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# Managing Institutional Conflicts of Interest:

# Overview and Certain Areas of Current Concern[1]

## I. Importance of Identifying and Managing Conflicts of Interest.

**A.** Allegations of conflicts of interest have been at the heart of nearly every recent major enforcement action involving multi-service financial institutions. These actions, most of which were settled without admission of wrongdoing, have nonetheless resulted in significant monetary penalties and reputational damage, and the scandals underlying the actions have threatened to undermine investor confidence in the securities market. Among the most prominent areas of regulatory focus in recent years:

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1 This outline was prepared by Dana G. Fleischman, a partner, and David Aman, an associate, of the law firm of Cleary Gottlieb Steen & Hamilton LLP and is current as of October 15, 2006. This outline is of necessity summary in nature and should not be considered or relied on as legal advice. The information contained in this outline regarding specific legal or regulatory matters has been obtained from publicly available sources.

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1. Research Analysts. In 2003, ten major investment banking firms settled enforcement actions with various regulatory authorities alleging that they engaged in acts and practices that created or maintained inappropriate influence by investment banking over research analysts, which resulted in conflicts of interest that the firms failed to manage or disclose in an adequate or appropriate manner. Among the principal allegations were that the firms had produced research containing fraudulent, exaggerated or unwarranted favorable claims regarding current and prospective investment banking clients, thereby misleading the recipients of the research in order to benefit the firms and their investment banking business.

2. Spinning. Also in 2003, a number of investment banking firms settled enforcement actions alleging that they engaged in a practice of favoring officers and directors of current and prospective investment banking clients in the allocation of shares in "hot" initial public offerings ("IPOs") over other customers in order to keep or obtain future investment banking business.

3. Mutual Fund Sales Practices. A number of enforcement actions have alleged that firms sold customers inappropriate classes of mutual fund shares in order to earn larger commissions, did not disclose the availability of breakpoint discounts or structured sales so as to avoid giving breakpoint discounts, or favored certain funds over others in return for undisclosed direct or indirect compensation from the favored funds.

4. Late Trading and Market Timing. Enforcement actions have been brought alleging that firms, or their personnel, assisted or allowed certain customers to engage in late trading and/or market timing of mutual fund shares, thereby giving those customers an unfair advantage at the expense of other mutual fund shareholders.[2]

[2] "Late trading" refers to the practice of placing orders to buy or sell mutual fund shares after the market close, but at the closing price, which allows the late trader to profit on post-closing market information that is not reflected in the closing price. "Market timing" refers to the practice of rapid or short-term buying and selling of mutual fund shares for the purpose of exploiting inefficiencies in mutual fund pricing, and at the expense or to the disadvantage of long-term investors. Although "market timing" is not *per se* illegal, certain of the practices used in that regard were deemed to have been deceptive and, in some cases, violative of the mutual funds' stated policies.

**B.** Many of the traditional areas of concern for broker-dealers also involve potential conflicts of interest. For example:

1. Insider trading. Insider trading, which is a "manipulative and deceptive device" prohibited by Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, is the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.

2. Front-running. Front running occurs when a broker-dealer receives a customer order for a security and, in anticipation that the customer order will affect the market price of the security, purchases or sells the security for its own account before executing the customer order.

3. Churning. Churning occurs when a broker-dealer engages in excessive trading in a customer's account for the purpose of generating additional commissions.

## II. Identifying Potential Sources of Conflicts of Interest.

### A. Top-to-Bottom Review.

1. In a September 9, 2003 speech to the National Regulatory Services Investment Advisor and Broker-Dealer Compliance/Risk Management Conference, Stephen Cutler (then Director of the SEC's Division of Enforcement) challenged every firm to "undertake a top-to-bottom review of its business operations with the goal of addressing conflicts of interest of every kind."[3]

2. Cutler noted that conflicts of interest are inherent in the financial services business – when a firm is paid to act as an intermediary, the "groundwork for a conflict between the investment professional and the customer is laid."

[3] http://sec.gov/news/speech/spch090903smc.htm (Sept. 9, 2003).

**B. <u>Strategy for the Conflicts Review</u>.** Cutler advised firms conducting a top-to-bottom review to:

1. Search for those business practices that have the potential to sacrifice the interests of one set of customers in favor of another.

2. Identify any situations in which the firm could place its or its employees' interests ahead of the interests of the firm's customers.

3. Identify where the firm makes its money—*i.e.*, "follow the money"!

   According to Cutler:

   - In many conflict of interest scenarios, the interests of a potentially more lucrative category of customers are being placed above those of another, less profitable group of customers. These fact patterns reflect an effort by the firm to find – or even to create – illicit opportunities to benefit the customers who are in the best position to enrich the firm.

   - The SEC will be "following the money" in their forward-looking efforts to identify conflicts that are cause for concern.

4. Cutler also noted that certain of the recent scandals involving conflicts of interest were about practices, like research analysts' recommendations being driven by the preferences of their firms' investment banking clients, that had long been known and accepted within the securities industry, but cautioned that:

   - Just because a certain way of doing things is second nature, and appears to be accepted standard operating procedure, doesn't mean that it's the correct way of doing things.

   - When customers finally do come to understand certain industry practices, they will care a great deal about undisclosed conflicts of interest.

   - When conflicts are exposed, the costs to the industry may be enormous – in dollars, in reputation, and in investor confidence and trust.

**C.** **Examples**. Cutler identified many examples of potential conflict of interest scenarios that were on the SEC staff's radar screen, including:

1. Analyst conflicts when:

    - The firm's equity sales and trading desk recommends and sells a large block of stock in a company covered by the analyst to a major institutional customer.

    - The firm's advisory affiliate holds a large position in a company covered by the analyst for the firm's advisory clients.

    - The firm has a proprietary ownership or creditor interest in a company covered by the analyst.

    - The firm's asset management group provides pension, 401(k), and cash management services for a company covered by the analyst.

2. Asset manager conflicts with respect to:

    - Investment decisions regarding companies whose asset management business the asset manager might want to obtain or retain.

    - Decisions regarding investments in IPOs underwritten by an asset manager's firm, which has an interest in demonstrating a strong track record of IPOs with good secondary market performance.

3. Arrangements or relationships with pension consultants retained by pension funds to advise them in selecting advisers, allocating assets, and other matters that give the pension consultant incentives to recommend advisers who are willing to direct the pension fund's brokerage business to that broker-dealer.

4. Situations in which a firm may be tempted to use the power of allocation to favor more lucrative clients over other customers rather than using a more equitable method of allocation, such as a lottery. For example:

    - A prime broker that is responsible for allocating a certain number of redemptions among its holders of callable bonds when having a bond called is costly to the holder.

- A firm that is required to allocate among its customers the profitable opportunity to supply shares in response to a company's tender for its own stock.

- Late-trade allocation: Allocating among customers after execution armed with the knowledge of where the security traded between the time of execution and time of allocation.

5. Mutual fund sales practices, including recommending funds:

   - When the sale of one fund rather than another would result in higher commissions for the firm.

   - Where there is a prospect of attracting or retaining the fund's portfolio execution or back office business.

6. Situations in which a firm provides credit to a hedge fund or takes an equity position in it, or provides execution or prime brokerage services to a fund while--without adequate disclosure of the potential conflict--recommending that fund to their customers.

**D.** **Results of the Reviews.** Beginning in 2005, SEC Commissioner Annette Nazareth (then Director of the SEC's Division of Market Regulation) gave a series of speeches in which she described some of the broad areas of conflicts that brokers-dealers and their affiliated asset managers had identified in their internal reviews and described to the SEC staff.[4] Among the situations described by Ms. Nazareth:

1. **Proprietary Trading.** Conflicts of interest are possible whenever a firm trades both as agent facilitating customer orders and as principal for the firm's own account. For example, a firm may be tempted to profit by:

   - Trading ahead of pending customer orders.

   - Trading ahead of research reports.

[4] Remarks Before the NABE 2006 Washington Economic Policy Conference, http://sec.gov/news/speech/spch031306aln_nabe.htm (Mar. 13, 2006); Remarks before the SIA Compliance and Legal Division Member Luncheon, http://sec.gov/news/speech/spch071905aln.htm (July 19, 2005); Remarks before the NYSE Regulation First Annual Securities Conference, http://sec.gov/news/speech/spch062105aln.htm (June 21, 2005).

- Trading on the basis of knowledge about a customer's portfolio of securities.
- Trading ahead of a future underwriting transaction.

