforcement actions where these are mandated by law or seem necessary to uphold the law's spirit. Where possible, however, the SEC usually prefers to adopt a *laisser-faire* approach, provided always that investors are presented with the full and accurate disclosure they need to decide for themselves whether an investment is wise.[14] As discussed in § III.B. below, the SEC's proposed new rulemaking represents a fundamental shift from its historical approach to regulating abusive research practices.

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12 17 C.F.R. § 240.10b-5 (1951) ("**Rule 10b-5**"). Although Securities Act § 17 is of similar effect, it applies only in the case of securities offerings. Other "antifraud" provisions, *e.g.* Securities Act §§ 11, 12, can impose liability for material misstatements or omissions in circumstances that fall far short of actual fraud (under § 11, for example, issuers are strictly liable). These provisions, however, apply only to *public* securities offerings. (§ 11 applies by definition only to public offerings subject to the Securities Act's registration requirement. As the result of the controversial Supreme Court decision in *Gustafson v. Alloyd Co*., 115 S.Ct. 1061 (1995), § 12 applies only to public offerings, although this would include those exceptional public offerings not subject to registration. The decision does, however, leave open the possibility that a future court decision could impose § 12 liability in the case of private offerings that share certain characteristics with public offerings.) Exchange Act § 10 and Rule 10b-5, by contrast, apply "in connection with the purchase or sale of any security", whether or not the transaction is effected by the person accused of the violation and whether or not in the context of an offering. *See* S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, Coates v. Securities and Exchange Commission, 394 U.S. 976 (1969); Basic Indus., Inc. v. Levinson, 108 S.Ct. 978 (1988).

13 *See above*, note 12.

14 *See generally* S. Hutter, *Zulassung von Aktien einer deutschen Aktiengesellschaft an einer US-amerikanischen Börse*, *in* I ARBEITSHANDBUCH FÜR UNTERNEHMENSÜBERNAHMEN, § 23B. (J. Semler & R. Volhard eds., 2001); J. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959).

2. SRO disclosure requirements

Even prior to the events that prompted the passage of the SOA, NASD and NYSE rules required banks to disclose certain potential conflicts of interest when publishing a research report recommending the purchase or sale of a specific security. The disclosure requirements of the then-existing NASD and NYSE rules[15], however, were weak. Furthermore, although they were generally similar in content, they differed in certain important respects, resulting in inconsistency.[16]

Prior to the reforms discussed in § III.C. below, the NASD and NYSE rules did generally require banks to disclose certain conflicts of interest when a bank (or one of its analysts) recommended the purchase or sale of a specific security. The bank was required to disclose whether it made a market in the security and whether it had been manager or co-manager of a public offering of the issuer within the last three years. In addition, banks were required generally to disclose any financial interest in the recommended security.

The NASD rule required banks and their officers or partners to disclose any ownership (above a nominal threshold) of options, rights or warrants to purchase any securities of the issuer whose securities were recommended in the report. The rule did not, however, require these persons to disclose ownership of the issuer's common shares. The analyst responsible for the report had no duty to disclose *any* financial interest in the issuer's securities. The NYSE rule applied both to the bank and its analysts, and required disclosure of all holdings of the issuer's securities, including common shares. Banks could, however, fulfill the requirements of this rule by using extremely vague disclosure language, *e.g.*, "The bank or its employees may own securities of a recommended issuer."

Both sets of rules were marked by serious lacunae. In addition to the inapplicability to analysts of the NASD rules' disclosure requirements, neither the NASD nor the NYSE rules governed public appearances by analysts. Nor did they address practices that could place analysts under pressure to modify their opinions to serve the interests of banks or issuers.

As with the proposed new SEC rules, the new NASD and NYSE rules discussed in § III.C. below, which became effective in April 2002, represent a significant change of course from the historical SRO regulation of research activities. Although these new SRO rules are already in effect, this memorandum discusses them in greater detail below, as they will form an important part of, and should be read in conjunction with, the SEC's implementation of the SOA through its proposed new regulation governing research practices.

