FREQUENTLY ASKED QUESTIONS ABOUT SEPARATION OF RESEARCH AND INVESTMENT BANKING

Background

What rules apply to Research and its relationship with Investment Banking?

The rules and regulations that apply to the relationship between the Research and Investment Banking departments of a firm include:

- FINRA[1] Conduct Rule 2711;
- NYSE Rule 472;
- SEC Regulation AC (Analyst Certification);
- SEC Rules 137, 138, and 139 under the Securities Act of 1933, as amended (the "Securities Act").

What is the Global Research Analyst Settlement?

The Global Research Analyst Settlement ("Global Settlement") is an enforcement agreement first announced in December 2002 and finalized on April 28, 2003, among the SEC, NASD (now FINRA), the NYSE, the New York State Attorney General and ten of the then-largest investment banking firms in the United States (the "Settling Firms").[2] The Global Settlement addressed issues related to conflicts of interest between the Research and Investment Banking departments of these firms that became apparent during the "dot com" boom and then bust of the late 1990s and early 2000s.

As part of the Global Settlement, the Settling Firms agreed to several rules designed to prevent abuse stemming from pressure by investment bankers on research analysts to provide favorable coverage of specific issuers or securities. The Settling Firms were required to separate their Investment Banking and Research departments from each other both physically and with information "firewalls." Additionally, the budget allocation for Research was to be independent of Investment Banking. Research analysts were also prohibited from attending pitches and road shows with

[1] As used herein, "FINRA" means the Financial Industry Regulatory Authority, "NASD" means the National Association of Securities Dealers, Inc., "NYSE" means the New York Stock Exchange, and "SEC" means the Securities and Exchange Commission. In July 2007 FINRA consolidated the NASD and the member regulation, enforcement and arbitration functions of the NYSE. While all Rules will be referred to herein as FINRA Rules, certain of them are still not consolidated and are considered NASD rules.

[2] The ten firms were: Bear, Stearns & Co. Inc.; Citigroup Global Markets Inc. (f/k/a Salomon Smith Barney, Inc.); Credit Suisse First Boston LLC; Goldman, Sachs & Co.; J.P. Morgan Securities Inc.; Lehman Brothers Inc.; Merrill Lynch, Pierce, Fenner & Smith Incorporated; Morgan Stanley & Co. Incorporated; UBS Warburg LLC; and U.S. Bancorp Piper Jaffray Inc.

investment bankers during the advertising and promotion of initial public offerings ("IPOs"). Finally, research analysts' previously issued ratings about issuers had to be disclosed and made available.

In addition to these regulatory actions, each Settling Firm was enjoined from violating the statutes and rules that it was alleged to have violated. The Settling Firms were also required to pay fines to their investors, fund investor education and pay for independent third-party market research. The total fine paid by the Settling Firms was approximately $1.435 billion, of which $387.5 million was restitution to harmed investors. The Global Settlement was amended in March 2010 (see "2010 Amendments to the Global Settlement" below).[3]

What are the SRO Rules?

The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") required the SEC to address conflicts of interest involving research analysts and investment bankers. In response to Sarbanes-Oxley, the NASD and the NYSE established rules and safeguards to separate research analysts from the review, pressure and oversight of investment banking personnel. These rules are intended to ensure the integrity of research, and to protect investors from being misled as a result of a failure to disclose potential conflicts of interest.

On July 29, 2003, the SEC announced the approval of a series of changes to the rules affecting research analysts, generally embodied in FINRA Rule 2711 and NYSE Rule 472 and commonly referred to as the "SRO Rules" (SRO refers to "self-regulatory organization"). The SRO Rules have since been amended multiple times (most recently on October 11, 2012 to conform the SRO Rules to provisions of the JOBS Act). It is worth noting that the SRO Rules had already generally incorporated the terms of the updated Global Settlement approved in March 2010.

What events led to the Global Settlement?

During the "dot com" boom and then bust of the late 1990s and early 2000s, research analysts published reports recommending investments in the securities of many companies with which their firms had an advisory or investment banking relationship. In 1999 the SEC began a review of industry practices regarding the disclosure of research analysts' conflicts of interest.

Committees of the U.S. House of Representatives and the Senate also held hearings on research analysts' conflicts of interests. In April 2002, the SEC announced a formal inquiry into industry practices concerning research analysts, their conflicts of interest and their relationships with the Investment Banking departments within their firms. Civil complaints were filed by the SEC and other federal and state regulatory and law enforcement authorities against these firms. Some of the violations that led to the Global Settlement include:

- issuing fraudulent research reports in violation of Section 15(c) of the Securities Exchange Act of 1934, as amended (the "Exchange Act");
- issuing research reports that violated the principles of fair dealing and good faith and related obligations in applicable NASD and NYSE Rules;

[3] The April 2012 JOBS Act has not yet resulted in any amendment to the Global Settlement to reflect the new rules concerning emerging growth companies, but to date that has not happened. See the SEC's "Jumpstart Our Business Startups Act Frequently Asked Questions About Research Analysts and Underwriters" (August 22, 2012) (the "SEC FAQs"), available at http://www.sec.gov/divisions/marketreg/tmjobsact-researchanalystsfaq.htm at Question 2.

- allegedly receiving payments for investment research without properly disclosing such payments, in violation of Section 17(b) the Securities Act; and
- failing to maintain appropriate supervision over their Research and Investment Banking departments in violation of FINRA Rule 3010.

Do firms not included in the Global Settlement need to comply with its requirements?

Technically, the Global Settlement applied only to the ten Settling Firms and their successors. However, many institutional investors have required non-settling firms to agree to follow its provisions. In addition, many of the Global Settlement provisions are now embodied in the SRO Rules.

Is the Global Settlement still in effect?

Yes. See "2010 Amendments to the Global Settlement" below.

Separation of Research and Investment Banking

What is the purpose of the separation of Research and Investment Banking?

The separation of Research and Investment Banking under the Global Settlement and SRO Rules is intended to provide investors with confidence as to the integrity of the research and knowledge of the potential conflicts of interest that could affect the research analyst's opinion.

How must the Research and Investment Banking departments be structured to maintain separation?

Research must be insulated from Investment Banking through restrictions on its communications and with companies that are the subject of the research being conducted. These restrictions include:

- separate reporting lines for both Research and Investment Banking;
- a dedicated legal and compliance staff for Research;
- prohibition on Investment Banking threatening to retaliate against research analysts for an unfavorable report;
- prohibition on Investment Banking directing a research analyst to engage in sales or marketing efforts related to any investment banking transactions;
- prohibition on three-way meetings with Research personnel, investors, and Investment Banking personnel (with the exception of certain meetings with emerging growth companies, described below under "*How does the JOBS Act affect the SRO Rules?*); and
- independent review of research analysts.

The head of Research may report to or through a person or persons to whom the head of Investment Banking also reports, *provided* that such person(s) have no direct responsibility for Investment Banking activities or decisions.

Source: Global Settlement (I)(1): http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf; FINRA Rule 2711; NYSE Rule 472.

How must Research and Investment Banking Departments be separated? Is a physical separation required?

In addition to the restrictions upon the interactions between Research and Investment Banking described above, the Global Settlement required a physical separation between a firm's Research and Investment Banking departments. This physical separation must be reasonably designed to ensure that there will not be any intentional or unintentional flow of information between Research and Investment Banking. While there are no specific guidelines for the physical separations required, separate floors, doors, and restricted access for the respective departments are generally believed to comply with the physical separation required between the two departments.

Source: Global Settlement (I)(4):

http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf.

What kinds of research reports are subject to the Global Settlement and SRO Rules?