2. **Research Analysts on the Trading Desk.** Some firms reported that certain research analysts sat on the trading desk, particularly in the fixed income areas, where gaining knowledge of otherwise confidential or restricted information is possible. Several firms acknowledged that their information barrier policies do not address information shared orally among those sitting on a trading desk. These firms also noted that research analysts are evaluated for purposes of performance and bonuses by sales and trading personnel, which may influence the analysts' objectivity.

3. **Allocation Decisions.** Firms or their employees may be incentivized to make allocation decisions that could prefer the firm's or an employee's interests over interests of customers, such as when portfolio managers allocate superior trades to proprietary or personal accounts rather than the publicly held funds they manage, or that could prefer one customer over another, such as when a prime broker decides to buy-in short positions of some customers and not others, or when a decision is made to allocate profitable trades to customers that generate higher fees or trading commissions.

4. **Capital Introduction.** Conflicts may also arise when a firm receives fees from a hedge fund (or other investment vehicle) for introducing potential investors to the fund (so-called "cap intro"), but the firm fails to disclose the receipt of such fees to those investors when recommending the fund to them.

5. **Firm or Employee Compensation for Sales.** Securities firms also described conflicts that result when they pay their registered representatives higher compensation for selling certain products (*e.g.*, proprietary products vs. non-proprietary products). Finally, firms may be inappropriately incentivized to recommend a particular investment or account structure that has the potential to generate more fees the firm, but may not be suitable for (or result in the lowest cost to) that investor. These issues may be particularly acute in the case of sales of mutual funds, which have multiple ways to compensate broker-dealers for brokerage services, including:

- o Sales fees (which broker-dealers earn at the time of the transaction, and often different from the loads paid by customers to the fund);
- o Asset-based 12b-1 fees;
- o Revenue sharing arrangements with the adviser or other affiliate of a fund;
- o Service fees, recordkeeping or transfer fees, or continuing education sponsorships; and
- o Portfolio brokerage commissions (commissions for effecting trades for the fund's own portfolio of investments).

Where firms receive differential compensation for selling mutual funds, they may also create conflicts by paying differential compensation to their in-house sales personnel. For example:

- o higher compensation for selling their customers B shares than A shares of the same fund, or
- o higher compensation for selling proprietary funds versus other funds, because the firm earns more from the former products.

6. **Multiple Relationships with Investment Banking Customers.** Securities firms also spoke of potential conflicts when broker-dealers render fairness opinions, with fees that are contingent on the success of the transaction, as well as advise on the investment banking aspects of the same deal. Conflicts also arise as a result of maintaining multiple relationships with clients, such as acting as an underwriter, advising on M&A transactions, market making, and/or holding principal debt or equity positions. Firms also may be asked to provide advice to the company at the same time they possess knowledge about that company gained through other confidential business relationships, *e.g.*, as a creditor of the company. In addition, conflicts may arise between the firm and customers who invest in an issuer client, but who may be unaware of the conflicts and the many opportunities for the securities firm (or its affiliates) to profit from acting in multiple capacities for the client.

7. **Soft Dollars.** The use of client commissions, or "soft dollars," to pay for research and brokerage presents financial advisers with significant conflicts of interest because the adviser obtains benefits for itself from directing client orders (and the associated commissions) to certain broker-dealers with which the adviser has a soft dollar arrangement.

## III. Addressing Conflicts of Interest.

### A. Information Barriers.

Information barriers (commonly known as "Chinese walls") are policies, procedures and physical apparatus designed to prevent the improper or unintended dissemination of market sensitive information from one area of a firm to another (*e.g.,* to prevent the dissemination of information about a proposed acquisition by an investment banking client from the investment banking area to the proprietary trading area) and trading procedures and reviews designed to prevent and detect trading on the basis of such information.

1. **Acknowledgment of the Efficacy of Information Barriers by the SEC and Self-Regulatory Organizations ("SROs").** Several specific SEC rules and SRO regulations specifically require, or provide for defenses to liability based on, information barriers. In addition to the research-related information barriers discussed in Part IV below, examples include:

   (a) **Rule 10b5-1 under the Securities Exchange Act of 1934 (the "Exchange Act").**

   (i) Rule 10b5-1(c)(ii) provides an affirmative defense to charges that a firm that buys or sells a security while in possession of material nonpublic information about the security or its issuer did not trade "on the basis of" such information (and therefore did not constitute insider trading) where the firm demonstrates that:

   - The individual making the investment decision on behalf of the firm was not aware of the information; and
   - The firm had implemented reasonable policies and procedures, taking into consideration the nature of the firm's business, to ensure that individuals making investment decisions would not violate the

laws prohibiting trading on the basis of material nonpublic information. The rule expressly provides that such policies and procedures may include those that restrict any purchase, sale, and causing any purchase or sale of any security as to which the firm has material nonpublic information, or those that prevent individuals making investment decisions from becoming aware of such information.

(b) **Exchange Act Rule 14e-3.** Rule 14e-3(a) imposes a duty of disclosure under Section 14(e) on any person who trades in securities which will be sought or are being sought in a tender offer while that person is in possession of material information which such person knows or has reason to know is nonpublic and has been acquired directly or indirectly from the offeror, from the issuer or from an officer, director, partner or employee or any other person acting on behalf of the offeror or the issuer.

Rule 14e-3(b) provides an affirmative defense for any person other than a natural person that shows that

- The individual(s) making the investment decision on behalf of such person to purchase or sell any security described in Rule 14e-3(a), or to cause any such security to be purchased or sold by or on behalf of others, did not know the material, nonpublic information; and

- Such person had implemented one or a combination of policies and procedures, reasonable under the circumstances, taking into consideration the nature of the person's business, to ensure that individual(s) making investment decision(s) would not violate Rule 14e-3(a), which policies and procedures may include, but are not limited to, (i) those which restrict any purchase, sale and causing any purchase and sale of any such security or (ii) those which prevent such individual(s) from knowing such information.

(c) **Exchange Act Section 15(f).** Section 15(f) of the Exchange Act requires registered broker-dealers to have procedures reasonably designed to prevent the misuse of material nonpublic information in violation of the Exchange Act or the rules and regulations thereunder. The SEC stated in the release adopting Rule 10b5-1 that the standards in Section 15(f) and Rule 10b5-1(c)(ii) "should be interpreted as essentially the same."

(d) **NYSE Rule 92.** NYSE Rule 92 generally prohibits NYSE members from entering orders for proprietary accounts if the person responsible for the entry of such order has knowledge of any particular customer's order on the same side of the market which could be executed at the same price. For purposes of this rule, the person responsible for entering proprietary orders is presumed to have knowledge of a particular customer order unless the firm has implemented "a reasonable system of internal policies and procedures to prevent the misuse of information about customer orders by those responsible for entering such proprietary orders."

(e) **NYSE Rule 97.** NYSE Rule 97 generally prohibits member organizations from executing within 20 minutes of the close certain purchases on a "plus" tick of stock in which it holds a long position in a proprietary account resulting from a block transaction with a customer if the person responsible for the entry of such order to purchase such stock has knowledge of the block position. Like Rule 92, Rule 97 provides that knowledge of the block position is presumed unless the firm has "implemented a reasonable system of internal policies and procedures to prevent the misuse of information about block positions by those responsible for entering such proprietary orders."

(f) **The Manning Rule (NASD IM-2110-2).** The NASD's Manning Rule generally prohibits a member firm holding an unexecuted customer limit order from trading for its own account the security at prices that would satisfy the customer limit order, without executing the customer limit order. By interpretation, however, "if the firm implements and utilizes an effective system of internal controls, such as appropriate information barriers, that operate to prevent non-market-

making desks engaged exclusively in proprietary trading from obtaining knowledge of customer limit orders held at the market-making desk, those other proprietary non-market-making desks may continue to trade in a principal capacity at prices the same as or inferior to the customer limit orders held at the market-making desk. An effective system of internal controls must include specific policies and procedures that prevent each of the desks separated by information barriers from obtaining knowledge regarding orders or trading activity of the other desks."[5]

(g) **NASD Rule 2111.** New NASD Rule 2111 (discussed in Part V.C below) generally prohibits a firm that accepts and holds a customer market order from trading for its own account at prices that would satisfy the customer market order, unless the firm immediately thereafter executes the customer market order. The NASD has provided guidance under Rule 2111 that "if the firm implements and utilizes an effective system of internal controls, such as appropriate information barriers, that operate to prevent non-market-making desks engaged exclusively in proprietary trading from obtaining any knowledge of customer orders held at the market-making desk, those other proprietary non-market-making desks may continue to trade in a principal capacity at prices that would satisfy the customer market orders held at the market-making desk."[6]

2. **Design of Information Barriers.** Although the type and formality of information barriers will of necessity vary with the size and activities engaged in by each firm, the SEC's Division of Market Regulation and the NYSE and NASD have provided guidance identifying certain minimum elements that they believe are necessary components of adequate information barrier procedures,[7] including:

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5 NASD NTM 95-43 SEC Approves Expanded Limit-Order Protection Rule, http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record_id=1159003774.