III. The "post-Enron" era: Sarbanes-Oxley and the new SEC/SRO initiatives

A number of spectacular corporate, accounting and investment banking scandals in recent years, together with overall serious declines in the U.S. and global capital markets, has spurred new efforts at reform on the congressional, SEC and SRO levels. The keystone of these reforms is the SOA. As discussed above, however, both the SEC and the SROs acting under SEC-delegated authority had already taken steps toward reform even prior to the SOA's enactment.

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15 NYSE Rule 472; NASD Rule 2210.

16 *See* SEC Exchange Act Release No. 34-45908 (May 10, 2002).

A. The Sarbanes-Oxley Act

Among the concerns that Congress addressed in the SOA was the perceived use by investment banks of their research analysts not to provide the market with an objective evaluation of securities but rather to assist the banks' sales efforts and to attract business from potential issuers. Section 501 (Analyst Conflicts of Interest) of the SOA adds to the Exchange Act a new § 15D to address this concern.

Section 15D directs the SEC to promulgate rules (to become effective no later than July 30, 2003) requiring investment banks to adopt structural reforms aimed at reducing the possibility of conflicts between the banks' interest in attracting issuer clients and selling securities and the analysts' interest in providing objective research.[17] As a primary means of preventing such conflicts of interest, these rules are to protect analysts from undue interference by bank employees active in investment banking activities.[18] Thus, for example, non-analyst personnel are to be restricted in their ability to determine the compensation of analysts or (except for legal and compliance officers) to clear or approve a research report prior to publication. Banks are also to be prohibited from taking retaliatory action against an analyst for issuing an unfavorable report.

In addition to these restrictive rules, § 15D calls for rules requiring disclosure in research reports of a number of items that could indicate a conflict of interest.[19] These include:

- any holding by the research analyst of securities of the issuer on whom he or she is reporting;
- whether the bank or any affiliate (including the analyst) has received fees or other compensation from that issuer[20];
- whether the issuer is or has during the year prior to publication of the report been a client of the bank and, if so, the nature of the services provided; and
- whether the analyst's compensation is tied (in part or in whole) to the bank's investment banking revenue.

B. New SEC rulemaking

The SEC has moved to address the concerns raised by Section 501 of the SOA by proposing[21] the new Regulation Analyst Certification ("**Regulation AC**").[22] In so doing, the

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17 The SOA permits the SEC to implement § 15D Exchange Act by direct rulemaking or by delegation to SROs. As discussed in § III.C. below, NASD and NYSE have in fact anticipated the SOA's requirements to a significant extent.

18 Exchange Act § 15D(a).

19 Exchange Act § 15D(b).In the case of each of these disclosure items, a public appearance at which a research analyst discusses an issuer is deemed, for purposes of § 15D, equivalent to the publication of a research report.

20 Section 15D(b)(2) permits an exception to be made, insofar as consistent with investor protection, where such disclosure would effectively reveal material non-public information about a potential future offering.

21 SEC Securities Act Release No. 33-8119/Exchange Act Release No. 34-46301 (Aug. 2, 2002).

22 17 C.F.R. §§ 242.500-02 (proposed 2002).

SEC in large measure anticipated the provisions of Section 501. Although the SEC issued its proposal for Regulation AC after the entry into force of the SOA, the Commission had in fact begun work on this proposal prior to the SOA's enactment (and had approved related NYSE and NASD rules several months prior thereto). Although the SEC has not to date done so, it noted in its release proposing Regulation AC that it may, alone or in collaboration with the SROs, take additional steps to implement the SOA's requirements.