For purposes of the Global Settlement and the SRO Rules, a research report is any written communication (including electronic communications) that includes an analysis of a security or an issuer and provides information reasonably sufficient to form the basis for an investor's investment decision.

Certain reports that do not include a specific analyst's recommendation or rating of individual securities or issuers are not included in the definition of a research report, including:

- reports discussing broad-based indices;
- reports commenting on economic political or market conditions;
- technical or quantitative analysis concerning the demand and supply for a sector index or industry based on trading volume and price;
- reports that recommend increasing or decreasing holdings in particular industries, sectors or types of securities; and
- statistical summaries of multiple companies' financial data and broad-based summaries or listings of recommendations or ratings contained in previously issued research reports, provided that such summaries do not include any analysis of individual companies.

Other types of reports, even if they *do* include a specific recommendation or rating of individual securities or issuers, are also excluded from the definition of a research report, including:

- a report prepared for an investing customer or group by a registered salesperson who is not principally engaged in the preparation or publication of reports; and
- periodic reports or other communications prepared for current or prospective investment company shareholders or discretionary investment account clients,

provided that such reports discuss past performance or the basis for prior investment decisions.

Source: FINRA Rule 2711(a)(9).

Who are considered Investment Banking personnel for purposes of the Global Settlement?

Investment Banking is defined as all firm personnel engaged principally in investment banking activities, including the solicitation of issuers and structuring of public offering and other investment banking

transactions. It also includes all firm personnel who are directly or indirectly supervised by such persons and all personnel who directly or indirectly supervise such persons, including the management of the Investment Banking department.

Source: Global Settlement Addendum A, available at http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf.

Who are considered Research personnel for purposes of the Global Settlement?

Research means all firm personnel engaged principally in the preparation and/or publication of research reports. It also includes all firm personnel who are directly or indirectly supervised by such persons and all personnel who directly or indirectly supervise such persons, including the management of the research department.

Source: Global Settlement Addendum A, available at http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf.

How does the required separation between Research and Investment Banking affect the budgets for each department?

The budgets for each department must be determined by the senior management of the firm. There can be no input from Investment Banking into budget decisions or allocations for Research. Any revenues or results generated by the Investment Banking department cannot be taken into account when allocating money for Research. However, overall firm revenues and results (which include those generated by Investment Banking) may be considered in determining the Research budget and allocation of research expenses.

There must be an annual review of the Research department budgeting and expense allocation by an audit committee (or comparable independent group that does not have any management responsibilities) to ensure compliance with these requirements.

Source: Global Settlement Addendum A, available at http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf.

How may the compensation of Research personnel be determined or structured?

Compensation of Research personnel must be determined solely by management in Research and the senior management of the firm without any input from Investment Banking. Compensation of Research personnel cannot be tied, directly or indirectly, to Investment Banking's revenues or results, although it can be tied to revenues or results of the firm as a whole. Further, significant portions of the compensation of any lead analyst must be based on quantifiable measures of the quality and accuracy of the lead analyst's research and analysis, including his or her ratings and price targets, if any. Other factors that a firm may use in determining an analyst's compensation include:

- the analyst's productivity, seniority and experience;
- interest of the firm's investing clientele in the sectors covered by the analyst;
- the correlation between the research analyst's recommendations and the stock price performance; and
- overall ratings received from clients, sales force, and peers independent of the firm's Investment Banking department, and other independent ratings services.

If a research analyst's compensation is based on the firm's overall profitability, which includes Investment Banking revenues, this fact must be disclosed.

Source: FINRA Rule 2711(d).

The Compensation Committee of the firm's holding/parent company (or comparable independent group that does not have any management responsibilities) must conduct an annual review of the compensation process for Research personnel. This review is designed to ensure that compensation decisions are made in a manner consistent with the appropriate requirements.

Source: Global Settlement Addendum A, available at http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf; FINRA Rule 2711(d).

How may the job performance of Research personnel be evaluated?

Evaluations of Research personnel must be conducted only by other Research personnel and cannot be conducted by, nor can there be any input from, Investment Banking personnel. The firm, in assessing the quality and accuracy of a research analyst's work, may rely on evaluations by the firm's investing customers, sales personnel, rankings in independent surveys and the actual performance of a company or its equity securities in comparison to the analyst's ratings, price targets and forecasts.

Source: FINRA Rule 2711(b)(1).

Can Research help solicit business for the Investment Banking?

Research personnel may not participate in efforts to solicit business for Investment Banking, including, among other things, participating in any "pitches," or otherwise communicating with a company or prospective client for the purpose of soliciting investment banking business. Further, SEC interpretive guidance states that it would be inconsistent with Section I.9 of Addendum A to the Global Settlement to allow Investment Banking personnel to include any information regarding any research analyst employed by the firm in a "pitch book" or any other presentation materials used to solicit Investment Banking business.[4]

Source: Global Settlement Addendum A, available at http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf.

Research personnel are not allowed to participate in any road shows sponsored by the company or Investment Banking related to a public offering or other investment banking transaction.[5] However, SEC interpretive guidance provides that Research personnel may listen (in listen-only mode) or view a live webcast of these road shows.[6] Research personnel may also access other widely attended presentations to investors from a remote location, but if the presentation is in the firm's building, they must be in a separate room.

Certain communications between a research analyst and an issuer *are* permitted in connection with an offering. At an issuer's request, Investment Banking personnel may arrange for a department of the firm other than Research to provide the issuer access to previously published reports regarding that issuer that

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[4] *See* Letter to Dana G. Fleischman from James A. Brigagliano, November 2, 2004 at Question 10, available at: http://www.sec.gov/divisions/marketreg/mr-noaction/grs110204.htm.

[5] The JOBS Act has modified this prohibition to permit Research personnel to participate in meetings with representatives of an emerging growth company in connection with that company's IPO, even if Investment Banking personnel are present. See "*How does the JOBS Act affect the SRO Rules?"*

[6] *Supra* note 4 at Question 6.

would be available from other sources. Should an issuer request Investment Banking personnel to arrange a meeting between the issuer and a research analyst, the investment bankers must instruct the issuer to contact Research directly and may not notify Research in advance. A research analyst is permitted to attend a meeting with an issuer and answer questions regarding the analyst's views on the company, but may not use it as an opportunity to solicit investment banking business, and Investment Banking personnel may not be present or participate in any of these meetings.

Source: FINRA Rule 2711(c).

How must the coverage of specific companies be determined?

Investment Banking may not have any input into determinations of companies to be covered by Research and whether to initiate or terminate coverage of a specific company. Investment Banking revenues or potential revenues may not be taken into account in making company-specific coverage decisions. These requirements do *not* apply to category-by-category coverage decisions (e.g., an industry sector, all issuers underwritten by the firm or companies meeting a certain market cap threshold).

What are the procedures if a firm decides to stop covering a specific company in its research reports?

When a decision is made by Research to terminate coverage of a specific company (whether it is a company-specific or a category-by-category decision), the firm must make available a final research report using the same means of dissemination as it would for its prior reports. The final report must be comparable to prior reports when practicable and must give notice of the intention to terminate coverage of the company.

The final report must disclose that the firm has decided to terminate coverage of the company and the rationale for the decision. No final report is required for any company as to which the firm's prior coverage has been limited to quantitative or technical research reports.

Source: FINRA Rule 2711(f)(5).

How is compliance with the SRO Rules monitored by a firm?

The SRO Rules generally require that any communications deemed to be research reports be prepared or approved in advance by a supervisory analyst. The rules also require that member firms adopt and implement written supervisory procedures reasonably designed to ensure compliance with the rules. In addition, a senior officer of the firm must attest annually that the firm has adopted and implemented procedures to ensure such compliance.

Source: FINRA Rule 2711(i); NYSE Rule 472 (k)(4).