6 NASD NTM 06-03 NASD Provides Guidance Regarding New Rule 2111 Prohibiting Members from Trading Ahead of Customer Market Orders Under Certain Circumstances http://nasd.complinet.com/file_store/pdf/rulebooks/nasd_06_03.pdf (Jan. 2006).

7 Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Non-Public Information, Report by the Division of Market Regulation,

(a) **Documentation.**

(i) The information barrier policies must be formalized, organized and incorporated within the firm's procedural/policy manuals.

(ii) The firm must keep documentation of actions taken pursuant to the information barrier policies and procedures (including with respect to communications or movements of personnel across information barriers and with respect to reviews, analyses and investigations of employee and proprietary trading) sufficient to recreate the actions taken.

(b) **Procedures to Limit Information Flows.** The firm must have policies and procedures designed to limit or contain the necessary flow of material nonpublic information to employees who have a "need to know." These procedures may be designed primarily to isolate investment banking and include:

(i) policy statements in this regard;

(ii) physical separation of trading and sales departments from departments that regularly receive confidential materials;

(iii) other restrictions to access, such as separate record-keeping and support systems for sensitive departments;

(iv) supervision of interdepartmental communications involving material nonpublic information;

(v) procedures for investment banking to obtain information from research or sales departments without tipping those departments; and

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http://www.sec.gov/divisions/marketreg/brokerdealerpolicies.pdf (Mar. 1, 1990); NYSE & NASD Joint Memo on Chinese Wall Policies and Procedures, http://nasd.complinet.com/nasd/display/display.html?rbid=1189&element_id=1159004097 (June 21, 1991).

(vi) in the event a person is brought "over the wall", that person is treated as a temporary member of the investment banking department, compliance/legal must be notified, and documentation of the "wall-crossing" must be kept.

(c) **Maintenance of Restricted and Watch Lists.** Firms must (with certain exceptions noted below) maintain watch (or "grey") and restricted lists of securities and issuers about which the firm has obtained confidential information.

(i) Watch lists have a very limited distribution (so that the placement on the watch list does not itself convey the nonpublic information) and are used by the firm's legal or compliance function to monitor, *ex post*, employee and proprietary trading for signs that the trading was based on the confidential information. Placement of a security on a watch list may also trigger certain trading restrictions.

(ii) Restricted lists are broadly distributed within the firm. Generally, trading in securities on a restricted list is prohibited, although there may be different levels of prohibition depending on the particular transaction in which the firm is involved. An issuer is typically placed on the restricted list once information regarding the issuer's activities are (or are about to become) known to the entire institution, for example, when a deal is publicly announced.

(iii) The polices must include reasonable written standards for adding and deleting securities from the lists and records must be kept of all additions and deletions.

(iv) The policies must provide for reviews of employee and proprietary trading in securities appearing on the watch or restricted lists, including employee trading outside the firm.

(v) The firm must reasonably inquire into or investigate for possible use of material nonpublic information and must keep records of each investigation.

(vi) Firms that do not conduct investment banking, research or arbitrage do not need restricted or watch lists, but still must have reasonable written procedures for periodically reviewing employee and proprietary trading for misuse of material nonpublic information.

(d) **Procedures to Educate and Train.** The firm must have procedures to educate and train its employees in applicable federal and state laws, SRO requirements and the firm's policies and procedures relating to the use of material nonpublic information, including:

(i) providing each employee with such requirements and obtaining (and retaining) an attestation from each employee of his or her knowledge and understanding of the requirements; and

(ii) implementing a process for updating employees regarding changes in the requirements.

(e) **A Central Role for the Compliance Area.** The compliance area must have a central role in connection with communications or movements of personnel across information barriers, with respect to adding and removing securities or issuers from watch or restricted lists, and with respect to employee trade surveillance.

**B. Disclosure and Consent.** Broker-dealers are required to disclose material conflicts of interest. Some conflicts of interest can be addressed in whole or in part by disclosing the conflict and obtaining the customer's consent. For instance,

1. The NASD's Manning Rule (IM-2110-2) and new NASD Rule 2111 (discussed above) both allow the broker-dealer to negotiate with its customer an exception when the customer is an "institutional account" or the customer order involves at least 10,000 shares and $100,000.

2. Under NASD Rule 2720(l), a member cannot execute a transaction in a discretionary account in securities issued by it or its affiliate, or by a company with which it has a conflict of interest, without the prior specific written approval of the customer.

**C.** **Culture of Compliance**. A "culture" of compliance at a firm is an overall environment that fosters ethical behavior and sensitivities to compliance with the law in all decision-making.[8]

1. **Characteristics of a Culture of Compliance.** It "includes a culture of doing not only what is within the strict parameters of the law, but also what is right — whether or not a regulator or anyone else is looking." According to Lori Richards, Director of the SEC's Office of Compliance Inspections and Examinations ("OCIE"), every good culture of compliance has at least five elements (which the OCIE uses as a formal approach to assessing a firm's culture of compliance):[9]

   (a) Strategic Vision. Compliance activities have to relate to some larger strategic goal.

   (b) Risk Identification. The specific risks that could arise within each strategic area must be identified. "The devil is in the details."

   (c) Control Points. Control points should be established for each identified risk.

   (d) Documentation. Documentation should provide transparency, both internal (*e.g.*, to senior management) and external (*e.g.*, to auditors and regulators).

   (e) Accountability. Specific people should be accountable for managing each specific element of the compliance system.

2. **Creating a Culture of Compliance.** Ms. Richards also provided some concrete steps that firms might take to instill a strong culture of compliance. In particular, she noted the following:[10]

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[8] Mary Ann Gadziala, Comprehensive Compliance Examinations for Securities Firms, speech before the Compliance Management and Structure Conference, http://sec.gov/news/speech/2006/spch051606mag.htm (May 16, 2006).

[9] The Culture of Compliance, Remarks at the Spring Compliance Conference: National Regulatory Services, http://sec.gov/news/speech/spch042303lar.htm (Apr. 23, 2003).

[10] Instilling Lasting and Meaningful Changes in Compliance, Remarks before the National Society of Compliance Professionals 2004 National Membership Meeting, http://sec.gov/news/speech/spch102804lr.htm (Oct. 28, 2004).

(a) "Tone at the Top": The firm's board, senior management and other key executives should make it clear that they expect the firm and all of its employees to operate ethically and consistent with fiduciary and legal obligations. Supervisors should also be held responsible for ensuring compliance with these standards. To be effective, firms' CEOs must put this mandate in writing, emphasize it repeatedly, and mean it.

(b) Training: Make sure all employees understand these expectations, and how the expectations apply in the context of their work. Use examples that they understand, since generalities will not communicate the importance of the mandate to them and it will not be clear to them how they are to live up to these expectations in their daily work.

(c) Compliance Over Profits: One the best ways to make the firm's culture of compliance evident to employees is for firm leaders to make decisions that demonstrate intolerance for compliance risks, even if it means losing the trade, the client, or the deal. Employees will remember this ethic the next time they are called upon to make a tough call.

(d) Establish Strong Policies and Procedures to Prevent and Detect Violations: One of most frequent findings in examinations is that firms lack adequate written policies and procedures. Review the firm's operations and ensure that key risk areas are covered by strong internal controls. Test procedures regularly, improve them, and question frequently whether they can be better. Compliance policies should not be static, written in stone, but should be improved over time with the benefit of the lessons learned from using them.

(e) Implement Policies and Procedures: Another frequent finding is that firms have good procedures, but don't follow them. This can communicate a lack of respect for all policies and procedures.

(f) Test for Compliance: Make sure supervisors are doing their job in reviewing conduct. Evaluate them not just on production standards, but also on their ability to prevent problems. Have a strong internal audit program -- give

internal auditors and compliance staff the teeth they need to detect problems.

(g) Deal With Detected Violations Quickly and Appropriately: Provide redress to investors, and make clear by how the firm deals with the violator that the firm really means it when it says it maintains a culture of compliance, even with respect to its big producers.

(h) Implement a Superior Compliance Program: Give compliance staff the resources, respect, and access they need. Ensure that all firm employees, particularly supervisors and senior managers, respect the work they do.

(i) Empower Employees to Question Conduct: Employees can help identify questionable conduct before it becomes a problem, and can help identify problems that should be remedied. Make sure your employees know who to speak with to discuss problems and concerns. Make sure that they feel encouraged to do so—this means being ready and able to hear bad news. Managers who subtly send the message that they only want to hear good news will not know what's really going on in their organization. There are many examples of otherwise non-culpable employees trying to cover up compliance problems just to avoid having to tell the boss about them.