As is often the case with SEC rulemaking, the proposed Regulation AC aims less to require or prohibit specific practices than to demand full disclosure of facts that may be material to an investor in making a properly informed investment decision. This approach is in keeping with the U.S. securities laws' general philosophy of disclosure rather than "quality control".[23]

The period for public comment on the proposed regulation that is required under U.S. administrative law ended on September 23, 2002. The SEC is currently considering the final form of Regulation AC. The final regulation may differ from the proposal in significant respects, so long as it (together with any future related rulemaking) implements the directives of Exchange Act § 15D.

As proposed, Regulation AC would require that research reports clearly and prominently display certifications by the research analyst that:

- the views expressed in the report accurately reflect the analyst's personal views about the subject securities and issuers; *and*
- no part of the analyst's compensation was, is, or will be directly or indirectly related to the specific recommendation or views contained in the report; *or*
- part or all of the analyst's compensation was, is, or will be directly or indirectly related to the specific recommendation or views contained in the report. In this case, the analyst must:
  - disclose the purpose, source and (to the extent already received) the amount of such compensation, and
  - warn that such compensation may influence the recommendation in the report.

In addition, Regulation AC would require banks to create records of all public appearances by their research analysts at which an analyst makes a specific recommendation or offers an opinion concerning a security or an issuer. The bank must create a record for a public appearance within thirty days after the calendar quarter in which the appearance took place. The record must include certifications by the analyst that:

- the views expressed in the public appearance accurately reflected the analyst's personal views about the subject securities and issuers; and
- no part of the analyst's compensation was, is, or will be directly or indirectly related to any specific recommendations or views expressed in the appearance.

If the analyst is unable to give these certifications, the record of the appearance must note the fact, disclosing the reasons for the analyst's inability.

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[23] *See above*, note 14.

It should be noted that the SEC has gone beyond the minimum requirements of the SOA by making the provisions of Regulation AC applicable to research reports covering debt securities as well as equity.

C. NASD and NYSE rulemaking

In implementing securities laws, the SEC frequently relies to a great degree (as discussed in § I.A. above) on subsidiary rulemaking through SROs. The reform of research practices is no exception. In April 2002, the SEC approved revisions by the NASD and the NYSE to their rules concerning analyst conflicts of interest.[24]

These new rules address subjects previously not covered by the rules of these SROs. The NASD and the NYSE coordinated their rulemaking closely, with the effect that the analyst conflicts of interest rules of both SROs are, in contrast to the past, now essentially identical in substance and effect. Unlike the SEC's proposed Regulation AC, however, the new NASD and NYSE rules apply only with respect to equity securities.

The NASD and NYSE rules contain a number of specific restrictions and prohibitions. In addition, they require prominent disclosure of facts that may indicate potential conflicts of interest.[25] Banks subject to these rules must adopt written procedures designed to ensure compliance by the bank and its employees. A senior officer of the bank must attest annually that the bank has adopted and implemented those procedures.

1. Restrictions and prohibitions on banks

Under the NASD and NYSE rules, a bank may not:

- submit a research report to the subject company before its publication. Under the supervision of its legal or compliance department, however, the bank may provide the company with specific sections of the draft report solely to verify factual accuracy of the information in those sections. In no case may the company receive the research summary, the research rating or the price target;
- pay any form of compensation to a research analyst based on a specific investment banking services transaction; or
- directly or indirectly (i) offer favorable research or a specific rating or price target, or (ii) threaten to change research, a rating or a price target, to a company as consideration or inducement for business or compensation.

The rules also restrict the ability of banks to publish research during "quiet periods" following the bank's involvement in an issuer's offering of securities. Specifically, banks that have acted as manager or co-manager in an offering must refrain from publishing research for 40 days following an IPO and for 10 days following a secondary offering.[26] The rules provide an exception for reports during these periods that discuss the effects on the issuer of

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24 NYSE Rule 472 (amended); new NASD Rule 2711; *approved in* SEC Exchange Act Release No. 34-45908 (May 10, 2002); *published in* 67 F.R. 34968 (May 16, 2002).