The JOBS Act

How does the JOBS Act affect the SRO Rules?

On April 5, 2012, the Jumpstart Our Business Startups Act (the "JOBS Act") was enacted. Title I of the JOBS Act establishes a new category of issuer called an emerging growth company ("EGC"). An EGC is defined as an issuer with total gross revenues of under $1 billion (subject to inflationary adjustment by the SEC every five years) during its most recently completed fiscal year. An issuer that qualifies as an EGC will remain an EGC until the earliest of:

- the last day of the fiscal year during which the issuer's total gross revenues exceed $1 billion; or
- five years from the issuer's IPO; or
- the date on which the issuer has sold more than $1 billion in non-convertible debt; or
- the date on which the issuer becomes a large accelerated filer (i.e., has a public float of $700 million).

A broker-dealer participating in an issuer's IPO is generally subject to certain blackout periods with respect to publishing of research reports about such issuer. The publication of research is prohibited in advance of the IPO and, once the IPO priced, no research can be published until 40 days following the offering. Additionally, the publication of any research must be suspended for the 15 days before and after the release or expiration of any lock-up agreement.

The JOBS Act prohibits any national securities association (FINRA is the only one) or the SEC from adopting any rule or regulation prohibiting a broker-dealer from publishing or distributing a research report or making a public appearance with respect to the securities of an EGC within any prescribed period of time following the EGC's IPO or the expiration date of any lock-up agreement. This eliminates the traditional post-IPO "quiet period" for EGCs.

On October 11, 2012 the SEC granted accelerated approval for amendments to the SRO Rules, (which became effective retroactive to April 5, 2012, the date the JOBS Act was enacted), that conform the SRO Rules to the requirements of the JOBS Act related to research analysts and research reports in certain offerings by EGCs. In addition, the amendments eliminated the quiet periods in connection with IPOs and secondary offerings of EGCs by the adoption of new FINRA Rule 2711(5), which states that the lock up periods discussed in paragraphs (f)(1), (f)(2) and (f)(4) of FINRA Rule 2711, "shall not apply to the publication or distribution of a research report or a public appearance following an initial public offering or secondary offering of the securities of an Emerging Growth Company." *See* http://www.sec.gov/rules/sro/finra/2012/34-68037.pdf.

The JOBS Act also did not explicitly permit publication or distribution of a research report relating to an EGC after the expiration, termination, or waiver of a lock-up agreement or prohibit quiet periods after a follow-on offering of an EGC's securities. The adoption of the amendments to the SRO Rules have made clear that both the SEC and FINRA interpret the JOBS Act to permit publication of research reports on an EGC's securities no matter how the lock-up period ends – by termination, expiration, or waiver – both before and after the termination, expiration, or waiver of the agreement, eliminating all quiet periods for EGCs.

Furthermore, Title I of the JOBS Act allows a broker-dealer assisting in *any* public offering of the common equity securities of an EGC to publish or distribute a research report about the issuer. This research report will not be deemed to be an "offer" under the Securities Act, even if the broker-dealer intends to participate, or participates, in the offering.

Does the JOBS Act affect the ability of Investment Banking personnel to arrange communications between a research analyst and a potential investor?

Under Section 105(b) of the JOBS Act, an associated person of a broker-dealer, including Investment Banking personnel, may arrange communications

between research analysts and investors. This activity would include, for example, an investment banker forwarding a list of clients to the research analyst that the analyst could, at his or her own discretion and with appropriate controls, contact. In turn, a research analyst could forward a list of potential clients with whom it intends to communicate to Investment Banking personnel as a means to facilitate scheduling. Investment bankers can also arrange, but not participate in, calls between analysts and clients. In the SEC FAQs, the SEC has stated that such arranging activity, without more, would not violate FINRA Rule 2711 or NYSE Rule 472 although it notes that firms should be mindful of other provisions of the Exchange Act and the SRO Rules as well as the applicability of the Global Settlement.[7]

How does the JOBS Act affect the ability of Research personnel to attend meetings or "pitches" with the management of an EGC in the presence of Investment Banking personnel?

The JOBS Act prohibits a national securities association or the SEC from maintaining rules restricting research analysts from participating in meetings with Investment Banking personnel and an EGC in connection with an EGC's IPO. Prior to the enactment of the JOBS Act, Research personnel were prohibited from attending meetings with issuer management that were also attended by Investment Banking personnel in connection with an IPO, including pitch meetings. Section 105(b) of the JOBS Act permits Research personnel to participate in any communication with the management of an EGC concerning an IPO that is also attended by any other associated person of a broker, dealer, or member of a national securities association whose functional role is other than as an analyst, including Investment Banking personnel. The SEC has interpreted this section as primarily reflecting a Congressional intent to allow Research personnel to participate in EGC management presentations with sales force personnel so that the issuer's management would not need to make separate and duplicative presentations to Research personnel at a time when resources of the EGC may be limited.

The SEC stated in the SEC FAQs that Research personnel must limit their participation in such meetings to introducing themselves, outlining their research program and the types of factors that they would consider in their analysis of a company, and asking follow-up questions to better understand a factual statement made by the EGC's management. In addition, after the firm is formally retained to underwrite the offering, Research personnel could, for example, participate in presentations by the management of an EGC to educate a firm's sales force about the company and discuss industry trends, provide information obtained from investing customers, and communicate their views. [8]

In the October 2012 amendments, FINRA amended Rule 2711(c)(4) to conform to the provisions of the JOBS Act, specifically to provide that, while research analysts are prohibited from soliciting business for investment banking, they are not prevented from attending a pitch meeting in connection with an initial public offering of an EGC that is also attended by Investment Banking personnel; provided, however, that a research analyst

[7] See SEC FAQs, *supra* note 3 at Question 3.

[8] *See* SEC FAQs, *supra* note 3 at Question 4.

may not engage in otherwise prohibited conduct in such meetings.[9]

Does the JOBS Act permit Research personnel to participate in a road show or other communications with investors in the presence of Investment Banking personnel or the management of an EGC about an existing or potential investment banking transaction?

In the SEC's view, Section 105(b)(2) of the JOBS Act allows a firm to avoid the ministerial burdens of organizing separate and potentially duplicative meetings and presentations among an EGC's management team, investment banking personnel, and research analysts. Section 105(b)(2) did not address communications where investors are present together with company management, analysts and investment banking personnel. Therefore, the SEC has taken the view that this provision of the JOBS Act does not affect the SRO Rules prohibiting analysts from participating in road shows or otherwise engaging in communications with customers about an investment banking transaction in the presence of investment bankers or the company's management. These rules apply to communications with customers and other investors and do not depend on whether analysts, investment bankers, and management are participating jointly in such communications.[10]

Does the JOBS Act affect NYSE Rule 472?

The SEC has stated that for the limited purpose of interpreting the applicability of JOBS Act Sections 105(b) and (d), it believes that Sections 105(b) and (d) were intended to apply to NYSE Rule 472 to the same extent as FINRA Rule 2711.[11] In addition, on October 11, 2012, the SEC granted accelerated approval to amendments to both FINRA Rule 2711 and NYSE Rule 472. The amendments conform the rules to the requirements of the JOBS Act and make other related changes.[12]

Does the JOBS Act modify all of the requirements imposed on research analysts by the SRO Rules and other SEC regulations?