(j) Report Problems to Senior Management and to the Board: Establish an expectation that compliance issues are important to the firm.

(k) Self-Assess Honestly and Periodically: As businesses, products, customers, and employees change, firms should assess periodically whether new conflicts of interest exist, and whether business practices assumed appropriate in the past continue to be so. Don't be lulled by the fact that "other firms are doing the same thing," or by so-called "best practices" that are really mediocre or "lowest common denominator" practices. Strive higher.

(l) Think Long Term: Reputations are forever damaged by actions motivated by short-term profits. Winning some

market share or performance "contest" this month, quarter or year at any cost simply isn't worth putting the firm in jeopardy.

(m) Keep Regulators Informed: Let regulators know about the problems the firm is faced with, and the changes being implemented. The firm is much better off being forthcoming with its regulators than if the regulators detect the problem themselves. More broadly, the firm and the regulators need to understand each other, and to make sure that their efforts at change are mutually supportive.

**IV. Research Analyst Conflicts.** Conflicts of interest relating to research analysts have been addressed by the so-called "Global Research Analyst Settlement", by the Sarbanes-Oxley Act, by NASD and NYSE regulations, by the SEC's Regulation AC, by various state regulators and by industry trade associations. Certain developments in this area are discussed below.

**A. Global Research Analyst Settlement.** On April 28, 2003, the SEC, NYSE, NASD, North American Securities Administrators Association, the New York Attorney General and various state securities regulators announced the settlement of enforcement actions against ten of the largest investment banking firms.[11] (The settlement has since been further amended by the parties and interpreted the staff of the SEC's Division of Market Regulation.) The settlement relates to charges by the regulators that the settling firms were engaged in acts and practices that created or maintained inappropriate influence by investment banking personnel over equity research analysts, which created conflicts of interest that were not adequately managed or disclosed. As part of the settlement, each of the settling firms agreed to make a number of structural reforms intended to insulate research personnel from improper investment banking influence. (For purposes of the settlement, the term "research" refers solely to equity research.) These structural reforms include:

1. **The Separation of Research and Investment Banking.** The research and investment banking functions within the firm must be physically separated and must have separate reporting lines within the firm (*i.e.*, research personnel cannot not report directly or indirectly to or through investment banking or to a person or persons with direct

[11] The settlements and their amendments are available at http://sec.gov/spotlight/globalsettlement.htm.

responsibility for investment banking activities). This separation includes:

(a) The research department must have its own dedicated legal and compliance staff.

(b) Research budget and allocation of research expenses must be determined by the firm's senior management without input from investment banking personnel and without regard to specific revenues or results derived from investment banking.

(c) Compensation of research analysts must be determined exclusively by research management and the firm's senior management (without any involvement of or input from investment banking personnel or investment banking management) and may not be based directly or indirectly on investment banking revenues or results. In addition:

  (i) A significant portion of the compensation for "lead" analysts must be based on quantifiable measures of the quality and accuracy of the analyst's research and analysis, including ratings and price targets, if any.

  (ii) The criteria used for compensation decisions must be determined by research management and the firm's senior management (not including investment banking) and set forth in advance.

  (iii) The basis for compensation decisions for certain research analysts and for research management must be documented.

  (iv) The compensation committee of the firm's parent holding company (or a comparable independent group without management responsibilities) must review the compensation process with respect to research personnel on an annual basis to ensure compliance with the foregoing requirements.

(d) Evaluations of research personnel must be done without any involvement of, or input from, investment banking personnel.

(e) Investment banking personnel may not have any input into company-specific research coverage decisions and investment banking revenues or potential revenues may not be taken into account in making company-specific coverage decisions.

(f) When a decision is made to terminate research coverage of a particular company, the firm must issue a final research report disclosing that the firm is terminating coverage and the rationale for that determination.

(g) The firm must create an oversight committee comprised of research management and, if desired, others (but not investment banking personnel) to review changes in ratings and material changes in price targets, and to monitor the overall quality and accuracy of the firm's research reports.

(h) Research personnel may not participate in "pitches" or any other efforts to solicit investment banking business.

(i) Research personnel may not participate in company-sponsored or investment banking-sponsored roadshows related to a public offering or other investment banking transaction.

(j) Investment banking personnel may not direct research personnel to engage in marketing or selling efforts to investors with respect to an investment banking transaction.

(k) After the firm receives an investment banking mandate relating to a public offering of securities, research personnel may communicate with investors orally regarding such offering, provided that such research personnel do not appear jointly with company management or investment banking personnel in those communications. In addition:

  (i) Oral communications by research personnel with investors in which a recommendation or view regarding the offering is expressed by research personnel must have a reasonable basis.

  (ii) Oral communications regarding the offering to 10 or more investors must be "fair and balanced", made in the presence of legal or compliance personnel, and a

record of the communication must be made and maintained.

(l) Information barriers must be put in place that are reasonably designed to prevent all communication between investment banking and research personnel other than those expressly permitted by the terms of the settlement.

(m) The firm must adopt and implement policies and procedures reasonably designed to ensure that its personnel do not seek to influence the contents of research reports or the activities of research personnel for the purpose of obtaining or retaining investment banking business.

(n) The firm must retain an independent monitor that will review the implementation and effectiveness of the policies and procedures adopted by the firm to achieve compliance with the structural reforms and other requirements of the settlement.

2. **Additional Disclosures.** Each of the settling firms also agreed to include disclosures in its research reports designed to put recipients on notice of the potential conflicts of interest arising from the firm's investment banking activities and cautioning such recipients that the report should be considered as only a single factor in making an investment decision.

**B. The SRO Analyst Conflicts Rules.** The NYSE and the NASD have adopted virtually identical rules to address conflicts in connection with equity research (the "SRO Analyst Rules") which are intended to operate uniformly.[12] In summary, the SRO Analyst Rules impose the following restrictions with respect to equity research:

1. **Interactions between Research and Investment Banking Personnel.**

(a) The firm's investment banking department may not supervise or control research analysts.

(b) Investment banking personnel and all other employees of the firm who are not directly responsible for investment research

[12] Principally, NASD Rules 2711 and 1050 and NYSE Rules 472, 344 and 351.

("non-research personnel"), other than legal or compliance personnel, may not review or approve a pending research report, except to verify its factual accuracy or review it for potential conflicts of interest, and then only if an authorized legal or compliance official intermediates or participates in the communication.

- The term "research report" is defined in the SRO Analyst Rules to mean a written or electronic communication that includes an analysis of equity securities of individual companies or industries that provides information reasonably sufficient upon which to base an investment decision. A document need not be created by the research department or contain a recommendation for it to be deemed a "research report."

(c) Research analysts may not participate in efforts to solicit investment banking business. This prohibition includes, but is not limited to, participating in any "pitches" for investment banking business to prospective investment clients or other communications with companies for the purpose of soliciting investment banking business.

(d) Research analysts may not participate in any roadshows relating to investment banking transactions, nor engage in communications regarding investment banking transactions with current or prospective customers in the presence of investment banking personnel or company management.

(e) Investment banking personnel may not, directly or indirectly, direct research analysts to communicate with current or prospective customers about investment banking transactions or engage in sales or marketing efforts related to investment banking transactions.

(f) Firms and their employees who are engaged in investment banking activities are prohibited from, directly or indirectly, retaliating against or threatening to retaliate against any research analyst employed by the firm or its affiliates as a result of a research report or public appearance by the research

analyst that may adversely affect the firm's present or prospective relationship with an investment banking client.

(g) There is a limited exemption from certain of these restrictions for certain small firms that over the 3 previous years, on average per year, have participated in 10 or fewer investment banking services transactions (excluding municipal securities transactions) as manager or co-manager and generated $5 million or less in gross investment banking services revenues from those transactions.

2. **Communications with the Company and Others.**

(a) A firm may not submit a research report to the subject company for approval prior to its publication. The firm may, however, submit to the subject company, solely in order to verify factual accuracy, sections of the report that do not contain the research summary, research rating or price target. In such case, a complete draft of the research report must have been previously submitted to the firm's legal or compliance department and any change in the proposed rating or price target following such submission to the subject company must be justified to, and approved in writing by, the firm's legal or compliance department.

(b) A firm may notify the subject company of an intended ratings change only on the business day prior to the announcement of the ratings change after the close of trading in the principal market for the subject company's securities.

(c) A firm may not promise favorable research, or threaten to change a specific rating or price target, as an inducement or consideration for the receipt of additional business or compensation.