25 Multi-issuer research reports covering the securities of six or more issuers may incorporate the required disclosures by reference to other reports covering these issuers. In this case, the multi-issuer report must clearly inform readers where they can obtain the referenced disclosures in written or electronic form.

26 Note that the NASD and NYSE rules are modeled on, albeit for a somewhat different purpose, the best-practices standards developed by banks as discussed in § II.A. above.

significant news or new events. The bank's legal or compliance department must authorize any such report prior to its publication. In addition, the rules specifically exempt reports published following non-IPO offerings pursuant to the SEC's Rule 139.

2. Restrictions and prohibitions on investment banking departments

Under the new rules, a bank's investment banking department (or any employees thereof) may not:

- exercise supervision or control over research analysts; or
- review or approve a research report before its publication (except to verify factual accuracy of information or to identify potential conflicts of interest, and then only through or under the supervision of an authorized legal or compliance official of the bank).

3. Restrictions and prohibitions on research analysts

The new rules subject research analysts to a number of restrictions on trading. In particular, an analyst may not:

- purchase or receive any securities of an issuer before the issuer's IPO if the issuer is principally engaged in the same types of business as other companies that the analyst follows; or
- purchase or sell any security (or related option or derivative) of an issuer that the analyst follows during a period beginning 30 calendar days before, and ending five calendar days after, the publication of a research report concerning the issuer or a change in a rating or price target of the issuer's securities.

The rules provide exemptions for certain classes of transactions, *e.g.*, trades made through a mutual fund in which the analyst has no investment discretion. Banks may also permit their analysts to trade in circumstances that would, under the rules, otherwise bar the analyst from trading. Banks may grant such permission only in accordance with policies and procedures reasonably designed to ensure that the transaction does not create a conflict of interest between the analyst's professional responsibilities and personal trading activities. All such grants of permission require the approval of the bank's legal or compliance department and are subject to record-keeping and disclosure obligations.

In addition, no analyst may trade in a security, even if the trade would otherwise be permissible under the rules, in a manner inconsistent with the recommendation in the bank's most recent research report covering the security.

4. Required disclosures of securities ownership and material conflicts of interest

Banks must disclose in each research report, and research analysts must disclose at each public appearance:

- whether the analyst or a member of the analyst's household has a financial interest in the securities of the subject company and, if so, the nature of that interest;
- whether the analyst or a member of the analyst's household serves as an officer, director or advisory board member of the subject company;
- whether the bank or any affiliate, as of the end of certain defined periods immediately preceding the publication of the report or the date of the appearance,

beneficially owns 1% or more of any class of common equity securities of the subject company; and

- any other actual, material conflict of interest of the bank or analyst of which the research analyst knows or has reason to know at the time of the publication or appearance.

A bank must also disclose in its research reports whether it was making a market in the subject company's securities at the time the report was published.

5. Required disclosures concerning compensation

Research reports must disclose whether:

- the principal research analyst responsible for the report received compensation based upon (among other factors) the bank's investment banking revenue; and
- the bank or any affiliate
  - managed or co-managed a public offering of securities for the subject company, or received compensation for investment banking services from the subject company, during the past 12 months; or
  - expects to receive (or intends to seek) compensation for investment banking services from the subject company during the next 3 months.

In addition, a bank's research analysts must disclose in public appearances whether they know or have reason to know that the subject company is a client of the bank or its affiliates.

6. Required disclosures concerning ratings and price targets

Research reports must:

- define the meaning of each rating term used in the bank's rating system; these definitions must be consistent with the terms' plain meanings;
- disclose, regardless of the actual rating terms the bank uses, the percentage of all securities rated by the bank to which the bank would assign a "buy," "hold/neutral," or "sell" rating;
- disclose the percentage of subject companies within each of these three categories for whom the bank has provided investment banking services within the previous twelve months;
- present a line graph, in any research report concerning an equity security for which the bank has assigned any rating for at least one year, of that security's daily closing prices for the shorter of (i) the period during which the bank has assigned any rating or (ii) a three-year period, indicating:
  - the dates on which the bank assigned or changed each rating or price target; and
  - each rating and price target assigned or changed on those dates; and
- disclose the valuation methods used to determine a price target. Price targets must have a reasonable basis and be accompanied by disclosure of the risks that may impede achievement of the target.