No. There are many provisions of the SRO Rules and existing SEC Regulations dealing with the separation of Research and Investment Banking that the JOBS Act does not eliminate or modify, even in relation to EGCs, including;

- the prohibition of Research personnel from soliciting business for Investment Banking;
- the prohibition on Research personnel from engaging in communications with prospective investors in the presence of Investment Banking personnel;
- the prohibition on sharing pre-deal research such as ratings and price targets, with an issuer;
- the prohibition on Investment Banking personnel from requiring a research analyst to arrange investor communications;
- the prohibition on compensating Research personnel based on Investment Banking revenue;
- the FINRA requirements relating to the preparation, review and approval of research reports disseminated by a firm; and

[9] *See* http://www.sec.gov/rules/sro/finra/2012/34-68037.pdf.
[10] *See* SEC FAQs, *supra* note 3 at Question 5.
[11] *See* SEC FAQs, *supra* note 3 at Question 6.
[12] See http://www.sec.gov/rules/sro/finra/2012/34-68037.pdf.

- compliance of research analysts with Regulation AC (as defined below).

Appendix A is a table that compares the actions, as they relate to the Research and Investment Banking personnel, that are permitted before and after the enactment of the JOBS Act.

How does the JOBS Act define a "research report?"

Section 105(a) of the JOBS Act defines a "research report" as "a written, electronic, or oral communication that includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, *whether or not* it provides information reasonably sufficient upon which to base an investment decision." This differs from the definition of a "research report" in the SRO Rules and Global Settlement, where the information contained in the report must be reasonably sufficient to form the basis for an investor's decision. Accordingly, the definition of research report for purposes of the JOBS Act would encompass nearly any written or oral communication relating to an EGC or its securities made by a broker-dealer.

Is there a difference between the permitted "testing-the-waters" communications prior to the official launch of an offering and distributing research reports once the offering has begun?

Section 105(a) of the JOBS Act provides that a research report published by a broker-dealer about an EGC that is planning a public offering of common equity securities will not be considered an offer for purposes of Section 2(a)(10) and Section 5(c) of the Securities Act. As a result, the issuance of a written research report by a broker-dealer will not trigger a Section 5 violation and would not constitute a written offer "by means of a prospectus" for purposes of potential liability under Section 12(a)(2). However, "testing-the-waters" communications under the JOBS Act does not provide an exemption from Section 12(a)(2) liability, but only from Section 5. Therefore, a research report would have greater protection from liability under the JOBS Act than "testing the waters" materials.

Whether an oral research report may be subject to Section 12(a)(2) liability is more complicated. The JOBS Act does not provide a safe harbor under Section 12(a)(2) with respect to oral research reports. Consequently, an oral research report could still result in Section 12(a)(2) liability if it is deemed to constitute an "offer" of a security.

Does the JOBS Act exempt the permitted research reports from potential liability under Rule 10b-5 of the Exchange Act and/or state anti-fraud laws?

No. The JOBS Act has no impact on liability under Rule 10b-5 or state anti-fraud laws.

Does the JOBS Act safe harbor allowing for the publication of research reports apply to a debt offering of an EGC?

No. The safe harbor for the publication of research reports concerning an EGC applies only to a public offering of the common equity securities of an EGC.

Source: JOBS Act Sec.105(a).

How does the JOBS Act affect the Global Settlement?

The JOBS Act does not directly address the Global Settlement and, as the Global Settlement is a judicial order and not an SEC or FINRA rule, it is technically not affected by the enactment of the JOBS Act. However, it is important to remember that the Global Settlement

only affects the eight remaining Settling Firms. All other broker-dealers not party to the Global Settlement are able to take advantage of the self-effectuating provisions of the JOBS Act described above. It remains to be seen whether the Settling Firms will petition the Court for another amendment to the Global Settlement to conform to the provisions of the JOBS Act. It is also unclear if the SEC will amend Rules 137, 138, and 139 to address the effects of the JOBS Act.

Disclosure/Transparency

Are subject companies allowed to view research reports prior to publication to the public?

The SRO Rules limit the extent to which subject companies may view research reports prior to distribution. A firm may submit sections of the report prior to publication to the subject company only to verify the factual accuracy of the report. Any such submission may not contain the research summary, research rating, or price target, and a full copy of the draft must be submitted to the legal or compliance department in advance.

Source: FINRA Rule 2711(c).

Are there prohibitions on promising favorable research?

The SRO Rules prohibit a member firm and its affiliates from promising a subject company favorable research or a specific rating or price target as consideration or inducement for the receipt of investment banking business from the company. These rules are not intended to prevent a firm from agreeing to provide research as part of its investment banking services.

Source: FINRA Rule 2711(e).

What are required disclosures in Research Reports?

The SRO Rules require disclosure in research reports and public appearances by analysts related to matters that give rise to, or could give the appearance of, a conflict of interest in the research, such as a financial interest of the firm or analyst in a subject company's securities, the firm's receipt of compensation from a covered company, or the firm's general client relationships. These disclosures include whether:

- the analyst, or member of the analyst's household, has any financial interest in the subject company;
- the analyst, or member of the analyst's household, serves as an officer, director or advisory board member of the company;
- the firm or any of its affiliates are the beneficial owners of any class of common equity securities of the subject company;
- the analyst received any compensation from the firm's investment banking revenues;
- the firm or any of its affiliates managed a public offering of securities for the subject company within the past year, received compensation for investment banking services from the subject company within the past year; and
- whether the firm expects to receive or seek compensation from the subject company for investment banking services in the next three months.

The amount of compensation and nature of the transactions need not be disclosed. Furthermore, disclosure of this information is not required if it would reveal material non-public information related to a

specific potential future investment banking transaction of the subject company.

Source: FINRA Rule 2711(h)(2)(C).

The SRO Rules also require that firms disclose whether any research analyst, not just the analyst responsible for the preparation of the report, received compensation based in any part on investment banking revenues, and whether any research analyst received compensation from a subject company in the past year. Research analysts must also disclose in public appearances receipt by the firm or analyst of *any* compensation from a subject company.

Source: FINRA Rule 2711(h)(2).

Firms must also disclose information about non-investment banking relationships with a subject company, including whether:

- it received any compensation from a subject company for products or services other than investment banking within the past year;
- the subject company is or was a client of the firm within the past year; if so details must be provided about all services performed for the subject company; and
- any of its employees or affiliates received compensation from the subject company within the past year for any services, both to the extent that it may influence the substance of a research report and to the extent that a research analyst has reason to know of such compensation.

In addition, the firm in its reports and analysts in public appearances must disclose any other actual material conflicts of interest of the firm or analyst that the analyst knows or has reason to know at the time of the report or appearance.

Source: FINRA Rule 2711(h)(2)(A).

What must firms disclose about their rating systems?

Firms must make significant disclosures about their rating systems. Ratings must be defined and the definitions must be consistent with their plain meaning. Each firm must disclose the percentage of *all* securities it rates to which it would assign a "buy," "hold/neutral" or "sell" rating, and the percentage of companies within each of these companies for which the firm has provided investment banking services within the past year, current to the end of the most recent calendar quarter. This requirement only applies if the research report includes a rating, express or implied, of the subject company's stock.

Source: FINRA Rule 2711(h).

For each rated security, a research report must include a line graph for the prior year including daily closing prices and the timing of rating and price target assignments and changes. If the report contains a price target, the firm must disclose the valuation method for reaching that price target. Each target must have a reasonable basis and must be accompanied by a statement explaining the risks that may impede the achievement of that target. A firm must also disclose if it is making a market in the subject company's securities.

In addition, the Global Settlement requires three disclosures to be made prominently on the first page of any research report and/or summary of recommendations contained in previous reports:

- "the firm does and seeks to do business with companies covered in its research reports. As

a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report;"

- "Customers in the United States can receive independent third-party research on the company or companies covered in this report, at no cost to them, where such research is available. Customers can access this independent research at [the appropriate website] or call [a toll-free number] to request a copy of this research;" and
- "Investors should consider this report only as a single factor in making their investment decision."

Source: Global Settlement Addendum A (II)(1), available at:

http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf.