(d) All communications (written or oral) by research analysts with current or prospective customers or internal personnel relating to investment banking transactions must be fair, balanced and not misleading, taking into consideration the overall context in which the communication is made.

3. **Analyst Compensation.**

(a) Investment banking personnel may not have any influence or control over the compensatory evaluation of research analysts.

(b) Analyst compensation may not be tied to a specific investment banking transaction.

(c) The compensation of a research analyst primarily responsible for the preparation of the substance of a research report must be reviewed and approved, at least annually, by a committee (excluding representatives from the investment banking department) that reports to the board of directors (or if none, to a senior executive officer) of the member firm.

(d) A firm's research reports must disclose if the analyst preparing such reports received compensation (i) based on (among other factors) the firm's investment banking revenues, or (ii) from the subject company in the past 12 months.

(e) A firm's research reports must disclose if the firm or its affiliates received investment banking compensation from the subject company within 12 months prior to, or if any such compensation is reasonably expected to be received or sought within 3 months following, publication of the research report.

(f) A firm must disclose in research reports (to the extent the research analyst or an employee of the member with the ability to influence the substance of the research knows or has reason to know) whether the firm or any affiliate thereof received any compensation for products or services other than investment banking services from the subject company in the past 12 months.

The research analyst and the firm will be presumed not to have reason to know if the firm maintains and enforces policies and procedures reasonably designed to prevent research analysts and employees of the member with the ability to influence the substance of research report from, directly or indirectly, receiving information from the affiliate concerning whether the affiliate received such compensation.

(g) A research analyst must disclose in public appearances if the firm or any affiliate thereof (to the extent the analyst knows or has reason to know), or the analyst himself or herself, received any compensation during the past 12 months from the subject company.

- The term "public appearance" is defined in the SRO Analyst Rules to mean any participation in a seminar, forum (including an interactive electronic forum), radio, television or print media interview, or other public speaking activity, or the writing of a print media article, in which a research analyst makes a recommendation or offers an opinion concerning an equity security.

(The compensation disclosure provisions provide for an exception for both research reports and public appearances in order to prevent the disclosure of material nonpublic information regarding specific potential future investment banking transactions of the subject company.)

4. **Analyst Personal Trading.**

(a) No "research analyst account" may acquire securities of any company in an industry that the research analyst covers before such company's initial public offering.

- "Research analyst account" includes accounts of the research analyst and members of the research analyst's household, but does not include "blind trust" accounts that are controlled by a person other than the research analyst or member of the research analyst's household where neither the research analyst nor member of the research analyst's household knows of the account's investments or investment transactions.

(b) No research analyst account may trade in the securities of a company covered by the research analyst during a blackout period beginning 30 calendar days before, and ending 5 calendar days after, the issuance of a research report on, or change in the rating or price target of, the securities of the subject company (subject to certain exceptions for significant

news events and unanticipated significant changes in personal financial circumstances).

(c) No research analyst account may trade in a subject company's securities in a manner inconsistent with the research analyst's most recent recommendation regarding such securities (subject to certain exceptions for unanticipated significant changes in personal financial circumstances).

(d) A firm's legal or compliance personnel must pre-approve all securities transactions of persons who supervise research analysts and other persons such as the director of research or member of a committee who has direct influence or control with respect to the preparation of research reports or establishing or changing a rating or price target of a subject company's equity securities, to the extent that the transactions involve securities of subject companies covered by research analysts.

5. **Quiet Periods.** The SRO Analyst Rules impose certain restrictions on the publication of research and public appearances by research analysts during "quiet periods" following registered securities offerings by the subject company underwritten by the analyst's firm and surrounding the expiration, waiver or termination of lock-up agreements in connection with such offerings.

6. **Disclosures.**

(a) **Disclosure Standards.**

(i) Disclosures and references to disclosures must be clear, comprehensive and prominent, and in research reports, must be on front page thereof (or the first page must direct the reader to where the required disclosures may be found).

(ii) Research reports covering six or more subject companies may incorporate disclosures by reference by directing the reader to current disclosures in written or electronic format.

(b) **Compensation.** *See* Parts 3(d) through 3(g) above.

(c) **Client Arrangements.**

(i) A firm's research reports must disclose if the firm or its affiliates managed or co-managed a public offering of securities for the subject company in the past 12 months.

(ii) A firm must disclose in research reports (to the extent the member knows or has reason to know, and a research analyst must disclose in public appearances, to the extent the analyst knows or has reason to know) whether the subject company is, or has been during the previous year, a client of the member, and if so, the types of services provided to the company.

(The client services disclosure provisions provide for an exception in order to prevent the disclosure of material nonpublic information regarding specific potential future investment banking transactions of the subject company.)

(d) **Financial Interests in Recommended Companies; Conflicts of Interest.**

(i) A firm must disclose in research reports, and a research analyst must disclose in public appearances, if the research analyst or a household member serves as an officer, director or advisory board member of, or has a financial interest in the securities of, the subject company, and if so, the nature of such interest.

(ii) A firm must disclose in research reports if the firm was making a market in the subject company's securities at the time the report was published or the firm or any of its affiliates managed or co-managed a public offering of the company's equity securities within the past 12 months.

(iii) A firm must disclose in research reports, and an analyst must disclose in public appearances, if (as of the previous month-end) the firm and its affiliates

beneficially owned 1% or more of any class of common equity securities of the subject company.

(iv) A firm must disclose in research reports, and an analyst must disclose in public appearances, other actual, material conflicts of interest of the firm or the research analyst of which the analyst knows or has reason to know at the time of the public appearance or publication of the report.

(e) **Research Ratings and Price Targets.** The firm must include in each research report (i) definitions of each rating used, (ii) information about the percentages of ratings in each category and the percentage of investment banking clients in each category, (iii) for equities that have been covered for at least a year, a line graph of daily closing prices showing ratings and price targets, (iv) the valuation method used to determine any price target and any risks that may impede achievement of such price target.

7. **Termination of Coverage.** If a firm terminates coverage of a company, it must provide notice that it has terminated coverage. The firm must also make available a final research report on the company using means of dissemination equivalent to those it ordinarily uses to provide a customer with its research reports on the company. The report must be comparable in scope and detail to prior research reports and must include a final recommendation or rating, unless it is impracticable for the member to produce a comparable report (*e.g.*, if the research analyst covering the company or sector has left the firm or if the firm terminates coverage of the industry or sector), in which case the final research report must disclose the firm's rationale for the decision to terminate coverage.

8. **Registration and Continuing Education Requirements.**

(a) Research analysts (defined for this purpose as those persons primarily responsible for the preparation of the substance of a research report or whose name appears on the report) and supervisory analysts are required to be registered with, and qualified (including by passing a Research Analyst Qualification Examination) and approved by, the NASD or the NYSE as applicable.

(b) All registered persons who function as research analysts and supervisory analysts are required to participate in the Firm Element of the Continuing Education Program that includes training in applicable rules and regulations, ethics, and professional responsibility.

(c) Foreign-based analysts employed by non-U.S. affiliates of member firms may be subject to SRO registration and licensing requirements if they are deemed "associated persons" of the member firm ("foreign research analysts"), although an exemption from the Research Analyst Qualification Examination is available under certain circumstances to foreign research analysts based in jurisdictions that the NASD and NYSE have determined to have acceptable local qualification standards and research analyst conflicts of interest rules.

9. **Compliance.**

(a) A firm must adopt and implement written supervisory procedures designed to ensure that the firm and its employees comply with the analyst conflicts rules.

(b) A senior officer of the firm must attest annually to the NASD and NYSE as to compliance with the written supervisory procedures requirement.

**C. Sarbanes-Oxley Act.**[13]

1. **Analyst Restrictions and Protections.** The SEC (or at the SEC's direction, a registered securities association or national securities exchange) must adopt rules reasonably designed to address conflicts of interest that may arise when securities analysts recommend equity securities in research reports and public appearances, including rules:

(a) Restricting the pre-publication clearance or approval of research reports by persons employed by the broker-dealer who are engaged in investment banking activities, or persons

[13] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002). (Note that the requirements of the Sarbanes-Oxley Act, insofar as they relate to research conflicts of interest, have been addressed by the SRO Analyst Rules.)

not directly responsible for investment research, other than legal and compliance staff.

(b) Limiting the supervision and compensatory evaluation of securities analysts to officials employed by the broker-dealer who are not engaged in investment banking activities.

(c) Prohibiting a broker-dealer and persons employed by the broker-dealer who are involved with investment banking activities from retaliating against a securities analyst employed by that broker-dealer as a result of an unfavorable research report that might adversely affect the investment banking relationship of the broker-dealer with the issuer that is the subject of the research report.