IV. SEC Enforcement Actions

In addition to its rulemaking function (whether exercised directly or through delegation to an SRO), the SEC is responsible for monitoring compliance with securities law and regulations and taking enforcement action against violators.[27] As in the case of SEC and SRO rulemaking in this area, SEC enforcement actions related to improper use of research were already underway before the enactment of the SOA; the new law has given the SEC's efforts additional impetus.

On January 9, 2003 the SEC filed a civil action[28] in federal district court against a managing director and senior research analyst employed by a California-based investment bank that played a major role in the wave of securities offerings by technology companies during the 1990s and early 2000s.[29] The SEC's complaint alleges that, in issuing research reports and making public statements regarding mergers proposed by two public companies, the analyst failed to disclose that he would, as a result of his stock ownership, profit significantly upon completion of each of the mergers. The complaint alleges further that the analyst's "buy" recommendation on another public company was false, misleading and inconsistent with his privately-held belief.

The SEC complaint charges that, through these actions, the analyst violated Exchange Act § 10 (b) as well as Rule 10b-5. Together, the statutory provision and the rule prohibit false or misleading statements in connection with the purchase or sale of securities. The complaint also charges the analyst with violating Securities Act § 17(a), which prohibits material false or misleading statements and failure to disclose material facts in the offer or sale of securities.

In its prayer for relief, the SEC requests that the court permanently enjoin the analyst from future violations of these statutory provisions and Rule 10b-5.[30] It also seeks to force the analyst to disgorge his profits from the transactions in question (including interest from the time of the alleged violation) and to pay a monetary fine.

Following the recent decline of the stock markets, the SEC together with the NASD, the NYSE, the Attorney General of New York and several other regulatory and law enforcement authorities initiated a major program to reform certain investment banking practices widely held to have contributed to the overvaluation and eventual collapse of the markets. All these practices created conflicts of interest, many of them related to the use of research. On December 20, 2002, the SEC announced that it and the other authorities had agreed with a group of the nation's leading investment banks to a settlement that would avoid the need for litigation alleging violations of Exchange Act § 10 and Rule 10b-5.

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27 The SEC has power to bring administrative and civil actions. It has no authority to bring criminal charges, but can (and often does) request that prosecutors commence criminal actions.

28 SEC v. Johnson, No. 03 CV 0177 (S.D.N.Y. filed 2003); *see also* SEC Litigation Release No. 17922 (Jan. 9, 2003).

29 In this matter the investment bank settled with the SEC by signing a consent decree and paying a total of $5 million in disgorged profits and fines. On January 9, 2003 the SEC also brought a separate lawsuit against the bank for alleged misconduct unrelated to the research activities at issue in *Johnson*.

30 The SEC frequently makes use of injunctions in its enforcement efforts. This technique makes it significantly easier to take action against the violator for any similar violations in the future, as such future violations would constitute contempt of court, permitting the court to take immediate and direct steps against the violator even in advance of a civil lawsuit by the SEC.

With respect to research activities, each bank obligated itself under this agreement:

- to sever the links between research and investment banking, including analyst compensation for equity research and the practice of analysts accompanying investment banking personnel on pitches and road shows;
- to contract, for a minimum five-year period, with no less than three independent research firms to provide research to the bank's customers; and
- to facilitate investors' comparative evaluation of its analysts' performance by making ratings and price target forecasts publicly available.

In addition, each of the banks agreed to pay fines, to contribute to a restitution fund for investors and to escrow monies to pay for independent research. The agreement calls for total payments of more than $1.4 billion.

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