How must a firm disclose the information required by the SRO Rules?

The SRO Rules require certain disclosures on the front page of the research reports. If this is not possible, the front page must have a specific reference to the location of the required disclosure. All disclosures must be clear and prominent on the page.

References on the front page of a report to the location of required disclosures must be separated from the body of the report, for example in a text box, and must be in a larger font size than the body of the text. References must contain the specific page number; section references will not suffice. Hyperlinks may be used to direct the reader to the required disclosures in electronically transmitted reports only. They can, however, be used as an additional point of reference in written reports. Regardless of where the disclosures are placed, they must be labeled using a heading such as "Important Disclosures" in a large and conspicuous font size. This section must include all the disclosures required and be presented in a clear and logical order.

There can be no disclaimers that contradict or are inconsistent with the disclosures and conditional or indefinite language is prohibited. Any disclosures not required by the SRO Rules must be clearly separated from the required disclosures and labeled as such. Finally, the use of stock symbols or tickers is only allowed in the disclosures section if they are accompanied by a specific direction where in the report the reader can identify the company by its proper name.

When a firm distributes a research report covering six or more subject companies (a "compendium report"), the compendium report may direct readers in a clear manner to where they may obtain applicable current disclosures. Electronic compendium reports may include a hyperlink to the required disclosures. Written compendium reports must provide either a toll-free number to call or a postal address to write to for the required disclosures, and may also include a web address of the firm where the disclosures can be found.

Must a firm disclose the performance results of its research analysts?

In order to make analyst performance more transparent to investors, a firm must make publicly available via its website in a downloadable format, within 90 days of the end of each calendar quarter, the following information provided in its research reports issued during the previous calendar quarter:

- names of subject companies;

- names of the analysts responsible for the certification of the reports (pursuant to Regulation AC–*see* "*Regulation AC*" below);
- dates of reports;
- price targets, and period within which price targets are to be achieved,
- earnings-per-share forecasts for the current quarter and current full year; and
- definitions or explanation of ratings used by the firm.

Independent Third Party Research

Under what circumstances may a firm provide third party research to investors?

The SRO Rules require that when a firm is distributing research conducted by a third party, it must include disclosures regarding:

- the firm's ownership of the subject company's equity securities if 1% or greater of the company's outstanding securities;
- if the firm has managed or co-managed a public offering of the company's securities in the past year, received compensation for investment banking services in the past year, or expects or intends to receive compensation for investment banking services in the next three months;
- if the firm was making a market in the subject company's securities at the time the research was distributed; and
- any other actual, material conflict of interest of the firm with the subject company at the time the research was being distributed.

These disclosures are not required where the customer requests the third party research from the firm or where the investment firm only makes the research available on its website.

Source: FINRA Rule 2711(h)(13)(B)(iii).

The firm is not liable for the information contained in the independent research reports. The firm also need not supervise the production of the independent research report and has no responsibility to comment on its content. The firm is permitted to advise its customers of this limitation of liability.

Source: FINRA Rule 2711(h)(13); NYSE Rule 472 (k)(4).

Who is considered an independent research provider?

In order for a firm to be considered an independent research provider, it must not perform investment banking services of any kind. The independent provider must also not provide brokerage services in direct and significant competition with the investment banking firm.

Source: Global Settlement Addendum A (III)(3), available at: http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf.

Exceptions, Exclusions and Safe Harbors to Separation

When may Research and Investment Banking communicate and work jointly?

There are express exceptions to the ban on general communications between Research and Investment Banking in the Global Settlement:

- Investment Banking personnel may seek the views of Research personnel on the merits of proposed investment banking transactions;
- Research personnel may give their views on the views of a specific transaction in the presence of Investment Banking personnel;
- Research personnel may give their views on the structuring and pricing of a transaction to the firm's equity capital markets group;[13]
- Research personnel may participate in efforts to educate the firm's sales personnel regarding a transaction;
- Research personnel may communicate with Investment Banking personnel regarding legal or compliance matters; and
- Research personnel may attend a widely attended conference or meeting given by Investment Banking personnel.

Proposed Transactions. Investment Banking personnel may seek, through Research management, or in the presence of internal compliance or legal staff, the views of Research personnel on the merits of a proposed transaction, a potential candidate for a transaction, or market trends, conditions or developments. Research personnel may respond to these inquiries through Research management or in the presence of compliance or legal staff. Once Investment Banking has initiated the process, Research may contact them to inform them of a change in their views regarding the transaction discussed without prompting from Investment Banking personnel. However, these conversations may not be initiated by Investment Banking, directly or indirectly, for the purpose of having the research analyst identify a specific company or transaction. Research personnel may also initiate discussions with Investment Banking personnel relating to market trends, conditions or developments, *provided* that the conversations are consistent in nature with the types of communications that an analyst might have with investing customers.

Specific Transactions. Research personnel may communicate their views about a specific transaction, or candidate for a transaction, in the presence of a committee that is reviewing the specific transaction. Investment Banking personnel are allowed to be present during such discussions; however, Research personnel must have the opportunity to speak to the committee outside the presence of Investment Banking personnel.

Research personnel are also permitted to assist the firm in confirming the adequacy of disclosure in the offering or other disclosure documents based on the analyst's communications with the company or other vetting previously conducted without the presence of Investment Banking personnel.

Equity Capital Markets. Research personnel may also participate in certain communications with equity capital markets personnel after the firm receives an investment banking mandate or in connection with a

[13] Equity Capital Markets is usually a department of a firm that functions as an intermediary between companies and financial institutions and raises equity capital for the companies. Equity Capital Markets departments typically handle the overall marketing, distribution and allocations of new equity securities and derivative instruments.

block bid or similar transaction. Research personnel are entitled to communicate their views on the structuring and pricing of a transaction to the firm's equity capital markets group and can provide information obtained from investing customers relevant to the pricing and structuring of a transaction.

Sales Force Education. Research personnel may also participate, either with the equity capital markets group or independently, in efforts to educate the firm's sales personnel regarding the transaction, such as preparing internal-use memoranda and communicating with the sales force. These communications may not occur with Investment Banking personnel and the following conditions must be satisfied:

- oral communication in which Research expresses a view or recommendation must have a reasonable basis;
- oral communication made to ten or more of the firm's sales force must satisfy a "fair and balanced" standard, as that phrase is generally understood under FINRA rules;[14]
- all internal-use memoranda that express the views of Research personnel must also comply with the fair and balanced standard;
- internal-use memoranda that are distributed to ten or more of the sales force must first be reviewed by internal legal or compliance personnel;
- a written log of oral communications to a group of ten or more of the sales force must be maintained; and
- internal-use memoranda that are distributed to ten or more of the sales force and the written log of oral communications to a group of ten or more of the sales force must be maintained for at least three years.

After a firm receives an investment banking mandate relating to a public offering, Research personnel may communicate with investors regarding the offering, *provided* that these communications may not occur jointly with the issuer's management or members of the Investment Banking department.

Legal or Compliance Matters. Research and Investment Banking personnel may also communicate with each other, in the presence (live or email) of the legal or compliance department, regarding legal or compliance matters. Research and Investment Banking personnel may have an unchaperoned call or meeting solely for the purpose of scheduling a later chaperoned call.

Conferences and Meetings. Research personnel may attend or participate in a widely attended conference attended by Investment Banking personnel or in which Investment Banking personnel participate (but may not participate in otherwise prohibited activities). Research and Investment Banking personnel may attend or participate in widely attended firm or regional meetings at which matters of general firm interest are discussed. Research management and Investment Banking management may attend meetings or sit on firm management, risk or similar committees at which general business and plans (including those of Investment Banking and Research) and other matters of general firm interest are discussed. Communications between Research personnel and Investment Banking

[14] *See* FINRA Rule 2210(d)(1).

personnel that do not relate to any research or investment banking issues are not restricted.[15]

Source: Global Settlement Addendum A (I)(10), available at: http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf.