(d) Defining periods during which brokers or dealers that have participated, or are to participate, in a public offering of securities as underwriters or dealers should refrain from publishing or distributing research reports relating to such securities or the issuer of those securities.

(e) Establishing internal safeguards to assure that securities analysts are separated by appropriate informational barriers within the firm from the review, pressure, or oversight of those whose involvement in investment banking activities might potentially bias their judgment or supervision.

(f) Addressing other issues as the SEC (or such association or exchange) deems appropriate.

2. **<u>Disclosure</u>.** The SEC (or at the SEC's direction, a registered securities association or national securities exchange) must adopt rules reasonably designed to require securities analysts to disclose in public appearances, and broker-dealers to disclose in research reports, any conflicts of interest that are known or should have been known by the analyst or broker-dealer (as applicable) at the time of the appearance or distribution of the report. These disclosures must include the following:

(a) The extent to which the analyst has debt or equity investments in the issuer that is the subject of the appearance or report.

(b) Whether any compensation has been received by the broker-dealer, any of its affiliates, or the analyst, from the issuer that is the subject of the appearance or report (subject to certain exemptions as the SEC may determine to be appropriate and necessary to prevent disclosure of material nonpublic information regarding specific potential future transactions by the issuer).

(c) Whether the issuer of the securities being recommended in the appearance or report is or has been a client of the broker-dealer at any time during the one-year period preceding the date of the appearance or the distribution of the report, and if so, stating the types of services that were provided to the issuer.

(d) Whether the analyst received compensation for a research report based in any part on the investment banking revenues of the broker-dealer.

(e) Such other disclosures of material conflicts of interest as the SEC (or such association or exchange) determines to be appropriate.

**D. Regulation AC.**[14]

1. Regulation AC—which, unlike the Global Research Analyst Settlement, the research-related provisions of the Sarbanes-Oxley Act and the SRO Analyst Rules, applies to both equity and debt research—generally requires broker-dealers and "covered persons" that publish, circulate or provide research reports (other than third-party research reports) to US persons in the United States to include in the report certain specified certifications. In particular, the report must contain certifications that:

(a) the views expressed in the research accurately reflect the analyst's personal views on the securities or issuers that are the subject of the report; and

(b) either

[14] 17 C.F.R. § 242.500 through 505.

(i) no part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the research analyst in the research report ("related compensation"); or

(ii) all or a part of the analyst's compensation consists of related compensation (in which case, the report must also contain disclosure as to the amount, source and purpose of such compensation and that the receipt of such compensation could influence the recommendations or views expressed in the research report).

2. Regulation AC also generally requires a broker-dealer that publishes, circulates or provides a research report prepared by a research analyst employed by the broker-dealer or covered person to make a record within 30 days after any calendar quarter in which the research analyst made a public appearance that contains:

(a) A statement by the research analyst attesting that the views expressed by the research analyst in all public appearances during the calendar quarter accurately reflected the research analyst's personal views at that time about any and all of the subject securities or issuers; and

(b) A statement by the research analyst attesting that no part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the research analyst in such public appearances.[15]

**E. <u>Best Practices for Fixed Income Research</u>.** In May 2004, The Bond Market Association ("TBMA") published "Guiding Principles to Promote the Integrity of Fixed Income Research" (the "Guiding Principles") to provide a

[15] If the broker-dealer does not obtain these certifications from the analyst, the broker-dealer must promptly notify its designated examining authority of such fact in writing and, for 120 days following this notification, disclose in any research reports prepared by the analyst and published, circulated, or provided to a U.S. person that the research analyst did not provide the required certifications.

"best practices" guide for firms in connection with the publication of fixed income research.[16]

1. **Regulation of Fixed Income Research.**

(a) As noted above, the Global Research Analyst Settlement, the research-related provisions of the Sarbanes-Oxley Act and the SRO Analyst Rules do not apply to fixed income research.[17]

(b) The NYSE and NASD have stated that egregious conduct involving fixed income research can nonetheless be reached and addressed by general anti-fraud statutes and existing SRO rules, such as NYSE Rules 401 (Business Conduct), 476(a)(6) (allowing for disciplinary proceedings against a member organization for "conduct or proceeding inconsistent with just and equitable principles of trade"), and NASD Rule 2110 (which requires that members "observe high standards of commercial honor and just and equitable principles of trade").[18]

(c) Although the Guiding Principles are not the equivalent of sanctionable rules, the NYSE and the NASD are monitoring the extent to which firms have adopted and adhere to the Guiding Principles (or other supervisory systems regarding fixed income research that are reasonably designed to achieve compliance with applicable SRO rules and securities laws and regulations) to inform their consideration of whether more definitive rules are needed.

(d) In July 2006, the NASD and NYSE published a synopsis of the results of examinations of certain member firms to assess how they had addressed conflicts of interest with respect to fixed income research. The synopsis cited many instances in which the examinations found failures to adhere to the Guiding Principles. (The most prevalent failure was a failure

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[16] http://bondmarkets.com/assets/files/Guiding_Principles_for_Research.pdf.

[17] Note, however, that NASD Rule 2210 and certain provisions of NYSE Rule 472 do apply to fixed income research and other communications with the public regarding fixed income securities.

[18] NASD NTM 06-36 NASD and NYSE Joint Interpretive Guidance on Fixed Income Research http://www.nasd.com/RulesRegulation/NoticestoMembers/2006NoticestoMembers/NASDW_01 (July 2006).

to provide the disclosures recommended by the Guiding Principles.)

2. **Differences between Fixed Income and Equity Research.** TBMA believes that there are well-recognized and critical differences between fixed income and equity research that affect the potential for, and the intensity of, any conflicts of interest. Among other things TBMA noted that:

(a) In contrast to the equity markets, where the views expressed in research reports may directly affect an issuer's share price, the prices of most debt securities are, by nature, relatively less sensitive to the views of a particular analyst because the value of debt securities depend heavily on objective external market factors, such as interest rates.

(b) Fixed income trading desk personnel, including individuals employed to provide analytical support for the trading desk's trade execution and market-making functions, may generate trader commentary, trade ideas and other analyses for the trading desk's counterparties. Such trader commentary, trade ideas and other analyses, however, are generally understood by counterparties to be part of the desk's market-making function (rather than "research") and are not to be relied upon as impartial since the commentary is generally about securities in which the desk has a position and will trade as principal.

(c) Credit rating agencies provide fixed income investors with an independent source of information about the relative creditworthiness of fixed income instruments and issuers, which (in addition to macroeconomic factors) is a significant determinant of a fixed income security's price.

(d) Favorable fixed income research has less potential to attract or retain issuer clients than equity research.

(i) Government and agency issuers, which are significant fixed income issuers, are less likely to be swayed by biased research and conduct many of their offerings through a competitive bid process, where underwriters are selected for providing the lowest bid without regard to any existing relationship.

(ii) Much fixed income research is macroeconomic rather than targeted at any particular issuer and fixed income security prices are largely determined by objective external factors.

(iii) Personal incentives that may be created by securities-based compensation (*e.g.*, stock options) for issuer management to pressure firms or their research analysts to issue unduly optimistic research to boost securities prices are absent in the fixed income markets.

(e) The majority of fixed income research is directed and disseminated to sophisticated market participants who have access to multiple research sources and often employ their own research staff, which reduces the ability of any one piece of fixed income research to influence investment decisions.

3. **The Guiding Principles.** TBMA identified ten Guiding Principles:

(a) Firms should promote the integrity of fixed income research and the ability of fixed income research analysts to express their own independent views. In particular, firms should implement prohibitions on promising favorable research, implement prohibitions on retaliation against analysts for research that may adversely affect investment banking or sales and trading interests, and ensure that decisions regarding research coverage are made by fixed income research department personnel.

(b) Supervisory and management structures should insulate fixed income research analysts from review, pressure, and control by investment banking personnel. In particular, firms should implement appropriate reporting line structures, ensure that fixed income research analyst evaluations are not carried out by investment banking personnel, and consider physical separation of research from other functions, where appropriate.

(c) Firms should take measures to prevent inappropriate influence by non-research department personnel and issuers over the content of fixed income research reports and the timing of

their publication. In particular, firms should implement firm-wide prohibitions on improperly influencing fixed income research analysts, implement restrictions on review or approval of draft research reports by non-research department personnel or by issuers, and implement mechanisms to review certain changes in investment conclusions.

(d) Fixed income research analysts should be compensated in a manner designed to promote their independence. For example, analyst compensation should not be:

(i) in return for expressing a specific view or recommendation about an issuer, security or industry;

(ii) based on an ability to secure or maintain investment banking business;

(iii) based on an investment banking employee's evaluation; or

(iv) based on the success of, or revenues derived from, any specific investment banking or sales and trading transaction or on investment banking revenues from services provided to a specific issuer or industry sector.