2010 Amendments to the Global Settlement

What did the Court change in 2010 regarding the Global Settlement?

On August 3, 2009, the remaining Settling Firms, after various discussions with regulators, submitted a motion proposing certain modifications for the court's consideration. On March 15, 2010, the Court modified the Global Settlement to allow Research and Investment Banking personnel to simultaneously participate in due diligence sessions with securities issuers and other parties in certain types of transactions and subject to certain conditions. Furthermore, Research personnel may now assist Investment Banking in confirming the adequacy of disclosures made in connection with securities offerings or other transactions based on Research's communications with the issuers and third parties.

In addition to allowing for joint due diligence sessions, the Court approved the SEC's and Settling Firms' request to delete the provisions of the Global Settlement that required:

- separate reporting lines for Research and Investment Banking;
- a dedicated Research legal and compliance staff;
- annual review by the firm's audit committee of the Research budget;
- no Investment Banking influence over Research compensation;
- no Investment Banking influence over evaluations of Research personnel;
- mandatory announcements when coverage of a stock is terminated;
- no Research participation in efforts to solicit investment banking business;
- no Research participation in road shows;
- no Investment Banking direction to Research to engage in marketing or selling efforts for investment banking transactions; and
- disclosure of analyst performance information.

The Court approved the removal of these terms from the Global Settlement because the SRO Rules generally cover the same issues for all firms. Where not covered by the SRO Rules, the SEC and the Settling Firms simply stated their joint view that elimination of these requirements would be consistent with the public interest.

What changes, if any, did the Court refuse to make in its 2010 Addendum to the Global Settlement?

There were some provisions of the Global Settlement that the Settling Firms had hoped to eliminate through the repeal of the entire Global Settlement, but at the

[15] As discussed above, Title I of the JOBS Act permits Research and Investment Banking personnel to communicate and work together in connection with offerings by EGCs. For all broker-dealers who are not signatories to the Global Settlement, the provisions of the JOBS Act became effective immediately upon it being signed into law. However, as the Global Settlement is a judicial order and not an SEC or SRO Rule it is technically unaffected by the JOBS Act and would require another amendment in order for the provisions of the JOBS Act to apply to the Settling Firms.

SEC's insistence the Court refused to change. These retained restrictions include the continuation of:

- the physical separation of Research and Investment Banking;
- the prohibition on Investment Banking input into company-specific research coverage decisions;
- the requirement that Research be given the opportunity to express its views on a proposed transaction to the firm's commitment committee outside the presence of Investment Banking personnel;
- the requirement that communications to the sales force (or to ten or more investors) be "fair and balanced" and that the views expressed have reasonable basis;
- the research oversight committee's review or ratings, targets and the overall quality of research; and
- the disclosure of any conflicts of interest that may exist.

Regulation AC

What is Regulation AC?

Regulation AC (Analyst Certification) was adopted by the SEC on February 6, 2003, and became effective on April 14, 2003. Regulation AC requires research analysts to certify the truthfulness of the views they express in research reports and public appearances, and to disclose whether they have received any compensation related to the specific recommendations or views expressed in those reports and appearances.

Why was Regulation AC enacted?

According to the SEC's proposing release,[16] Regulation AC was designed to address the core issues of research analyst integrity: analysts' beliefs in, and the influence of compensation on, their recommendations. Regulation AC was adopted to focus on research that is most susceptible to pressures, like the desire to generate investment banking revenues, that might compromise the integrity of the research. It is directed to broker-dealers and covered persons because the SEC believes that they are subject to the greatest conflicts. Therefore, the research report certification provisions of Regulation AC apply to investment advisers and banks, among others, that are covered persons and publish or provide research reports.

Who must comply with Regulation AC?

Regulation AC applies only to broker-dealers and covered persons, a category that generally includes all associated persons of a broker-dealer and specifically *excludes* associated persons that satisfy the following two conditions:

- *separate officers and employees* – the associated person does not have officers or employees in common with the broker-dealer who are able to influence the activities of research analysts of the broker-dealer or the content of the research reports; and
- *communication barriers* – the broker-dealer maintains and enforces written policies and procedures that are reasonably designed to prevent the broker-dealer and any of its controlling persons, officers, and employees

[16] *See* Securities Exchange Act Release No. 34-46301 (August 2, 2002), 67 FR 51510 (August 8, 2002).

from influencing the activities of research analysts and the content of research prepared by the associated person.

Neither Regulation AC nor the adopting release specifies what these policies and procedures entail. In the adopting release, the SEC notes that it does not expect these policies and procedures to interfere with other communications made between the broker-dealer and its associated persons made in the ordinary course of business.[17]

In contrast to Rules 137-139 (see *"SEC Research Reports Rules"* below), Regulation AC applies to debt securities as well as equity securities. The SEC has determined that applying Regulation AC to debt securities as well as equity securities provides to debt investors the same benefits as it does to equity investors by promoting the integrity of research reports and confidence in research analyst recommendations.

Source: Securities Exchange Act Release No. 34-47384 (February 20, 2003).

What must be provided under Regulation AC in connection with published research reports?

Regulation AC requires that broker-dealers and certain associated persons include in research reports that they provide to U.S. persons a clear and prominent statement by the research analyst certifying that:

- the views expressed in the report accurately reflect the analyst's personal views about the subject securities and issuers; *and*
- the analyst's compensation is not directly or indirectly related to the specific views or recommendations expressed in the report.

Regulation AC also requires a broker-dealer to maintain quarterly records containing similar certifications regarding public appearances made by its research analysts during the quarter. The term "public appearance" means any participation by a research analyst in a radio, television or other interview in which the research analyst makes a specific recommendation or provides information reasonably sufficient upon which to base an investment decision about a security or an issuer. These public appearance requirements apply only to broker-dealers and not to "covered persons" unless those persons are broker-dealers themselves.

A research analyst does not have the option of certifying that his/her personal views are not accurately reflected in a report. If a research report does not accurately reflect the views of the analyst, then distributing the report would violate Regulation AC. This applies both to the analysis and any summary rating contained in the report. The name of the research analyst need not appear on the report, but it must be clear that the certification was made by the lead analyst who prepared the report. Only the lead analyst need certify the report. Junior analysts do not need to do so. When an analyst is not identifiable because the report is based on the firm's quantitative or technical model, the firm itself may provide the certification.

The certification must appear in a "clear and prominent" place on the report. The adopting release provides that this means that the certification appears on either the cover page or that the cover page specifies where in the report the certification may be found.

Source: Securities Exchange Act Release No. 34-47384 (February 20, 2003).

[17] *See* Securities Exchange Act Release No. 34-47384 (February 20, 2003) at n. 20.

What reports are excluded from Regulation AC?

The term "research report" as used in Regulation AC means a written communication (including electronic communication) that includes an analysis of a security or an issuer, and provides information reasonably sufficient upon which to base an investment decision. This is consistent with the definition of research report that appears in the SRO Rules, with the one difference being that the SRO Rules apply to research reports covering equity securities only, while Regulation AC applies to debt and equity securities alike.[18]

The following communications would *not* be considered research reports under Regulation AC as long as they do not include an analysis of, or recommend or rate, individual securities or companies:

- reports discussing broad-based indices such as the Russell 2000 or the S&P 500;
- reports commenting on economic, political or market conditions;
- technical analyses concerning the demand and supply for a sector, index, or industry based on trading volume and price; and
- reports that recommend increasing or decreasing holdings in particular industries or sectors or types of securities.

The following communications would *not* be considered research reports under Regulation AC *even if* they recommend or rate individual securities or companies:

- statistical summaries of multiple companies' financial data that do not include any analysis of an individual company's data;
- analyses prepared for a specific person or limited group of fewer than fifteen people;
- periodic reports or other communications prepared for investment company shareholders or discretionary investment account clients discussing past performance or the basis for previously made discretionary investment decisions; and
- internal communications not provided to customers.

Are there any exemptions or safe harbors from Regulation AC?

Regulation AC will not apply to a broker-dealer that distributes research prepared by a third party research analyst whose employer satisfies certain independence criteria:

- the employer does not have officers or employees in common with the broker-dealer or covered person distributing its research; *and*
- the broker-dealer has written policies and procedures designed to prevent the broker-dealer, its controlling persons, officers, and employees from influencing the activities of the third-party research analyst and the content of his or her research reports.

A narrow exception has been created for foreign persons located outside of the United States and are not associated with a registered broker-dealer that prepares and provides research on foreign securities to major U.S. institutions in the United States pursuant to Rule 15a-6(a)(2) promulgated under the Exchange Act.

In the case of a research analyst employed outside the United States by a foreign person located outside the United States, Rule 502 of Regulation AC only applies to

[18] It should be noted, though, that FINRA is currently proposing rules with respect to research on debt securities as well.

public appearances while the research analyst is physically present in the United States.

When a research report covers more than one company and each research analyst required to certify with respect to the views expressed in a portion of the report is able to certify that:

- the views expressed in the research report accurately reflect such research analyst's personal views about the subject securities and companies; and
- that no part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendation or views contained in the research report,

The firm may comply with Regulation AC by including one clear and prominent combined certification that, as to each company covered, the respective research analyst (or analysts) certifies as to the above.

Is Regulation AC affected by the JOBS Act?

No. Regulation AC is not affected by the JOBS Act.[19]

SEC Research Reports Rules

What is Rule 137 under the Securities Act?

Rule 137, along with Rules 138 and 139 under the Securities Act, is designed to protect analysts, brokers and dealers from general solicitation and gun-jumping violations in connection with their regularly disseminated research reports. Rule 137 applies to broker-dealers *not* participating in a registered offering and therefore not "underwriters." In order not to violate the gun-jumping provisions and solicitation prohibitions, the broker-dealer:

- must publish the report in the ordinary course of its business; and
- may not receive any consideration from, and may not act under any direct or indirect arrangement with, the issuer of the securities, a selling security holder, any participant in the distribution of the securities, or any other person interested in the securities.
- Furthermore, the issuer may not be, nor have been in the past three years:
- a blank check company;[20]
- a shell company;[21] or
- a penny stock issuer.[22]

Independent research prepared by a broker-dealer not participating in an offering, but paid for by a broker-dealer participating in the offering, will be considered distributed by an offering participant and thus will not satisfy the Rule 137 safe harbor; however, subscription payments in ordinary course by those receiving the reports are permitted.

Source: SEC Rule 137.

[19] *See* SEC FAQs, *supra* note 3 at Question 12.

[20] A blank check company is a development stage company that has no specific business plan or purpose or has indicated its business plan is to engage in a merger or acquisition with an unidentified company or companies, other entity, or person. *Securities Act Rule 419(a)(2).*

[21] A shell corporation is a company that serves as a vehicle for business transactions without itself having any significant assets or operations. *Securities Act Rule 405.*

[22] A penny stock issuer is a very small issuer of low priced speculative securities. Since penny stocks are difficult to accurately price, there are specific SEC rules that must be satisfied prior to a broker-dealer selling a penny stock, and the SEC does not allow the issuer to use certain exemptions from the registration requirements when selling their securities. *Exchange Act Rule 3a51-1.*

What is Rule 138 under the Securities Act?

Rule 138 applies to broker-dealers participating in the distribution of a *different security* from that being discussed in the research reports. Rule 138 permits a broker-dealer that is participating in the distribution of an issuer's securities to publish and distribute research reports that either:

- relate solely to the issuer's common stock, debt securities, or preferred stock convertible into common stock, where the offering involves solely the issuer's non-convertible debt securities or non-convertible non-participating preferred stock; or
- relate solely to the issuer's non-convertible debt securities or non-convertible, non-participating preferred stock, where the offering involves the issuer's common stock, debt securities, or preferred stock convertible into common stock.

In order to take advantage of Rule 138 the broker-dealer must regularly report on the types of securities that are the subject of the research report. The issuer involved must not be a blank check company, shell company or penny stock issuer *and* be *either:*

- a reporting company (foreign or domestic) and current in its Exchange Act filings; or
- a foreign private issuer that meets all of the registrant requirements of the revised Form F-3[23] (other than the reporting history provisions of General Instructions I.A.1 and I.A.2(a) to Form F-3) *and either*:
  - satisfies the $75 million minimum public float threshold in General Instruction I.B.1. of Form F-3; *or*
  - is issuing non-convertible securities other than common equity, and meets the provisions of General Instruction I.B.2. of Form F-3; *and either:*
    - has its equity securities trading on a "designated offshore securities market" as defined in Rule 902(b) of the Securities Act, and has had them trading for at least 12 months; *or*
    - has a worldwide public float of $700 million or more.

Source: SEC Rule 138 (a)(2).

What is Rule 139 under the Securities Act?

Rule 139 applies to broker-dealers participating in the registered distribution of the *same security* as that discussed in their disseminated research reports. The broker-dealer must:

- publish or distribute research reports in the regular course of its business; *and*

[23] Effective September 2, 2011, the SEC amended Form S-3 and Form F-3 by revising General Instruction I.B.2 to eliminate the use of credit ratings as a transaction eligibility standard and replace it with an alternative set of standards. The new standards provide that an offering of non-convertible securities is eligible to be registered on Form S-3 or Form F-3 if the issuer meets the "Registrant Requirements" in General Instruction I.A, and either has issued at least $1 billion of non-convertible securities in transactions registered under the Securities Act, other than equity securities, for cash during the past three years, has outstanding at least $750 million of non-convertible securities, other than common equity, issued in primary offerings for cash registered under the Securities Act (each as measured from a date within 60 days of the filing of the registration statement); or is a wholly owned subsidiary of a WKSI.

- such publication or distribution cannot represent either the initiation of publication or the re-initiation of publication.

The issuer may not be a blank check, shell or penny stock issuer, *and* must:

- have filed all required Exchange Act reports during the preceding 12 months;
- meet all the registrant requirements of the revised Form S-3/F-3 (other than the reporting history provisions of General Instructions I.A.1. and I.A.2(a) to Form F-3), *and* either:
  - satisfies the minimum public float threshold in General Instruction I.B.1. of Forms S-3/F-3,
  - is or will be offering non-convertible securities other than common equity and meets the threshold pursuant to General Instruction I.B.2 of Form S-3/F-3;[24] *or*
  - is a WKSI[25] as defined in Rule 405 of the Securities Act; or is a foreign private issuer that satisfies the same requirements as for Rule 138 (described above).

Source: SEC Rule 139(a).

When dealing with industry-specific reports, certain conditions must be satisfied. The broker-dealer:

- must publish or distribute research reports in the regular course of its business; and
- at the time of publication or distribution, must include information about the issuer or its securities similar to that contained in the similar reports about other issuers.

The issuer must be either a reporting company or meet the foreign private issuer requirements described above with respect to issuer-specific reports. The reports:

- must contain similar information with respect to a substantial number of issuers in the industry or sub-industry;
- must contain a comprehensive list of securities (not just industry-specific) currently recommended by the broker-dealer;
- cannot give materially greater space or prominence to the analysis regarding the issuer or its securities, compared to the analysis regarding other issuers or securities; and
- may include projections, *provided* that:
  - the broker-dealer has previously regularly published or distributed projections in its reports;
  - it is publishing or distributing projections with respect to that issuer at the time of the current publication or distribution; and
  - the projections cover the same or similar periods with respect to either a substantial number of issuers in the industry/sub-industry, or substantially all the issuers represented in the comprehensive list of securities included in the report.