(e) Firms should impose personal trading restrictions on fixed income research analysts to manage potential conflicts of interest.

(f) Firms and fixed income research analysts should inform investors of potential conflicts of interest that may affect fixed income research. Fixed income research reports should include (where applicable) the following disclosures:

(i) if the analyst's compensation is based in part on investment banking revenues or the profitability of the fixed income department or of the asset class covered by the analyst;

(ii) if the analyst has a financial interest in the security of the subject issuer (or in related derivatives), except investment grade sovereigns;

(iii) if the analyst or a household member is an officer, director or advisory board member of the subject issuer;

(iv) if the firm has managed or co-managed a public or Rule 144A offering of securities for the issuer in the preceding 12 months;

(v) if the firm trades or may trade as principal in the securities that are the subject of the report (or in related derivatives); and

(vi) the meaning of any ratings in the report.

(g) Fixed income research analysts should not act as marketers or solicitors of investment banking services.

- Assistance to the investment banking department in performing certain functions, such as carrying out due diligence responsibilities, screening potential investment banking clients, informing firms and issuers of likely market reactions to proposed transactions, and assisting in the pricing and structuring of investment banking transactions, is consistent with this principle.

(h) Firms should manage potential conflicts of interest relating to their trading desks and the publication of fixed income research. In particular, firms should establish mechanisms to prevent research from being prejudiced by the firm's trading activities, implement prohibitions on improperly trading securities ahead of fixed income research reports and disclose potential conflicts.

(i) Trader commentary, trade ideas, and other analyses produced by trading desk personnel must be clearly identified as such, and as not being produced by the fixed income research department. More stringent procedures should be considered for any material that is distributed to persons who are not institutional investors.

(j) Firms should allocate sufficient supervisory resources to promote the integrity of the fixed income research process. In particular, firms should establish appropriate written policies and procedures to supervise research analysts and provide periodic training.

## V. **Selected Regulatory Actions and Other Recent Developments**.

**A. Knight Securities – Late Allocation between Proprietary Account and Institutional Customer Account.** In 2004, the SEC and the NASD settled charges against Knight Securities.[19] According to the SEC order, Knight defrauded its institutional customers by acquiring a substantial position for the firm's proprietary account upon receipt of an institutional customer order. Rather than fill the customer order promptly on terms most favorable to the customer, Knight would wait to see if its proprietary position increased in value during the trading day. When the market price increased above Knight's acquisition cost, Knight would fill the customer order and pocket the difference as profit on the transaction. When the market decreased below Knight's acquisition cost, Knight executed its remaining position in the order to the customer at prices that still generated profits for Knight. In addition to the fraud charge, the NASD found several failures to supervise in connection with the alleged scheme, including a failure to supervise the use of proprietary "back book" accounts used by some Knight employees. (See below for further discussion of "back book" trading.)

**B. Citigroup Australia – Proprietary Trading Prior to the Announcement of a Takeover Bid.** In March 2006, the Australian Securities and Investments Commission brought an action against Citigroup Global Markets Australia PTY Ltd. The complaint alleged that, in the midst of intense media speculation that Toll Holdings would be making a takeover bid for Patrick Corporation and after Citigroup's Investment Banking Division had been engaged to act for Toll in the takeover, Citigroup's Proprietary Trading Department engaged in extensive trading in Patrick shares. Although central to the complaint is an allegation that Citigroup's information barriers had been breached, the case has attracted much attention because the complaint requests "an injunction restraining Citigroup from engaging in the breach of Section 12CA of the ASIC Act by trading in securities on its own account while acting for clients to whom Citigroup owes duties in relation to the price of those securities," which suggests that any proprietary trading in a security in which an investment banking client has an interest violates Australian law,

[19] Admin. Proc. File No. 3-11771, http://www.sec.gov/litigation/admin/34-50867.htm.

whether or not there are information barriers between proprietary trading and investment banking.

- Also notable is that the alleged breach of the information barrier was the communication to the proprietary trader's manager that they "may have a problem" with the purchases of Patricks shares by a proprietary trader and the manager's subsequent instruction to the proprietary trader to cease buying Patricks shares. After receiving the instruction to cease buying, the proprietary trader is alleged to have sold a portion of the Proprietary Trading Department's position in Patricks shares, but is not alleged to have purchased any additional shares.

**C.** **<u>Morgan Stanley – Inadequate Watch List Procedures</u>.** In June 2006, the SEC filed a settled administrative proceeding against Morgan Stanley for failures relating to surveillance of its watch list.[20] The proceeding alleged that Morgan Stanley's written procedures were inadequate because they failed to provide clear guidance regarding the manner in which surveillance was to be conducted, that Morgan Stanley had failed to maintain and implement its policies for placing companies on the watch list, and failed to review trading in certain watch list securities or by certain categories of employee and employee-related accounts.

**D.** **<u>New NASD Rule 2111, Trading Ahead of Customer Market Orders</u>.** Recently adopted NASD Rule 2111 prohibits a firm that accepts and holds a customer market order from trading for its own account at prices that would satisfy the customer market order, unless the firm immediately thereafter executes the customer market order. (Similar protection for limit orders has long been provided under the "Manning Rule.") Rule 2111 includes an exception for riskless principal transactions under certain conditions. Also, as discussed above, Rule 2111 allows firms to negotiate specific terms and conditions applicable to market orders for "institutional accounts" or transactions involving at least 10,000 shares and $100,000 (see Part III.B.1 above) and has an exception for transactions by non-market-making proprietary desks where there are information barriers that operate to proprietary trading desk from obtaining any knowledge of customer orders held at the market-making desk (see Part III.A.1(g) above).

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[20] Rel. 34-54047, Morgan Stanley & Co. Incorporated and Morgan Stanley DW Inc. http://sec.gov/litigation/admin/2006/34-54047.pdf (Jun. 27, 2006).

**E.** **NYSE IM 05-11: Customer Account Sweeps to Banks.** In 2005, the NYSE published recommended practices for obtaining customer consent to new customer account "sweep programs" and for disclosures about existing sweep arrangements.

1. To comply with NYSE Rule 472(f)'s prohibition on communications that contain any untrue statement, omit a material fact, or are otherwise false or misleading, the NYSE stated that firms must include in their disclosures or agreements any conflicts of interest in connection with cash sweep programs, including whether the firm receives compensation or other benefits for customer balances maintained at the receiving bank, and if so the expected range of such compensation, as well as a disclosure of the difference, if any, between the rates of return applicable to an existing money market fund and the proposed bank sweep fund.

2. One conflict noted by the NYSE is that, when customer funds are swept to an affiliated bank, it is in the interest of the member organization and its affiliate to pay as low a rate as possible, while of course the customer wishes to obtain the highest rate possible.

**F.** **NASD NTM 05-26: Best Practices for Reviewing New Products.** In 2005, motivated by a concern that some of the increasingly complex products being introduced had unique features not well understood by investors or registered persons or raised concerns about suitability and potential conflicts of interest, the NASD published recommended best practices for reviewing new products.

1. The NASD said that procedures for developing and vetting new products should, at a minimum, (i) include clear, specific and practical guidelines for determining what constitutes a new product, (ii) ensure that the right questions are asked and answered before a new product is offered for sale, and (iii) when appropriate, provide for post-approval follow-up and review, particularly for products that are complex or are approved only for limited distribution.

2. Among the factors that should determine whether a product is "new" and should be subjected to the review is whether the product raises conflicts that have not previously been identified and addressed.

3. Among the questions that every firm should ask and answer before offering a new product for sale are the following questions intended to identify potential conflicts of interest:

   (a) What are the risks for investors? If the product was designed mainly to generate yield, does the yield justify the risks to principal?

   (b) What costs and fees for the investor are associated with this product? Why are they appropriate? Are all of the costs and fees transparent? How do they compare with comparable products offered by the firm or by competitors?

   (c) How will the firm and registered representatives be compensated for offering the product? Will the offering of the product create any conflicts of interest between the customer and any part of the firm or its affiliates? If so, how will those conflicts be addressed? For example, does the firm stand to benefit from the sale of the product beyond the clearly disclosed sales charges or commissions (*i.e.*, are there revenue sharing or similar arrangements)? If so, the firm may have an obligation under NASD Rule 2110, governing just and equitable principles of trade, to disclose that conflict, even if the product is otherwise suitable for an investor.

4. A new product should not be offered if it is not suitable for targeted investors or presents insurmountable conflicts between the firm and its customers.