Source: SEC Rule 139 (a)(2).

[24] *Id*.
[25] *See supra* note 23.

To what types of offerings do Rules 137, 138 and 139 apply?

The safe harbors of Rules 137, 138, and 139 are available to registered offerings, as well as offerings covered under Rule 144A and/or Regulation S. Under Rule 144A, publication of a research report will not be considered an offer for sale or an offer to sell a security, general solicitation, or general advertising. Under Regulation S, publication of a research report will not constitute directed selling efforts, nor will it be inconsistent with the offshore transaction requirement.

Source: SEC Rules 137(b)(c), 138(b)(c), and 139(b)(c).

To what types of reports do Rules 137, 138 and 139 apply?

For purposes of Rules 137, 138 and 139, a research report means a written communication, including graphic communications,[26] that includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision.

Source: SEC Rules 137(e), 138(d), 139(d).

[26] Graphic communications include all forms of electronic media, including, but not limited to, audiotapes, videotapes, facsimiles, CD-ROM, electronic mail, Internet websites, substantially similar messages widely distributed (rather than individually distributed) on telephone answering or voice mail systems, computers, computer networks and other forms of computer data compilation. *Securities Act Rule 405.*

Joint Due Diligence Sessions

What communications are permitted between Research and Investment Banking with regard to joint due diligence sessions?

Research and Investment Banking personnel may simultaneously participate in meetings or calls with an issuer or third parties, subject to certain conditions. One such condition is that joint due diligence sessions be chaperoned by either in-house counsel or outside counsel. Other conditions apply as well:

- the meeting or call must be for gathering or confirming information about the issuer or be related to the proposed transaction;
- the firm's legal or compliance staff must reasonably believe that the Investment Banking department will not have a meaningful opportunity to conduct separate due diligence communications with the relevant parties before the award of a mandate if they do not do so in conjunction with the Research department; and
- the meeting or call must take place in connection with:
  - an initial public offering and be scheduled only *after* the firm has been granted an investment banking mandate; *or*
  - a block bid or competitive secondary or follow-on offering or similar transaction in which the issuer or selling shareholder has contacted the Investment Banking department to request that it submit a proposal.

Source: Global Settlement Addendum A, March 2010 modification Section (I)(10)(c)(i) available at: http://www.subjecttoinquiry.com/finra-investigations/Pauley%20March%2015%202010.pdf.

Who should act as a chaperone during diligence sessions?

For an IPO, a joint due diligence session can be chaperoned by Investment Banking's internal legal or compliance staff or underwriters' counsel or other counsel on the transaction. For a non-IPO, internal legal or compliance staff should serve as chaperone. In response to the general requirements of the Global Settlement, The Securities Industry and Financial Markets Association ("SIFMA") recommends that if outside counsel chaperones a joint due diligence meeting or call, that counsel's role should be limited to that particular meeting or call. If any follow-up discussions take place, outside counsel should not be expected to chaperone. Outside counsel should direct Research or Investment Banking personnel to their compliance department for further instructions. In all cases, the chaperone must be knowledgeable regarding research and investment banking conflicts and the terms of the modified Global Settlement. In addition, SIFMA recommends that, as a matter of best practice, the chaperone be a partner or other senior attorney of his or her firm.

What are the duties of the chaperone?

The Global Settlement does not contain specific chaperone obligations. SIFMA has developed guidelines for the duties of a chaperone. Before any joint due diligence session, the chaperone should obtain a list of names and titles, specifying whether each person is from Research or Investment Banking. If there are any changes to the roster of participants, the chaperone should obtain an updated list after the session, so he or she can complete his or her recordkeeping obligations. If the session is an in-person meeting, the chaperone must be physically present at a meeting. If the session is a conference call, the chaperone should be dialed in and able to speak whenever he or she wishes, or an active participant in the call. It is also important that the chaperone set up a contact person from each participating firm. The contact person will be the recipient of any recordkeeping information and contact person for issues that may arise during or after the session. If a due diligence questionnaire is going to be used, Investment Banking personnel and Research personnel should prepare separate questionnaires or agendas.

During the session the chaperone should introduce him or herself at the very beginning of the meeting or call. SIFMA provides a sample introduction.[27] The chaperone should encourage speakers to identify themselves, including by mentioning which institution they represent and their role at that institution. The chaperone should be engaged in the conversation and be attentive for any actions by participants inconsistent with the purpose of the due diligence session (to gather or confirm factual information). The chaperone should consider whether any participant is deviating from this purpose, including attempts to influence an analyst's views on the proposed transaction or frustrate the ability of an analyst to participate in the session. SIFMA recommends that participants in a joint due diligence session, whether Research or Investment Banking, direct their comments, questions or other communications to the issuer or its representatives and

[27] *See* http://us.practicallaw.com/cs/Satellite/6-504-6486.

not to each other. This helps prevent, for example, an exchange between Investment Banking and a research analyst that may appear to be a debate about a factual matter or the character of a factual matter.

If the chaperone perceives an improper communication to be occurring, the chaperone should interject and steer the discussion away from the topic. This might include reminding participants that comments be directed to the issuer, and not be between bankers and analysts. If the chaperone thinks an improper communication has occurred, the chaperone may remove the relevant persons from the session and/or terminate the meeting or call immediately. He or she should promptly call his or her contact person at the relevant investment bank to report what happened and to discuss appropriate follow-up actions. If some of the meeting participants plan to remain in the room or on the call after the joint due diligence session to conduct other business, the chaperone should excuse the Investment Banking or Research personnel from the meeting or call, as applicable.

After the session is complete, the chaperone should send an email to the legal or compliance department of the institutions that participated in the session. The recordkeeping email should include:

- the date and time of the meeting or call;
- the duration of the meeting or call;
- the list of participants;
- the name of the issuer;
- the type of transaction;
- the topic of the meeting or call; and
- the name of the firm acting as chaperone.

SIFMA suggests that the email also include a confirmation by the chaperone that he or she is knowledgeable about the Global Settlement and conflicts of interest between Investment Banking and Research. If the chaperone believes any improper communications occurred at thru meeting, he or she should promptly call the contact person at the relevant institution to report what happened and to discuss appropriate follow-up actions.

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APPENDIX A

May Research Personnel…	**Pre-JOBS Act**	**Post-JOBS Act**	
	All Issuers	**EGC**	**Non-EGC**
Publish research reports concerning the securities of an issuer immediately following its IPO or expiration of any lock-up agreement?	Prohibited	Permitted	Prohibited
Publish research reports concerning issuers that are the subject of *any* public offering of common equity securities (even if the firm is participating in the offering)?	Prohibited	Permitted	Prohibited
Participate in meetings with representatives of an issuer, attended by Investment Banking personnel?	Prohibited	Permitted	Prohibited
Contact potential investors in an issuer's IPO?	Prohibited	Permitted	Prohibited
Make public appearances concerning the securities of an issuer?	Prohibited	Permitted	Prohibited
Solicit business for Investment Banking personnel?	Prohibited	Prohibited	Prohibited
Engage in communications with potential investors in the presence of Investment Banking personnel?	Prohibited	Prohibited	Prohibited
Share price targets and ratings with an issuer prior to the launch of a deal?	Prohibited	Prohibited	Prohibited
Be compensated based on Investment Banking revenue?	Prohibited	Prohibited	Prohibited