**G.** **NASD NTM 05-51: Volume-Weighted Average Price Transactions.** In 2005, the NASD issued Notice to Members 05-51 to remind member firms that, when executing a volume-weighted average price (VWAP) or other large, potentially market-moving transactions for a customer, it is inconsistent with just and equitable principles of trade and a firm's best execution obligations to engage in proprietary trading activity that compromises the customer's interest in favor of a member's proprietary trading interest. Moreover, firms who have received such orders have a duty to disclose in writing to the customer that the firm may engage in hedging or other positioning activity that could affect the market for a security that is involved in the transaction. Depending on the nature of the order and the specificity known about it by the firm, a duty to disclose such trading activity may arise even before the firm is awarded the order for execution.

- The disclosure must be made prior to receipt and/or execution of the order and be in the form of an affirmative consent letter that covers potential hedging and positioning transactions related to the handling of VWAP and other large orders. Firms need not obtain affirmative consent on a transaction-by-transaction basis; however, they should at least annually take steps to have their customers reaffirm their consent.

- Other than for the purpose of fulfilling the customer order, a firm may not trade for its proprietary account on the non-public information it receives from the current or prospective customer or communicate such non-public information to another entity or person outside of the firm. Such conduct is inconsistent with just and equitable principles of trade and may also violate other NASD rules or the federal securities laws. A firm may continue to engage in market making or proprietary trading in the subject securities only where it has established effective information barriers reasonably designed to prevent internal disclosure of the nonpublic information.

- Whether or not they have disclosed their proposed activities, firms also may not take any steps to create an artificial appearance of demand (or supply) for the security or establish artificially high (or low) prices by engaging in unnecessary trading, increased quote activity, or entering orders around the close of when a VWAP or other large order is executed.

**H.** **Back-Book Trading.** A task force has been formed by the NYSE to focus on conflicts in so-called "back book" trading. "Back book" trading occurs when a broker-dealer buys a portion of a block trade from an institutional customer when the firm cannot find a third-party buyer. The concern that has been expressed is that the broker-dealer might purchase the block for the firm's own account, knowing that the stock price is going to increase. Specific areas to be reviewed include:

- Whether the trader who makes the trade for the firm should be allowed to trade that stock from the firm's account or whether the stocks should be held in different accounts.

- What information barriers need to be constructed to prevent conflicts.

- Standards for due diligence to demonstrate that the trader has sufficiently tried to sell the block in the market.

## I. Continuing Focus on Research Analysts

1. **Enforcement Actions for Rule Violations**. The SEC, SROs and other regulators continue to investigate and bring actions involving alleged violations of the rules governing the issuance of research reports and conduct of research analysts. Among others, the alleged violations include:

   - Trading by an analyst contrary to the views expressed in the analyst's published research reports.
   - Trading during the SRO imposed research quiet periods.
   - Retaliation against analysts who issue (or propose to issue) reports or recommendations unfavorable to the firm's investment banking clients.
   - Failure to include required disclosures in research reports.

2. **Relationships with Hedge Fund Managers.** According to Thomas Biolsi, associate regional director for examinations in the SEC's Northeast Regional Office, the SEC staff is currently reviewing brokerage analysts' relationships with hedge funds. In particular, it appears that some hedge fund managers have been marketing their funds to brokerage analysts and it is possible that they are doing so because the analyst can provide the manager with information about the subjects of the analysts' research and in which the hedge fund invests.[21]

3. **Proposed Amendments to SRO Analyst Rules.** On September 27, 2006, the NASD and NYSE each filed two proposed amendments to the SRO Analyst Rules discussed in Part IV.B above.[22] One of the

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[21] SEC Reviews Analysts' Relationships with Hedge Fund Managers, Compliance Reporter, Oct. 2, 2006, pp. 1, 16.

[22] SR-NASD-2006-113, Proposed Rule Change To Amend NASD Rules 1050 and 2711 Relating to Research Analyst Conflicts of Interest http://www.nasd.com/RulesRegulation/RuleFilings/2006RuleFilings/NASDW_017554; SR-NASD-2006-112, Proposed Rule Change to Amend NASD Rule 2711 to Codify Existing Interpretive Guidance Relating to Research Analyst Rules,

proposed amendments would incorporate certain guidance from two joint interpretative memoranda previously published by the NASD and NYSE. The other, which resulted from a joint report issued by the NASD and NYSE in December 2005 regarding the operation and effectiveness of the SRO Analyst Rules, proposes the following changes:

- Exclude from the definition of "research report" sales material regarding open-end registered investment companies not listed or traded on an exchange and direct public participation programs. (Comment is requested regarding whether Exchange Traded Funds or "ETFs" should also be excluded.)

- Exempt from the registration and qualification requirements associated persons for whom the provision of investment research is not a primary job function, such as a registered representative who occasionally produces communications that technically meet the definition of "research report" and are distributed to 15 or more clients, or a trader who similarly produces market commentary that includes an analysis of an individual security.

- Eliminate permission for pre-publication review of research for factual accuracy by investment banking and other non-research employees. (Note that such contact is already prohibited under the terms of the Global Research Analyst Settlement.)

- Eliminate the quiet period for secondary offerings, and adopt a uniform 25-day quiet period for all participating underwriters and dealers in IPOs (including managers and co-managers).

- Modify the quiet period around the expiration, waiver or termination of lock-up agreements.

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http://www.nasd.com/RulesRegulation/RuleFilings/2006RuleFilings/NASDW_017551; SR-NYSE-2006-78, Proposed Amendments to Rules 344 and 472 Incorporating SRO Report Recommendations to Research Analyst Conflicts Rules, http://apps.nyse.com/commdata/pub19b4.nsf/docs/790CA663E8440738852571F600716E07/$FILE/NYSE-2006-78.pdf; SR-NYSE-2006-77, Proposed Amendments Codify Prior Interpretative Guidance to Research Analyst Conflicts Rule, http://apps.nyse.com/commdata/pub19b4.nsf/docs/729A630785C882E0852571F600716DF0/$FILE/NYSE-2006-77.pdf.

- The NASD proposes eliminating this quiet period in favor of a certification that the member has a bona fide reason for issuing research within 15 days before or after the lock-up expiration and the research was not otherwise issued for any reason pertaining to conditioning the market price of the subject security.

- The NYSE proposes reducing this quiet period from 15 to 5 days on either side of the lock-up expiration and also adding an interpretation that an announcement of earnings is "significant news" that would qualify for the exception to the quiet period for the publication or distribution of research or a public appearance concerning the effects of significant news or significant events on the subject company.

- Modify the NASD personal trading restrictions to permit investments in any fund so long as neither the analyst nor any member of the analyst's household is aware of the fund's holdings or transactions other than through periodic shareholder reports (including sales material based on such reports) and provided that the analyst owns no more than 1% of the fund. The NYSE is not proposing to make this change, but seeks comment on whether it should do so.

- Modify the personal trading restrictions to permit orderly divestment (with compliance and legal oversight) by analysts in the event the firm decides to prohibit their analysts from owning shares of the companies they cover.

- Permit members with a conflict of interest to disclose their conflicts of interest by including a prominent warning (in language set out in the rule) on the cover of a research report that such conflicts exist, together with information on how the reader may obtain more detail from the member's web site, in lieu of publishing the details in the research report itself.

  - The disclosure would have to cite actual conflicts of interest rather than the possibility of such conflicts.

  - Comment is requested regarding whether the same disclosure could be used for disclosures of conflicts in public appearances.

- Other required disclosures (*e.g.*, the price chart and information about the member's ratings) would still need to appear in the report itself.

- Extend the prohibition on retaliation against analysts to cover retaliation by *any* employee (rather than only the member and employees involved in the member's investment banking activities).

- Exclude from the definition of "research analyst account" registered investment companies over which the analyst or a household member has discretion or control but no financial interest other than a performance or management fee.

- Extend the prohibition of research analysts engaging in communications with current or prospective customers in the presence of investment banking personnel or company management about an investment banking services transaction to also cover such communications with internal sales personnel.

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Questions regarding this outline may be directed to Dana G. Fleischman or David Aman at Cleary Gottlieb Steen & Hamilton LLP (212-225-2000).

CLEARY GOTTLIEB STEEN & HAMILTON LLP

**NEW YORK**
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

**WASHINGTON**
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

**PARIS**
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 45 63 66 37 Fax

**BRUSSELS**
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

**LONDON**
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

**MOSCOW**
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 501 258 5006
7 501 258 5011 Fax

**FRANKFURT**
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

**COLOGNE**
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

**ROME**
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

**MILAN**
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

**HONG KONG**
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

**BEIJING**
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax