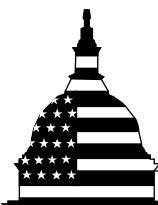


January 2012

SECURITIES
RESEARCH

Additional Actions
Could Improve
Regulatory Oversight
of Analyst Conflicts of
Interest



G A O

Accountability * Integrity * Reliability

Why GAO Did This Study

In 2003 and 2004, the Securities and Exchange Commission (SEC), self-regulatory organizations (SRO), and others settled with 12 broker-dealers to address conflicts of interest between the firms' research and investment banking personnel. The regulators alleged that the firms allowed their investment bankers to pressure equity research analysts in ways that could cause them to issue misleading research to the harm of investors. Under the Global Research Analyst Settlement (Global Settlement), the firms had to undertake reforms designed to sever links between research and investment banking. The SROs also adopted equity research rules to address analyst conflicts across the industry, but these rules were not as stringent in some areas as the Global Settlement. The Dodd-Frank Wall Street Reform and Consumer Protection Act required GAO to study these issues. This report discusses (1) what is known about the effectiveness of the regulatory actions taken to address analyst conflicts and (2) what further actions, if any, could be taken to address analyst conflicts. GAO reviewed empirical studies and SEC and SRO rules, examination findings, and enforcement actions. GAO interviewed SEC and Financial Industry Regulatory Authority (FINRA) staff, and market participants and observers.

What GAO Recommends

GAO recommends that SEC formally assess and document whether any of the Global Settlement's remaining terms should be codified. SEC agreed with the recommendation.

View [GAO-12-209](#). For more information, contact A. Nicole Clowers at (202) 512-8678 or clowersa@gao.gov.

SECURITIES RESEARCH

Additional Actions Could Improve Regulatory Oversight of Analyst Conflicts of Interest

What GAO Found

Existing research and stakeholder views suggest that the Global Settlement and other regulatory actions have helped to address conflicts faced by equity research analysts. The results of the empirical studies that GAO reviewed generally suggest that the Global Settlement and equity research rules adopted by the SROs were associated with improvements in analysts' stock recommendations. FINRA officials and SEC staff told GAO that the regulatory reforms have been effective, citing minor deficiencies in their examinations and the limited number of enforcement actions involving conflicts between research and investment banking as evidence of the reforms' effectiveness. Independent monitors, which were required as part of the Global Settlement, also found that the 12 firms generally were complying with the Global Settlement. Finally, broker-dealers, institutional investors, and others told GAO that the regulatory actions have helped insulate equity research from investment banking influence, although some noted that not all conflicts can be eliminated and certain restrictions can be circumvented.

Although SEC and FINRA have been taking regulatory action to further address conflicts faced by research analysts, additional action is warranted. FINRA has been working to finalize a rule proposal designed to broaden the obligations of firms to identify and manage equity analyst conflicts and better balance the goals of helping ensure objective and reliable research with minimizing regulatory costs and burdens. FINRA also has been working to finalize another rule proposal that would address conflicts faced by debt research analysts. The current SRO research rules do not cover debt research analysts, although these analysts face conflicts of interests similar to those faced by their equity analyst counterparts. In the absence of an SRO debt research rule, the SROs have relied on antifraud statutes and SRO rules requiring ethical conduct. They also have encouraged firms—with limited success—to comply voluntarily with industry-developed principles designed to address debt analyst conflicts. FINRA plans to package its two rule proposals together and submit them to SEC in the first half of 2012. In contrast, SEC and FINRA have not proposed codifying the Global Settlement's remaining terms. At the request of the broker-dealers, a court modified the Global Settlement in 2010 and eliminated settlement terms where, for the most part, comparable SRO rules existed. Nonetheless, some of the Global Settlement's terms that serve to protect investors have not been codified. As a result, the Global Settlement firms continue to be subject to the requirements of the Global Settlement and the SRO research analyst rules, while other firms that provide the same services are subject only to the SRO research analyst rules. As a result, investors may not be provided the same level of protection. GAO has previously reported that a regulatory framework should ensure that market participants receive consistent and useful information as well as consistent protections for similar financial products and services. SEC staff told GAO that they periodically have discussed and analyzed the Global Settlement terms but have not formally assessed and documented whether any of the Global Settlement's remaining terms should be codified. By not formally assessing whether codifying any of the Global Settlement's remaining terms provides an effective way of furthering investor protection, SEC may be missing an opportunity to provide the same level of protection for all investors.

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Abbreviations

BMA	The Bond Market Association
FINRA	Financial Industry Regulatory Authority
Global Settlement	Global Research Analyst Settlement
NASD	National Association of Securities Dealers
NASAA	North American Securities Administrators Association
NYSE	New York Stock Exchange
SEC	Securities and Exchange Commission
SRO	self-regulatory organizations

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G A O

Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

January 12, 2012

The Honorable Tim Johnson
Chairman
The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing and Urban Affairs
United States Senate

The Honorable Spencer Bachus
Chairman
The Honorable Barney Frank
Ranking Member
Committee on Financial Services
House of Representatives

In 2003, federal and state authorities reached a landmark settlement with 10 of the nation's top broker-dealers¹ to address conflicts of interest between their equity research analysts and investment bankers—resulting in more than \$1.4 billion in penalties and other payments.² In the enforcement actions leading to the Global Research Analyst Settlement (Global Settlement), the Securities and Exchange Commission (SEC) and other authorities alleged that the firms allowed their investment bankers to pressure equity research analysts in ways that could and, in some cases, did cause them to issue misleading or false research to the potential harm of investors. For example, investment bankers at certain firms could influence the amount of compensation received by equity analysts, potentially enabling them to pressure the analysts into improperly promoting the stocks of companies whose investment banking business the firms were seeking to attract. To resolve the allegations of

¹In 2004, the federal and state authorities commenced enforcement actions against 2 other broker-dealers involving analyst conflicts, and the firms settled substantively under the same terms as the other 10 firms.

²Conflict of interest often describes a situation in which a fiduciary who, contrary to the obligation and duty to act for the benefit of a designated individual, exploits the relationship for personal benefit. We are defining a conflict of interest more generally in this report as a situation in which financial or other personal considerations reasonably could interfere with the independence of an analyst's securities research or recommendations. However, it is important to note that the existence of a potential conflict of interest does not necessarily mean that research analysts or their research is biased.

misconduct, the broker-dealers agreed under the Global Settlement to implement a number of structural reforms intended to sever links between equity research and investment banking, thereby insulating analysts from investment banking influence or pressure.

Prior to the Global Settlement, the National Association of Securities Dealers (NASD) and New York Stock Exchange (NYSE)—the principal self-regulatory organizations (SRO) in the securities industry at the time—had adopted rules specifically to address analyst conflicts at their member firms.³ They later amended their rules to include additional requirements that were similar to some of the Global Settlement’s reforms. Although the NASD and NYSE rules generally apply across the industry—not just to the broker-dealers subject to the Global Settlement (Global Settlement firms), the rules are less stringent than the Global Settlement’s reforms in some areas and more stringent in other areas.⁴ In that regard, some market observers have raised concerns that the current lack of industrywide rules mirroring the Global Settlement’s reforms creates regulatory inconsistencies: for example, investors could be provided with different levels of protection, depending on whether the securities research was produced by a Global Settlement firm or other firm.

Section 919A of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires us to identify and examine potential conflicts of interest between investment banking and both equity and fixed-income (debt) research staff in the same firm.⁵ This report examines (1) the effectiveness of the regulatory actions taken to address research analyst

³An SRO is an entity responsible for regulating its members by adopting and enforcing rules that govern its members’ business conduct. In 2007, NASD and NYSE’s member regulation, enforcement, and arbitration functions merged to form the Financial Industry Regulatory Authority, the primary securities industry SRO responsible for overseeing broker-dealers.

⁴The Global Settlement includes provisions requiring the firms to reform their practices in many areas where investment bankers can influence or pressure research analysts. As described in appendix II, many of these provisions have been incorporated into the SRO rules. However, the SRO rules also cover areas where research and investment banking can intersect but which are not covered under the Global Settlement. These include an anti-retaliation provision, a prohibition on the promise of favorable research, quiet periods, personal trading restrictions, specific disclosure requirements, and restrictions on communication with a subject company regarding a research report.

⁵Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 919A, 124 Stat. 1376, 1837-1838 (2010).

conflicts of interest, and (2) additional actions regulators could take to further address research analyst conflicts.

To understand the nature of research analyst conflicts and identify regulatory actions to address them, we reviewed academic, GAO, and other studies; enforcement actions taken by SEC and state attorneys general beginning in the early 2000s; existing and proposed SEC and SRO rules and other releases; and Global Settlement documents. To help evaluate the effectiveness of regulatory actions taken to address research analyst conflicts, we reviewed and analyzed studies that empirically examined the effects of the regulatory reforms on analyst research and recommendations. We limited our review to studies issued after January 1, 2005, because of the time frames in which the regulatory reforms were adopted. We also analyzed data on relevant broker-dealer examinations and investigations conducted by the Financial Industry Regulatory Authority (FINRA) between 2005 and 2010, SEC and FINRA enforcement actions that involved conflicts between research and investment banking and were taken between 2005 and 2010, and independent monitor reports that assessed the Global Settlement firms' compliance with the Global Settlement.⁶ We assessed the reliability of the examination and investigation data obtained from FINRA and found the data sufficiently reliable for our purposes. To gain insights on the effectiveness of the regulatory actions taken to address analyst conflict and to identify additional actions that could be taken to address such conflicts, we interviewed officials from SEC, FINRA, and the North American Securities Administrators Association (NASAA), including officials from five of its member state securities commissions. We also interviewed academics and representatives from broker-dealers, institutional investors, independent research firms, and associations representing such entities and retail investors. Our report focuses on potential conflicts between a broker-dealer's research analysts and investment bankers and is not a comprehensive review of potential conflicts that could arise from other sources. Appendix I contains more information on our scope and methodology, and we provide a list of studies included in our literature review at the end of the report.

⁶FINRA is an SRO. It is involved in various aspects of the securities business, including registering and educating industry participants, examining securities firms, writing rules, enforcing those rules and the federal securities laws, informing and educating the investing public, providing trade reporting and other industry utilities, and administering a dispute resolution forum for investors and registered firms.

We conducted this performance audit from September 2010 to January 2012 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Broker-Dealers May Provide a Range of Services, Including Research for Investors

Broker-dealers may provide a range of financial services to clients, including corporations, financial institutions, governments, and individuals. A full-service broker-dealer (or a related subsidiary or affiliate) may employ (1) investment bankers to assist clients with raising capital through underwritings and private placements of equity and debt securities and by offering advisory services on mergers, acquisitions, and restructurings; (2) investment advisers who provide investment advisory and financial planning services to clients; (3) brokers who facilitate client transactions in fixed-income, equity, currency, and commodity products; and (4) securities research analysts who provide equity and fixed-income research services.

Securities research analysts play an important role in providing investors with information that may affect their investment decisions. Analysts typically research the current and prospective financial condition of publicly traded companies in the particular industry or sector of the economy in which they specialize. They then make recommendations (e.g., buy, sell, or hold) about investing in the securities issued by the companies the analysts cover in their research.⁷ To develop judgments about the future prospects of a company and its securities, analysts may evaluate the company's expected earnings, revenue, and cash flow; operating and financial strengths and weaknesses; long-term viability; and dividend potential.

⁷Although research analysts usually summarize their research reports with a brief recommendation, firms use their own rating system. For example, one firm's rating system may consist of buy, outperform, neutral, underperform, and avoid recommendations, and another firm's rating system may consist of strong buy, buy, hold, and sell recommendations.

Analysts often specialize in equity or fixed-income (debt) securities research.⁸ Sell-side analysts typically work for full-service broker-dealers and make recommendations on the securities they cover through their research. In contrast, buy-side analysts typically work for institutional money managers, such as mutual funds, hedge funds, or investment advisers, which purchase securities for their own accounts. Finally, independent analysts typically are not associated with firms that underwrite the securities they cover in their research.

Oversight of Securities Broker-Dealers and the Global Settlement

The securities industry generally is regulated under a combination of self-regulation (subject to oversight by SEC) and direct oversight by SEC. Securities industry SROs primarily are responsible for establishing the standards under which their members conduct business; monitoring the way that business is conducted through regularly scheduled compliance examinations; bringing disciplinary or enforcement actions against their members for violating applicable federal statutes, SEC rules, and their own rules; and referring potential violations of nonmembers to SEC.⁹ In 2007, NASD and NYSE's member regulation, enforcement, and arbitration functions merged to form FINRA, the primary securities industry SRO responsible for overseeing broker-dealers.¹⁰ As of November 2011, FINRA's membership included nearly 4,500 broker-dealers. According to FINRA, as of November 2010, approximately 220 firms conduct both investment banking and research. SEC's oversight of FINRA includes inspecting its operations and reviewing and approving its rule proposals. SEC also directly regulates broker-dealers by conducting

⁸Although equity and fixed-income securities analysts serve similar functions, the nature of the markets and role of the analysts can differ. For example, some market participants have noted that prices of debt securities are relatively less sensitive to the views of research analysts than the prices of equity securities. For example, see the Bond Market Association, *Guiding Principles to Promote the Integrity of Fixed-Income Research: A Global Approach to Managing Potential Conflicts of Interest* (May 2004).

⁹As part of their statutory responsibilities for regulating their members, SROs examine their members to ensure compliance with SRO rules and federal securities laws. SROs also can take enforcement or other disciplinary actions against their members for violations of SRO rules and federal securities laws.

¹⁰FINRA has been developing a consolidated rulebook that will consist solely of FINRA rules. Until the completion of this process, the FINRA rulebook will include NASD rules, NYSE rules, and FINRA rules. While the NASD rules generally apply to all FINRA members, the NYSE rules apply only to those members of FINRA that also are members of NYSE.

examinations; taking disciplinary actions against broker-dealers; and interpreting, implementing, or changing its existing regulations.

A series of actions involving various federal and state entities culminated in the Global Settlement. SEC reviewed industry practices and conducted targeted examinations regarding analyst conflicts in 1999 and reported the preliminary findings of the examinations to Congress in 2001. In April 2002, the New York Attorney General's office announced an enforcement action against a broker-dealer based on evidence that analysts were pressured to issue positive stock recommendations to please investment banking clients. Soon after, state regulators, SROs, NASAA, and SEC formed a joint task force to investigate the undue influence of investment banking interests on securities research at broker-dealers. Analyst conflicts allegedly found by the investigations included the following examples.

- Research analysts supported investment banking by pitching business to prospective clients and marketing investment banking deals to institutional customers through road shows.¹¹
- Equity research analysts' compensation was determined partly by the degree to which they assisted investment banking or their contribution to investment banking revenue.
- Investment bankers evaluated research analysts' performance, influencing research analysts' compensation.
- Investment bankers implicitly promised their potential clients favorable research, with analysts participating in the sales presentations.
- Investment bankers influenced whether analysts would start or continue research coverage on existing or potential investment banking clients.

Based on evidence compiled in their investigations, the joint task force members determined the conditions of a settlement to resolve the allegations of misconduct. In April 2003, 10 broker-dealers agreed to the Global Settlement, concluding the joint investigation. In 2004,

¹¹A road show is a series of presentations made to potential investors in conjunction with the marketing of an upcoming underwriting.

enforcement actions were commenced against two other broker-dealers involving analyst conflicts, and the firms settled substantively under the same terms as the Global Settlement.

Under the Global Settlement, the firms were required to reform their structures and practices to insulate equity analysts from investment banking pressures. A three-part addendum to the Global Settlement constitutes its operative portions (see app. II for a complete description for the separation of research and investment banking, and the disclosure/transparency and other issues sections).¹² Section I of the addendum set forth the structural reforms designed to separate equity research from investment banking. For example, the firms had to

- physically separate research and investment banking departments;
- not base research analysts' compensation, directly or indirectly, on investment banking revenues or input from investment banking personnel;
- prohibit investment bankers from having a role in company-specific coverage decisions;
- prohibit research analysts from participating in efforts to solicit investment banking business; and
- create and enforce firewalls restricting interaction between investment banking and research personnel, except in specifically designated circumstances.

Section II of the addendum includes disclosure requirements that serve to inform investors about potential analyst conflicts and the performance of analysts' recommendations. It also includes a provision that allows any Global Settlement term to be superseded by an SEC or SRO rule that expressly purports to do so. With regards to any term that was not superseded in this way within 5 years from the entry of the final judgment of the Global Settlement, the firms could move to amend or modify any term (other than the terms relating to independent research), subject to court approval, unless SEC believed that such amendment or

¹²Appendix II does not include a discussion of the independent, third-party research section because the section is no longer in effect.

modification was not in the public interest. Section III required the Global Settlement firms to provide customers with independent research.¹³

Firms also had to make various payments under the Global Settlement—totaling more than \$1.4 billion. Specifically, each firm had to pay civil penalties and disgorgements, in part to establish distribution funds to recompense harmed investors, and other monies to create investor education funds and provide customers with independent research.¹⁴

Analyst Conflicts and Investor Harm

Views about what harm, if any, analyst conflicts cause investors vary. SEC and FINRA have asserted that analyst conflicts can harm investors. For instance, because of a conflict, an analyst could issue a misleading recommendation on which investors rely and suffer a loss. In a 2003 report, the International Organization of Securities Commissions similarly noted that the conflicts faced by sell-side analysts can result in biased research that harms investors and undermine the fairness, efficiency, and transparency of markets.¹⁵ Also, some investors claimed in lawsuits that biased analyst recommendations artificially inflated market prices of the covered stocks. In turn, they claimed that they bought stocks or held onto stocks that they otherwise would have sold based on the biased recommendations and suffered losses when the stocks returned to their true value. Finally, some academics have suggested that institutional investors may be able to trade strategically to take advantage of

¹³This obligation expired for most of the Global Settlement firms in July 2009.

¹⁴A penalty is a monetary payment from a securities law violator that SEC obtains pursuant to statutory authority. A penalty fundamentally is a punitive measure, but penalties occasionally can be used to compensate harmed investors. A disgorgement is the repayment of illegally gained profits (or avoided losses) for distribution to harmed investors whenever feasible.

¹⁵International Organization of Securities Commissions, Report on Analyst Conflicts of Interest, A Report of the Technical Committee of the International Organization of Securities Commissions (September 2003). Sell-side research analysts typically work for full-service broker-dealers and make recommendations on the securities they cover.

misinformed individual investors that naively follow biased analyst recommendations.¹⁶

In contrast to such views, some economists and others have questioned whether biased analyst recommendations, such as overly optimistic recommendations, can lead to investor harm. For example, one economist has argued that SEC enforcement actions against the Global Settlement firms did not establish a clear connection between the analyst conflicts and losses suffered by investors.¹⁷ In support of his argument, he noted that in private litigation against one of the firms involving analyst conflicts, the judge found that the plaintiff's attorneys were not able to craft an argument to show that investor losses could be attributed to the allegedly conflicted research reports issued by a broker-dealer. In addition, some evidence from empirical studies indicates that market prices anticipate and incorporate analysts' biases, suggesting that biased analyst recommendations do not artificially inflate stock prices to the harm of investors.¹⁸

¹⁶See, for example, Gus De Franco, Hai Lu, and Florin P. Vasvari, "Wealth Transfer Effects of Analysts' Misleading Behavior," *Journal of Accounting Research*, vol. 45 (2007). The study examined the economic consequences of the trading behavior of individuals and institutions over the period in which the equity analysts at the Global Settlement firms allegedly issued biased recommendations. It found statistical evidence suggesting that the recommendations issued by analysts led to a systematic wealth transfer from individual investors to institutional investors.

¹⁷Erik Sirri, "Investment Banks, Scope, and Unavoidable Conflicts of Interest," *Economic Review*, Federal Reserve Bank of Atlanta, Fourth Quarter 2004.

¹⁸For example, see Oya Altinkılıç and Robert S. Hansen, "On the Information Role of Stock Recommendation Revisions," *Journal of Accounting and Economics*, vol. 48 (2009); Hamid Mehran, René M. Stulz, "The Economics of Conflicts of Interest in Financial Institutions," *Journal of Financial Economics*, vol. 85 (2007); Erik Sirri, "Investment Banks, Scope, and Unavoidable Conflicts of Interest," *Federal Reserve of Atlantic Economic Review*, 4th Quarter (2004).

Data and Stakeholders' Views Suggest That Regulatory Actions Have Helped Address Conflicts Faced by Equity Analysts

We reviewed empirical studies, analyzed examination and enforcement action data, and interviewed market participants and observers to assess the extent to which regulatory actions have addressed equity analysts' conflicts of interest. In addition to the Global Settlement, regulatory actions taken to address conflicts faced primarily by equity research analysts include the following SEC, NASD, and NYSE rules issued between 2002 and 2005:

- In May 2002, SEC approved NASD and NYSE proposals to address analyst conflicts. NYSE's proposal amended NYSE Rule 472, and NASD's proposal established NASD Rule 2711.¹⁹ These rules (SRO research analyst rules) were substantively similar and designed to restore public confidence in the validity of research and the veracity of equity research analysts, who were expected to function as unbiased intermediaries between securities issuers and investors. The SRO research analyst rules require clear, comprehensive, and prominent disclosure of conflicts in research reports and public appearances by equity analysts. The rules also implement basic reforms to separate research from investment banking. These include prohibiting investment banking personnel from supervising analysts or approving research reports, members from offering favorable research to induce investment banking business, and analysts from receiving compensation based on specific investment banking transactions.
- In February 2003, SEC adopted Regulation Analyst Certification, which requires, among other things, equity and fixed-income analysts to certify that the views expressed in their research reports accurately reflect their personal views and disclose whether they received compensation or other payments in connection with their views.
- In July 2003, SEC approved amendments to the SRO research analyst rules.²⁰ The rule amendments were designed to further promote analyst objectivity and transparency of conflicts in research

¹⁹NYSE also proposed amendments to NYSE Rule 351 to require members to submit, on an annual basis, a written attestation that they have established and implemented written procedures reasonably designed to comply with NYSE Rule 472. SEC approved the amendment.

²⁰As part of these amendments, SEC approved SRO rules that put in place registration and qualification requirements for research analysts. The rules were intended to ensure that research analysts possess a certain competency level to perform their jobs effectively and in accordance with applicable rules and regulations.

reports and implement changes mandated by the Sarbanes-Oxley Act of 2002. This act required SEC or SROs to adopt rules “reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances.” The act also set forth specific rules to be promulgated, some of which were not already in the SRO research rules, including the prohibition on research analysts participating in investment banking pitches. Accordingly, NASD and NYSE amended their rules. The amendments require disclosure of a client relationship and noninvestment banking compensation a firm receives from a covered company and prohibit retaliation against research analysts for publishing unfavorable research on an investment banking client.

- In April 2005, SEC approved an amendment to the SRO research analyst rules to prohibit research analysts from participating in road shows and other matters, which are similar in certain aspects to the Global Settlement’s terms.

While the SRO research analyst rules generally apply to all broker-dealers, they are less stringent than the Global Settlement’s terms in some respects and more stringent in other respects (as discussed in detail in the following section and in app. II).

Research Suggests Regulatory Reforms Were Associated with Improvements in Analyst Recommendations, but Other Effects Were Mixed

Numerous academic studies empirically examined the effects of the regulatory reforms—namely NASD Rule 2711, NYSE Rule 472, and the Global Settlement—on various aspects of recommendations and research issued by research analysts. We reviewed 10 of these studies.²¹ Because the vast majority of the outstanding recommendations in mid-2000 were buy recommendations (in contrast to hold or sell), some market observers believed that sell-side equity analysts were issuing overly optimistic or positive recommendations to help their firms attract or retain investment banking business. Six of the 10 studies in our review examined whether the reforms made sell-side analyst recommendations less optimistic, and these and the other studies also examined other

²¹Although the breadth of research on research analyst conflicts is extensive, we focused our review of the literature on academic studies that empirically examined the effects of the regulatory reforms on recommendations and research issued by sell-side securities analysts. We included both published papers and working papers but limited our review to studies issued after January 1, 2005.

Empirical Results Indicate Relationship between the Reforms and Less Optimistic Analyst Recommendations

effects of the reforms.²² The studies generally found evidence that indicated the stock recommendations of sell-side analysts became less optimistic after the regulatory reforms, suggesting the reforms have helped to address analyst conflicts. In addition, some of these studies examined other effects, such as whether one or more of the reforms made analyst recommendations more informative for investors, increased the profitability of recommendations, or increased the accuracy of analyst earnings forecasts. However, these results generally were mixed.

Five of the six studies examining changes in the distribution or relative optimism of recommendations issued by analysts found that sell-side analysts were issuing fewer positive recommendations, more negative recommendations after the regulatory reforms, or both.²³ While the studies commonly inferred from the empirical evidence that the regulatory reforms helped to make recommendations less optimistic, they recognized that other factors could have played a role. Key findings of these studies include the following:

- Buy recommendations of analysts at investment banks and brokers increased substantially from 1996 to 2000, with the ratio of buy-to-sell recommendations reaching 35 to 1 at one point.²⁴ From mid-2000 to June 2003, the percentage of buy recommendations declined steadily, with the ratio declining to 3 to 1. The buy recommendations issued by the Global Settlement analysts declined more sharply than the buy recommendations issued by other analysts after the adoption of NASD Rule 2711.

²²As noted previously, sell-side research analysts typically work for full-service broker-dealers and make recommendations on the securities they cover. The studies we reviewed generally focus on sell-side research analysts but may use affiliated analysts or other terms to refer to them and may draw distinctions between them.

²³Leslie Boni, "Analyzing the Analysts after the Global Settlement," working paper, University of New Mexico (Sept. 28, 2005). The author classified recommendations made by the Global Settlement analysts as "high" (strongest recommendation), "medium" (middle), and "low" (least strongly recommended) and found that the analyst recommendations were more optimistic after the Global Settlement. However, these results do not attempt to control for differences in analyst characteristics and other factors that might influence recommendations.

²⁴Brad Barber, M. Reuven Lehavy, Maureen McNichols, and Brett Trueman, "Buys, Holds, and Sells: The Distribution of Investment Banks' Stock Ratings and the Implications for the Profitability of Analysts' Recommendations," *Journal of Accounting and Economics*, vol. 41 (2006). The study focuses on analysts at investment banks and brokerage firms, with a sample period from January 1996 through June 2003.

-
- Analysts affiliated with firms engaging in investment banking issued fewer strong buy recommendations after the regulatory reforms and fewer strong buy recommendations than independent analysts after the adoption of NASD Rule 2711, NYSE Rule 472, and the Global Settlement.²⁵
 - Settlement bank analysts issued, on average, less-optimistic recommendations relative to the other types of analysts after the adoption of NASD Rule 2711 and NYSE Rule 472, as well as the Global Settlement.²⁶ More specifically, these analysts issued not only fewer favorable recommendations but also more unfavorable recommendations than the other analysts for the same stocks.
 - After the adoption of NASD Rule 2711 and NYSE Rule 472, and the Global Settlement, analysts at the Global Settlement firms and the next 10 largest brokerage houses started to issue more neutral and pessimistic recommendations and fewer optimistic recommendations.²⁷ In addition, the Global Settlement analysts started to issue pessimistic recommendations much more often than analysts at the other brokerage houses.

²⁵Jonathan E. Clarke, Ajay Khorana, Ajay Patel, and P. Raghavendra Rau, "Independents' Day? Analyst Behavior Surrounding the Global Settlement," *Annals of Finance*, vol. 7, no. 4 (2009). The study focuses on (1) independent analysts whose employers were never classified as a lead or comanager on any equity deal or advised either the target or acquirer in an acquisition at any point in its sample period, (2) affiliated analysts whose employers advised a firm at any point during 2004-2007, and (3) unaffiliated analysts. The sample period was from November 2000 through December 2007.

²⁶Yuyan Guan, Hai Lu, and M.H. Franco Wong, "Conflict-of-Interest Reforms and Investment Bank Analysts' Research Biases," *Journal of Accounting, Auditing & Finance* (2011). The study focuses on analysts at investment banks, syndicate firms, brokerage firms, and research firms. The sample period (from January 1998 through December 2007) was divided into three subperiods: (1) from January 1998 through December 2001, the prereform period; (2) from January 2002 through December 2003, the transition period; and (3) from January 2004 through December 2007, the postreform period.

²⁷Leonardo Madureira, "Conflicts of Interest, Regulations and Stock Recommendations," working paper, University of Pennsylvania (2004). The study focuses on analysts at the 10 Global Settlement firms and the next 10 largest brokerage houses. Its sample period was from July 1995 through December 2003.

Empirical Results Suggest Relationship between the Reforms and Weakened Influence of Conflicts on Analyst Recommendations

Two studies found evidence indicating that the influence of conflicts of interest on analyst recommendations weakened after the regulatory reforms.

- Before the adoption of the regulatory reforms, analysts affiliated with brokers that recently underwrote securities were more likely to make buy recommendations for those securities than unaffiliated analysts.²⁸ The bias largely disappeared after the reforms. At the same time, affiliated analysts were less likely than unaffiliated analysts to issue hold or sell recommendations after the regulatory reforms.
- Before the adoption of NASD Rule 2711, sell-side analysts' recommendations were positively related to two variables—a company's net external financing and the underwriting business provided by analysts' employers—which were intended to capture factors that could lead sell-side analysts to issue overly optimistic recommendations to attract new or retain existing investment banking business.²⁹ After the rule adoption, the positive relationship continued but became weaker—suggesting that the influence of conflicts on analyst recommendations had weakened.

Empirical Results Suggest Association between the Reforms and Increased Analyst Independence

Two studies found that the relationship between analyst recommendations and valuation estimates strengthened after the regulatory reforms, indicating that the reforms improved analyst independence. The studies examined the relationship between the recommendations and earnings forecasts of sell-side analysts and expected these two variables to be positively correlated. Underlying the analysis is the assumption that analysts use their earnings forecasts to

²⁸Ohad Kadan, Leonardo Madureira, Rong Wang, and Tzachi Zach, "Conflicts of Interest and Stock Recommendations: The Effects of the Global Settlement and Related Regulations," *The Review of Financial Studies*, vol. 22, no. 10 (2009). The study focuses on analysts at brokers and covers two periods: (1) from November 2000 through August 2002, the preregulatory reform period, and (2) from September 2002 through December 2004, the postregulatory reform period.

²⁹Chih-Ying Chen and Peter F. Chen, "NASD Rule 2711 and Changes in Analysts' Independence in Making Stock Recommendations," *The Accounting Review*, vol. 84, no. 4 (2009). The study focuses on sell-side analysts and has a sample period from 1994 through 2005.

Empirical Results on Other
Effects of the Regulatory
Reforms Were Mixed

estimate stock values and then compare their valuation estimates to the current stock prices to arrive at their buy, hold, or sell recommendations.³⁰

- The consensus recommendations of sell-side analysts were negatively related to stock valuation estimates based on earnings forecasts before the adoption of SEC Regulation Full Disclosure. However, the relationship became less negative after the adoption of the regulation and turned positive after the adoption of NASD Rule 2711, NYSE Rule 472, and the Global Settlement.³¹
- The relationship between sell-side analysts' stock recommendations and valuation estimates based on earnings forecasts became significantly stronger after the adoption of NASD Rule 2711.³²

Most of the studies we reviewed also examined other effects of the regulatory reforms. However, the empirical results generally were mixed on whether the regulatory reforms increased the profitability of analysts' recommendations, made analysts' recommendations more informative for investors, or increased the accuracy of analysts' earnings forecasts. That is, some studies arrived at different conclusions about the effectiveness of the regulatory reforms on factors other than analyst independence and objectivity.

³⁰The studies further assume that their valuation models are the same models used by analysts and that these models do not vary across the firms. See Mark T. Bradshaw, "Analyst Information Processing, Financial Regulation, and Academic Research," *The Accounting Review*, vol. 84, no. 4 (2009).

³¹Ran Barniv, Ole-Kristian Hope, Mark J. Myring, and Wayne B. Thomas, "Do Analysts Practice What They Preach and Should Investors Listen? Effects of Recent Regulations," *The Accounting Review*, vol. 84, no. 4 (2009). The study focuses on sell-side analysts. Its sample period was from January 1993 through May 2005, divided into four subperiods corresponding to periods before and after the adoption of SRO research analyst rules and SEC Regulation Full Disclosure, effective October 2000. The SEC regulation prohibits issuers from selectively disclosing material nonpublic information to certain people—often, research analysts or institutional investors—before disclosing the same information to the public.

³²Chen and Chen, "NASD Rule 2711 and Changes in Analysts' Independence in Making Stock Recommendations."

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- Three studies examined whether the regulatory reforms improved the profitability of analyst recommendations.³³ The results of one of the studies suggested that NASD Rule 2711 enhanced the investment value of sell-side analyst recommendations, but the results of the other studies generally did not.³⁴
 - Four studies examined whether investors found analyst recommendations to be more informative after the regulatory reforms. Three studies found evidence indicating that investors viewed changes in recommendations made by sell-side analysts to be less or equally informative after the reforms.³⁵ One study found that after the adoption of NASD Rule 2711 the market reacted more strongly to buy and sell recommendations made by sell-side analysts.³⁶
 - Two studies examined the effect of the regulatory reforms on the accuracy of analyst earnings forecasts. One study found that the earnings forecasts of investment bank analysts became less accurate, on average, in comparison with the forecasts of other types of analysts after the regulatory reforms.³⁷ The other study found that the

³³The general question of whether analysts' stock recommendations have investment value has been studied extensively. Some studies suggest that investors can earn positive risk-adjusted returns by following stock recommendations, but other studies suggest that revisions of analysts' recommendation generally do not provide new information. For example, Lily H. Fang, and Ayako Yasuda, "Are Stars' Opinions Worth More? The Relation between Analyst Reputation and Recommendation Values," working paper (2010).

³⁴See Chen and Chen, "NASD Rule 2711 and Changes in Analysts' Independence in Making Stock Recommendations"; Guan et al., "Conflict-of-Interest Reforms and Investment Bank Analysts' Research Biases"; and Boni, "Analyzing the Analysts after the Global Settlement."

³⁵Clarke et al., "Independents' Day? Analyst Behavior Surrounding the Global Settlement"; Boni, "Analyzing the Analysts after the Global Settlement"; and Kadan et al., "Conflicts of Interest and Stock Recommendations: The Effects of the Global Settlement and Related Regulations."

³⁶Michael T. Cliff, "Do Affiliated Analysts Mean What They Say?" *Financial Management*, vol. 36, issue 4 (2007). The study focuses on two groups of analysts: (1) analysts at brokers that served as lead or joint-lead for a firm's securities issuance and (2) analysts at firms that do not perform a material amount of underwriting. Its sample period was between 1992 and 2005.

³⁷Guan et al., "Conflict-of-Interest Reforms and Investment Bank Analysts' Research Biases."

analyst forecasts overestimated actual earnings before the Global Settlement, but the bias declined after the Global Settlement.³⁸

SEC and SROs Generally View the Regulatory Reforms as Effective in Addressing Equity Analyst Conflicts

The SROs reviewed the effectiveness of the research analyst rules shortly after their adoption and concluded that the reforms were generally effective. At SEC's request, NASD and NYSE staff jointly conducted a review of the operation and effectiveness of their research analyst rules and submitted their report to SEC in December 2005.³⁹ As part of their study, NASD and NYSE staff reviewed examinations of their members for compliance with the research analyst rules, enforcement actions taken against members for violations of the rules, and academic studies and media reports and commentary. The NASD and NYSE staff concluded that the SRO research analyst rules were effective in helping to restore integrity to analyst research by minimizing the influences of investment banking and promoting transparency of other potential conflicts of interest. They also noted that evidence suggested that investors were benefiting from more balanced and accurate research to aid their investment decisions.

In addition, FINRA officials and SEC staff told us that they view the regulatory reforms as effective—citing their examination findings and the limited number of enforcement actions involving conflicts between research and investment banking as evidence of the reforms' effectiveness. According to FINRA officials, FINRA examines its member broker-dealers on a cyclical basis. The officials said that the scope of each examination is based on a risk-assessment of the firm. In that regard, although FINRA has developed examination modules to assess broker-dealer compliance with the SRO research analyst rules and the Global Settlement, examiners may not cover these areas in every examination. In addition, FINRA officials and SEC staff told us that they can bring enforcement actions against broker-dealers for violations of rule or statute. Examination findings and enforcement actions provide useful information on the extent to which firms have been complying with the

³⁸Armen Hovakimian and Ekkachai Saenyasiri, "Conflicts of Interest and Analyst Behavior: Evidence from Recent Changes in Regulation," *Financial Analysts Journal*, vol. 66, no. 4 (2010). The study focuses on sell-side analysts, and its sample period was from 1996 through 2006.

³⁹NASD and NYSE, *Joint Report by NASD and the NYSE on the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules* (2005).

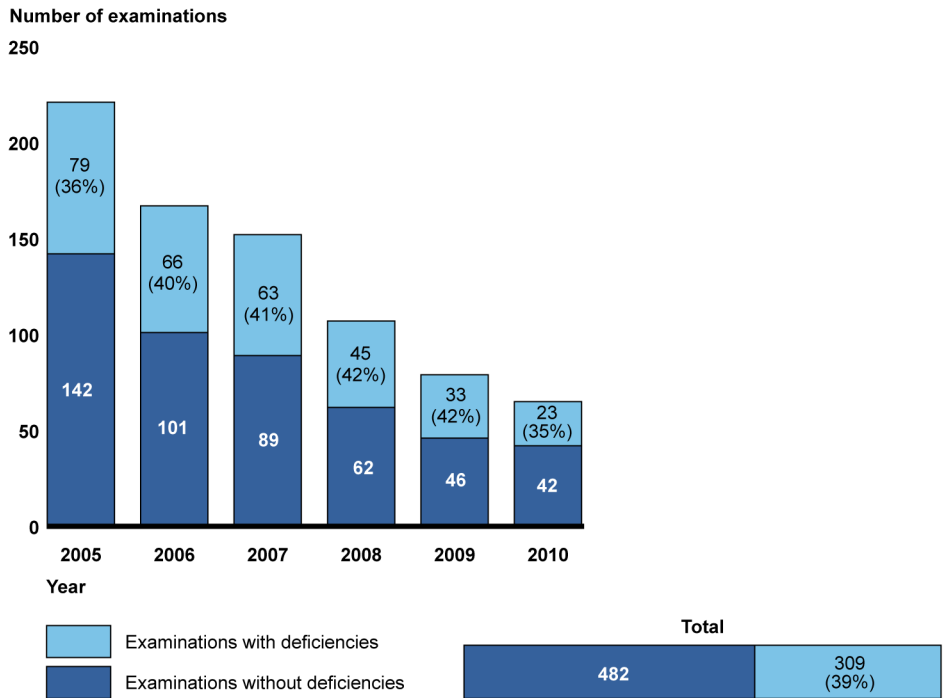
research analyst rules and the Global Settlement and, in conjunction with the empirical studies and other evidence, an indication of the effectiveness of those regulatory actions.

FINRA Examination Findings

Although FINRA found deficiencies in a high percentage of its examinations, the nature of the findings generally were minor, according to FINRA's data, and indicated that broker-dealers largely have been complying with the SRO research analyst rules. From 2005 through 2010, FINRA conducted 791 cycle broker-dealer examinations that covered compliance with the SRO research analyst rules, according to data provided by FINRA.⁴⁰ Of the 791 examinations that included a review of general research, 309 (39 percent) found some rule-related deficiencies. As shown in figure 1, the number of examinations covering the SRO research analyst rules declined steadily each year, from a high of 221 in 2005 to a low of 65 in 2010. While the number of examinations declined over this period, so did the number with deficiencies, from 79 in 2005 to 23 in 2010. The nature of the exceptions found in the examinations generally included technical disclosure or supervisory deficiencies. Matters considered for formal action included instances of noncompliance with the requirements to separate research and banking or to disclose relevant information about potential or actual conflicts. For example, some firms failed to implement firewalls to properly separate investment banking from research, and some failed to disclose that they were to receive or already had received investment banking compensation from a company covered by their research analysts. FINRA referred 38 of the 309 examinations with deficiencies to its Enforcement Department for formal disciplinary action. While some referrals involved firms that failed to properly separate research from investment banking, most involved matters other than conflicts between research and investment banking, such as analysts engaging in personal trading against their recommendations.

⁴⁰Some of these examinations were conducted by NASD or NYSE Regulation before they merged to form FINRA.

Figure 1: FINRA Cycle Examinations That Included Reviews for Compliance with SRO Research Analyst Rules and Number of Deficiencies, 2005 through 2010



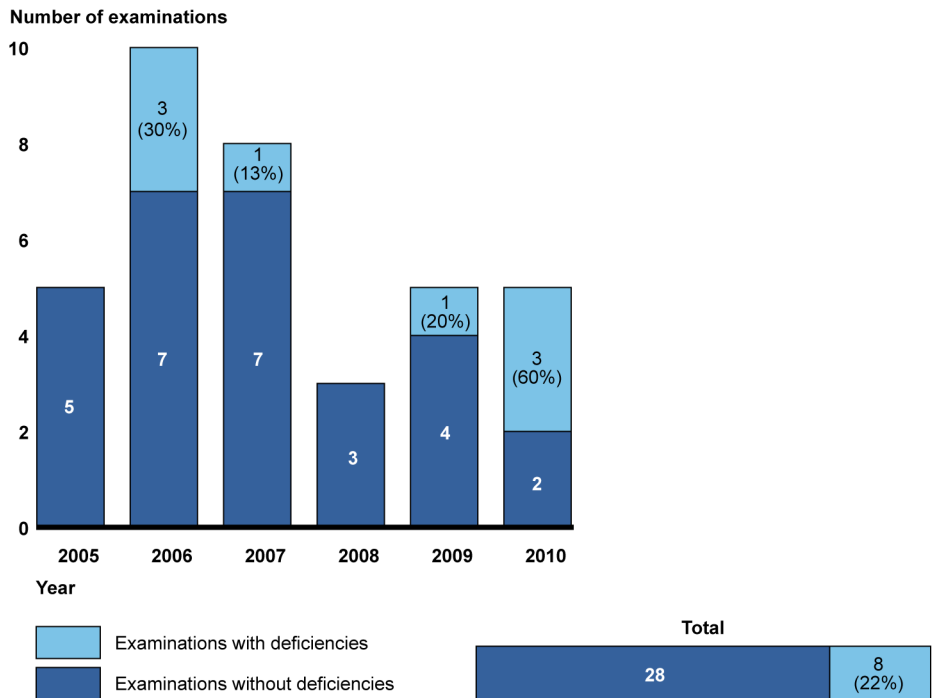
Source: GAO analysis of FINRA data.

Similarly, FINRA’s examination findings indicate that the Global Settlement firms generally have complied with the Global Settlement. From 2005 through 2010, FINRA conducted 36 cycle examinations of the Global Settlement firms that covered their compliance with the Global Settlement, according to data provided by FINRA (see fig. 2). While some Global Settlement firms were examined more often than others, each was examined at least once during this period for compliance with the Global Settlement’s terms.⁴¹ Eight of the 36 Global Settlement examinations found deficiencies. Five of the deficiencies involved disclosure violations, such as failing to reference the specific page number on which investors could locate disclosure information. The remaining three deficiencies involved violations of the Global Settlement’s structural reforms. For

⁴¹Specifically, two of the Global Settlement firms were examined five times, three were examined four times, two were examined three times, three were examined twice, and two were examined once for compliance with the Global Settlement’s terms.

example, one firm failed to ensure that its oversight committee reviewed research reports for changes in ratings or price targets before publication, while another firm disclosed to examiners that its communications firewall failed to block electronic communications between its research and investment banking staff for nearly 9 months. According to FINRA officials, none of the deficiencies in the examinations resulted in a referral for formal disciplinary action, although the matter involving problems with one firm’s communications firewall still is under review.

Figure 2: FINRA Cycle Examinations That Included Reviews for Compliance with the Global Settlement and Number of Deficiencies, 2005 through 2010



Source: GAO analysis of FINRA data.

During the same time frame, FINRA also initiated numerous cause examinations involving the SRO research analyst rules, but most did not involve conflicts between research and investment banking.⁴² In 2010, FINRA initiated two cause examinations to examine whether the broker-

⁴²In addition to its cycle examinations, FINRA officials said they conduct cause examinations based on a tip, complaint, prior examination finding, or other reason.

dealers were permitting their investment banking staff to improperly influence their research analysts' recommendations. According to FINRA officials the two examinations are ongoing.

According to SEC staff, their broker-dealer examination findings indicate that the regulatory reforms have been effective in addressing analyst conflicts.⁴³ SEC staff said that they do not have an examination module specifically designed to cover the SRO research analyst rules or the Global Settlement but have reviewed whether broker-dealers were complying with such requirements in some of their examinations of broker-dealers examined by FINRA.⁴⁴ Based on their review of broker-dealer examination reports dating to 2005, SEC staff told us that they identified a few examinations that found deficiencies related to the SRO research analyst rules.⁴⁵ According to the staff, these deficiencies included broker-dealers failing to disclose analyst conflicts in their research reports and failing to comply with requirements that restrict an analyst's public appearance.

FINRA and SEC Enforcement Actions

In addition to their findings from broker-dealer examinations, FINRA officials and SEC staff said that the limited number of enforcement actions involving conflicts between equity research and investment banking suggests that the regulatory reforms have been effective. From 2005 through 2010, FINRA took 10 enforcement actions against broker-dealers for violations of NASD Rule 2711 that involved conflicts between research and investment banking. Five of the enforcement actions were taken against Global Settlement firms and largely involved failures to

⁴³SEC directly assesses broker-dealer compliance with the federal securities laws through examinations, such as cause and risk-targeted examinations. If examiners identify compliance findings during broker-dealer examinations, they may assess the quality of any recent FINRA examinations of the broker-dealer and provide oversight comments to FINRA.

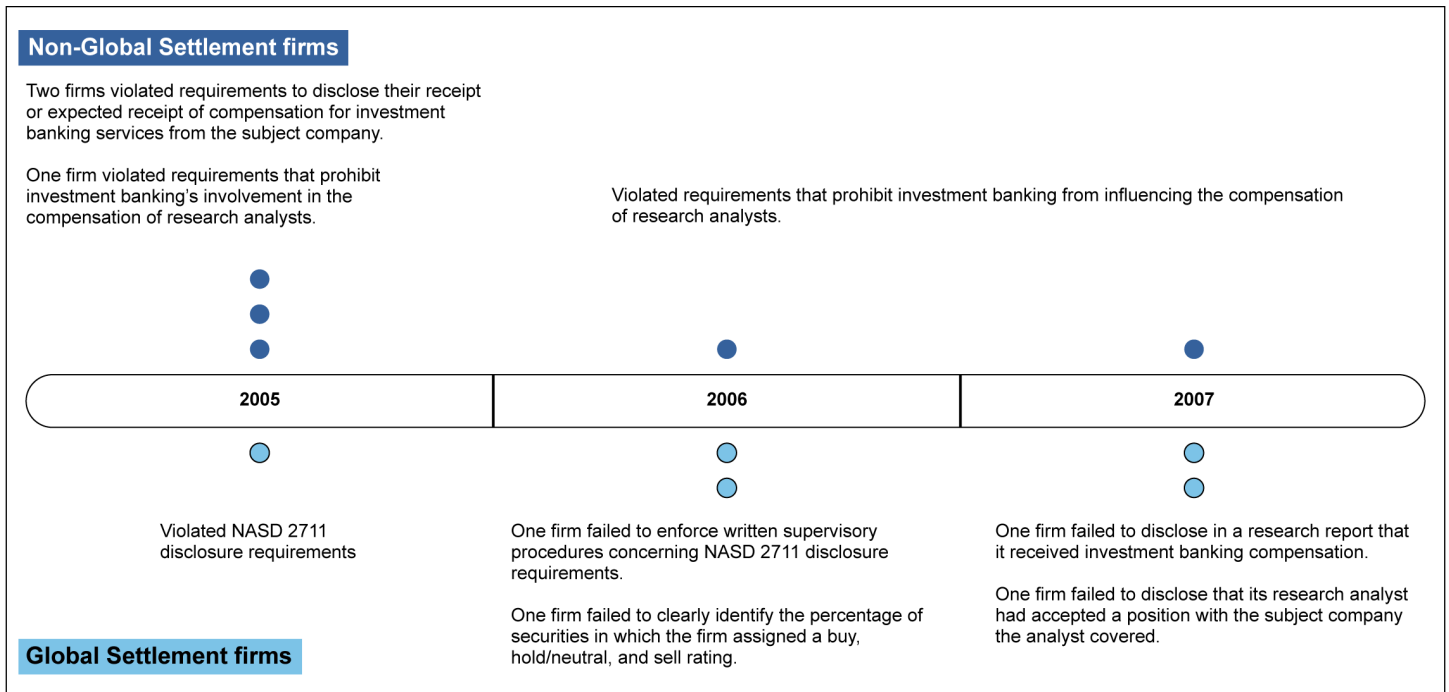
⁴⁴SEC also may conduct other types of examinations of broker-dealers, such as cause or risk-targeted examinations.

⁴⁵The SEC staff's review may not have captured all of the examinations that covered conflicts between research and investment banking. SEC staff told us that the agency's examination database does not have an electronic search capability that can be used to identify which examinations included a review of which specific SRO rules. According to SEC staff, the agency has been developing a new examination database with improved search capabilities and currently is testing the system.

adequately comply with disclosure requirements (see fig. 3).⁴⁶ The other five enforcement actions were taken against nonGlobal Settlement firms: three for allowing investment banking personnel to influence analyst compensation and two for failing to comply with requirements to disclose the firm's compensation for investment banking services. In each instance, the firm was required to sign an Acceptance, Waiver, and Consent, a settlement wherein the broker-dealer consents, without admitting or denying the findings, to the entry of the findings and to the imposition of sanctions. In addition, FINRA censured the firms for their misconduct and imposed monetary fines.

⁴⁶A total of seven enforcement actions were taken against Global Settlement firms during the period. In addition to the five actions involving conflicts between research and investment banking, the remaining two actions involved failure to disclose the availability of independent third-party research per the requirements of the Global Settlement.

Figure 3: Violations Involving Research and Investment Banking Conflicts That Led to FINRA Enforcement Actions, 2005 through 2010



Source: GAO analysis of FINRA enforcement actions.

SEC also has taken enforcement actions involving conflicts between research and investment banking. Specifically, SEC took a total of three such actions from 2005 through 2010. In 2005, SEC brought a settled action against two research supervisors for their failure to reasonably supervise an equity research analyst who published fraudulent research. The case focused on the adequacy of supervision of a research analyst, who was subject to a prior enforcement action that alleged the analyst produced biased research to support the firm's investment banking business. In 2007, SEC issued a cease and desist order against a firm for employing business practices that linked research and investment banking, creating incentives for its analysts to support the firm's investment banking business. In 2010, SEC issued a cease and desist order against a firm for failing to establish and enforce policies and procedures to prevent the misuse of material, nonpublic information. The firm engaged in securities research and was the parent of an investment advisory subsidiary that shared the same chief compliance officer. In its order, SEC alleged that the firm failed to prevent its investment advisory subsidiary from misusing material research information, such as the

**Independent Monitors
Generally Found the Broker-
Dealers in Compliance with the
Global Settlement**

initiation of research coverage or changes in price targets, produced by its research department.

Additionally, under the Global Settlement, each of the 12 broker-dealers had to (1) hire an independent monitor to assess whether the firm had developed adequate policies and procedures to ensure compliance with the Global Settlement and (2) certify compliance with the Global Settlement within 5 years of the date of the entry of the final judgment. Each independent monitor generally completed and filed their reports between October 2003 and February 2006.

Based on our review of the independent monitor reports, all the monitors generally concluded that each firm had implemented effective policies and procedures to comply with the Global Settlement. To conduct their reviews, the monitors typically examined each firm's policies and procedures, reviewed supporting documents to verify the implementation and effectiveness of the policies and procedures, made observations, conducted inspections (for example, of physical separation of research and investment banking), and interviewed the firm's management and staff. Although the independent monitors concluded that each firm was in compliance with the Global Settlement, all of them included recommendations in their reports. The recommendations generally were intended to clarify or enhance a firm's compliance policies and procedures or improve a firm's ability to track and monitor its compliance. According to SEC staff, all the Global Settlement firms certified that they were in compliance with the Global Settlement by August 2008. According to SEC staff, on a number of occasions, the Global Settlement firms self-reported instances of noncompliance with the Global Settlement to SEC staff. These reported instances largely concerned technical failures to provide disclosures regarding the availability of independent research or ratings on customer account statements and confirmations. Upon receiving these reports, SEC staff typically notified the other regulators involved in the Global Settlement, discussed the violations and remedial measures with the reporting firm, and asked that the firm write to inform the court of the matter.

**While Market Participants
and Others Generally View
the Reforms as Effective,
Some Noted Conflicts
Could Not Be Completely
Addressed or Eliminated**

Most market participants and observers we interviewed told us that the regulatory reforms have been effective in mitigating analyst conflicts but provided different reasons why. Examples cited by market participants and observers as to why the structural reforms have been effective include the following:

-
- Research analysts are shielded from investment banking influence, according to officials from broker-dealers, an independent research firm, and institutional money managers;
 - Securities research is more independent but not necessarily better, according to officials from an institutional money manager; and
 - The regulatory reforms provide a compliance structure that requires broker-dealers to manage their analyst conflicts, according to state securities regulators.

In addition to the structural reforms, market participants and observers said that the disclosure requirements have been effective in addressing analyst conflicts, in part because investors are more aware of potential analyst conflicts, according to officials from broker-dealers, a consumer interest group, and independent research firms. Furthermore, officials from the consumer interest group said that the media attention surrounding the investigations that led to the Global Settlement helped to raise investors' awareness of analyst conflicts.

Despite generally viewing the regulatory reforms as effective, some market participants and observers told us that the reforms do not completely eliminate research analysts' conflicts. For example, according to an academic, the SRO research analyst rules and the Global Settlement prohibit sell-side analysts from being compensated based on their investment banking contributions, but their pay may be based on their firm's overall profitability—of which investment banking can be a major source. As a result, sell-side analysts face inherent conflicts because they know that negative ratings can harm their firm's investment banking business and, in turn, their personal compensation, according to state securities regulators, institutional investors, academics, and others with whom we spoke. Officials from a consumer interest group told us that this inherent conflict can be eliminated by prohibiting firms from engaging in both investment banking and research. In addition, although the Global Settlement requires the firms to physically separate research and investment banking staff, this prophylactic measure can be circumvented, according to officials from an investor advocacy group and a consumer interest group. For example, officials from the investor advocacy group said analysts and investment bankers could talk outside of the firm. In their reports, two independent monitors recognized the limitations of the reform but their reports suggest that physical separation reinforced the idea that analysts and investment bankers were not supposed to talk with each other.

Regulators Have Opportunities to Enhance Investor Protection and Streamline or Harmonize Oversight

Although SEC and FINRA have taken regulatory actions to address conflicts of interest faced by securities research analysts, additional opportunities exist to adopt or revise rules to enhance investor protection and streamline or harmonize oversight.

FINRA Plans to Finalize Equity Analyst Rules Intended to Enhance Investor Protections and Reduce Regulatory Burden

FINRA plans to finalize an equity analyst rule that includes longstanding internal recommendations intended to enhance investor protections, increase information flow to investors, and reduce regulatory burden, according to FINRA officials. In a December 2005 report, NASD and NYSE staff made recommendations to amend the SRO research analyst rules, but the recommendations have yet to be implemented. As part of its 2005 request that the SROs review the effectiveness of their research rules, SEC asked NASD and NYSE to make any recommendations for rule changes or additions. To address this request, NASD and NYSE staff conducted a section-by-section review of the rules, which included assessing whether the rules were accomplishing their purpose, comparing the rules to the Global Settlement, considering gaps in coverage, and reviewing industry questions and comments about the rules. As discussed in the following paragraphs, the SRO staff recommended revising their rules to prohibit a practice that was not permitted under the Global Settlement's terms. In general, the staff recommended several rules changes that were intended to improve rule effectiveness by striking a better balance between trying to ensure objective and reliable research and permitting the flow of information to investors and minimizing costs and burdens to firms. Specifically, the recommendations included:

- changing the definition of "research analyst," "research report," and other terms used in the rule, to codify exceptions set forth in previous interpretive material and to align with SEC Regulation Analyst Certification and the Global Settlement;
- eliminating a provision that permitted investment banking personnel to review research before publication (to verify factual information), because SRO staff believed that such a review raised concerns about the objectivity of the research and noted that such a review was not permitted under the Global Settlement's terms;

-
- amending the disclosure rules to provide more effective disclosure by allowing, in lieu of disclosure in the research report itself, a prominent warning on the cover of research reports that conflicts exist and information about how investors could obtain more details about those conflicts of interest on the firm's website, because staff were concerned that the volume of disclosures in the reports could obscure their overall message; and
 - amending the provision that prohibited investment banking personnel from retaliating against research analysts as a result of unfavorable research to include all of a firm's employees.

Similar to the concerns raised by the SRO staff about the conflict disclosures, various market participants and observers we interviewed questioned the effectiveness of or raised concerns about the burden of the conflict disclosures. For example, some broker-dealers told us that that the volume and complexity of the disclosures have made the information less useful for investors. Also, officials from three associations representing investors and an institutional investor said the disclosures are important but do not convey sufficient information for investors to fully understand the nature and magnitude of analyst conflicts. Broker-dealers further noted that their need to continually collect a wide range of data to track analyst conflicts is costly and burdensome.

In 2008, FINRA issued a proposal to consolidate the NASD and NYSE research analyst rules in a new FINRA rule and move to a more principles-based regulatory approach in this area.⁴⁷ The proposal included most of the recommendations made by the NASD and NYSE staff in their December 2005 report.⁴⁸ Additionally, FINRA's proposed consolidated rule would broaden the obligations of its member broker-dealers to identify and manage analyst conflicts. Specifically, it included a provision to require FINRA members to establish, maintain, and enforce

⁴⁷FINRA, Research Analysts and Research Reports, Regulatory Notice 08-55 (October 2008).

⁴⁸In a December 2005, NASD and NYSE staff recommended a number of changes to the SRO research analyst rules. NASD and NYSE filed proposals with SEC in September 2006 to amend their research analyst rules and implement the recommendations. FINRA's 2008 proposal would supersede the NASD and NYSE proposals and omitted the recommendation to allow for Web-based conflict disclosures, because SEC interpreted the Sarbanes-Oxley Act as requiring that such disclosures be made only in the research reports.

policies and procedures reasonably designed to identify and effectively manage conflicts related to the preparation, content, and distribution of research reports and public appearances by equity analysts. The proposal also specified that the policies and procedures must address information barriers and other safeguards to insulate research analysts from pressure by investment banking personnel. The proposal largely maintained the same disclosures, including a provision that would require a member to disclose in any research report all conflicts that reasonably could be expected to influence the objectivity of the report and that are known or should have been known on the date of the report's publication or distribution. FINRA received five comment letters on its proposal. The comments (which were from a venture capital association, a securities industry association, a securities firm, a law office, and an individual) generally supported the proposal but expressed concerns, including that some terms were too broadly defined and, thus, would make compliance difficult.

FINRA has not yet finalized its 2008 proposal designed to consolidate the SRO research analyst rules and implement recommendations made by NASD and NYSE staff in 2005. According to FINRA officials, FINRA has delayed finalizing the proposal until it finalizes a proposal to address conflicts of interest faced by fixed-income (debt) research analysts. SEC staff and FINRA officials told us that SEC encouraged FINRA to consider adopting a rule to address conflicts of interest faced by fixed-income research analysts. As discussed later in the report, FINRA recently issued a concept release for a fixed-income research rule. According to FINRA officials, their tentative plan is to seek comment on a regulatory notice on a revised debt research proposal and then package the final debt and

equity research rule proposals together and submit a single proposed consolidated research analyst rule to SEC in the first half of 2012.⁴⁹

SEC and FINRA Have Not Formally Assessed and Documented Whether Any of the Global Settlement's Remaining Terms Should Be Codified

Although the Global Settlement has been in place since 2003 and includes a provision that allows for it to be modified or superseded, SEC and FINRA have not proposed codifying the Global Settlement's remaining terms. The Global Settlement provided that if SEC adopts a rule or approves an SRO rule with the stated intent to supersede any of the Global Settlement's terms, then that term would be superseded. The Global Settlement also originally provided that SEC would agree, subject to court approval, to modify any term in Section I or II of the addendum that had not been superseded within 5 years of the entry date of the Global Settlement, unless SEC determined the modification would not be in the public interest.

While NASD and NYSE adopted research analyst rules that are similar to many of the Global Settlement's terms (see app. II for a comparison of the Global Settlement and SRO research analyst rules), they did not expressly state that their rules superseded the terms.⁵⁰ In 2009, the Global Settlement firms, with SEC's agreement, submitted a request to a

⁴⁹FINRA's Board of Governors must approve a proposed rule for filing with SEC. When FINRA files a proposal with SEC for notice and comment, SEC staff must review the proposal to determine whether the proposed rule change is consistent with the Securities and Exchange Act of 1934 and the rules and regulations thereunder. In response to comments or questions from SEC staff, FINRA may seek to modify or supplement its proposal with additional descriptive text or legal analysis. SEC then publishes the proposed rule in the Federal Register for public comment. Depending on the comments received, FINRA may respond to the questions and concerns raised by the commenters. For proposals subject to SEC approval before they may take effect, SEC would publish an approval order or disapproval order in the Federal Register. If approved, FINRA may announce the approval in a regulatory notice. For proposals that are immediately effective by operation of law, no further SEC action is necessary for the rule to take effect. However, SEC may suspend an immediately effective proposal within 60 days of the filing thereof, in which case it would institute proceedings to determine whether to approve or disapprove the proposal.

⁵⁰For example, in 2005, NASD and NYSE proposed amending their research analyst rules to prohibit research analysts from participating in road shows relating to investment banking services transactions. The SROs noted that the proposed rule changes were similar in certain aspects to the Global Settlement's provisions. They stated that the proposed rule changes were not proposed for the purpose of conforming to the Global Settlement or addressing differences between the Global Settlement and SRO rules. Rather, the SROs believed that the proposed rules were appropriate in that they would facilitate the goal of more objective and reliable research.

federal district court to modify the Global Settlement's addendum. In their request, the firms stated that the addendum should be terminated in its entirety, and they, like other broker-dealers, should be subject only to the SEC and SRO research analyst rules. However, the firms noted in their request that SEC indicated that certain provisions should be retained in the public interest. Consequently, the firms did not ask the court to terminate in full Sections I and II, but instead to modify the majority of the terms in Section I and a disclosure requirement in Section II.⁵¹ The broker-dealers primarily justified their requested changes based upon the existence of the SRO research analyst rules that addressed the same concerns and provided comparable protections.

On March 15, 2010, the federal district court approved all but one of the requested changes.⁵² The court declined to allow research and investment banking personnel to communicate with each other—outside the presence of internal legal or compliance staff—about market or industry trends, conditions, or developments, provided that such communications were consistent in nature with communications that an analyst might have with investing customers. The court noted that the change was counterintuitive and would undermine the separation between research and investment banking. Under the modified Global Settlement approved by the court, terms that remain in place include:

- investment banking cannot have input into the research budget,
- research analysts and investment banking must be physically separated,
- investment banking cannot have input into company-specific coverage decisions,
- research oversight committees must ensure the integrity and independence of equity research,
- investment banking personnel and research analysts cannot communicate about the merits of a proposed transaction or a potential

⁵¹As previously noted, Section III expired in July 2009 and therefore was not discussed in the Letter Motion request to amend the Final Judgment, which was filed in August 2009.

⁵²See appendix II for a description of the March 15, 2010, modifications to the Global Settlement.

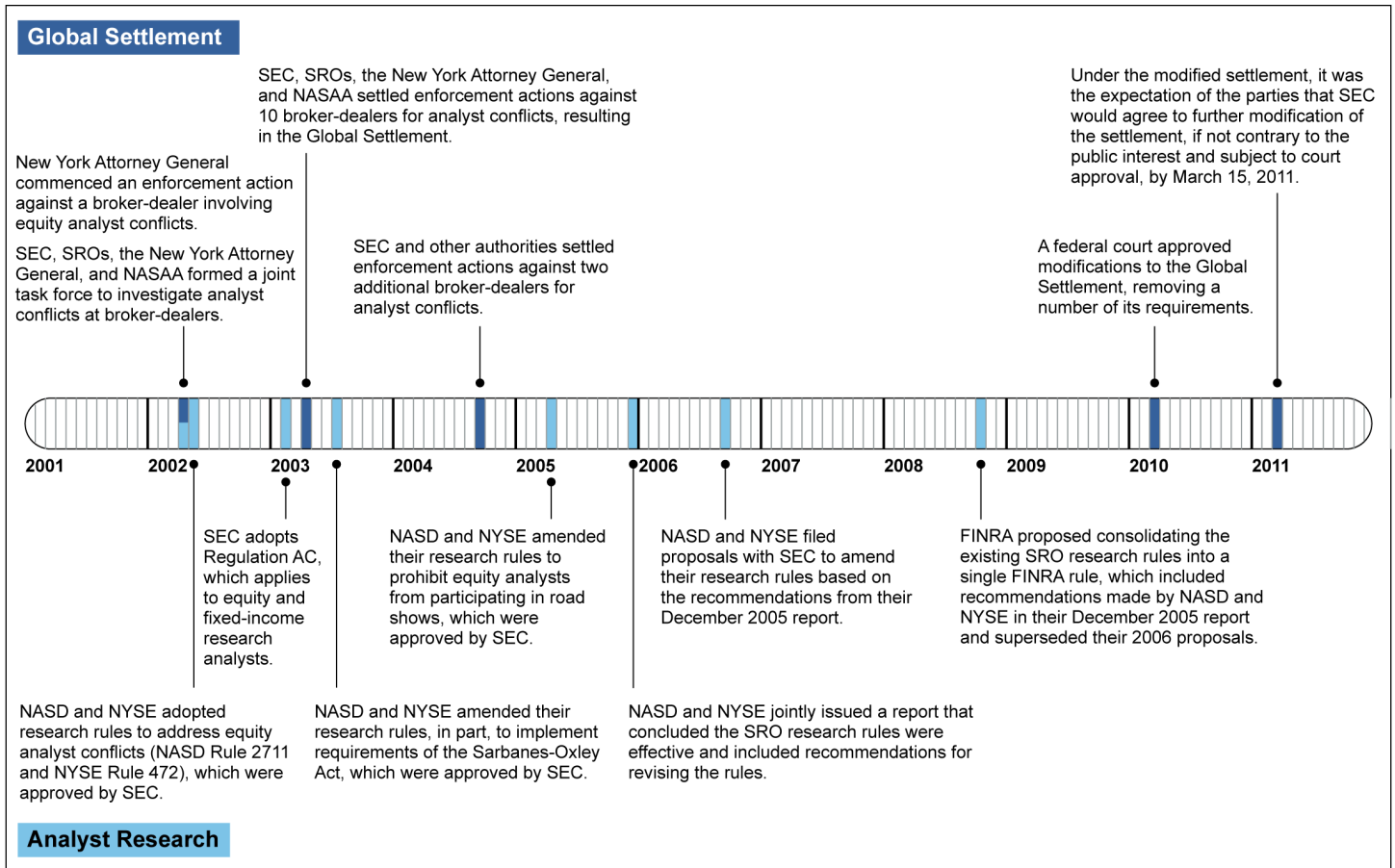
candidate for a transaction unless a chaperone from the firm's legal or compliance department is present,

- research analysts and investment bankers cannot communicate for the purpose of having research personnel identify specific potential investment banking transactions, and
- research analysts must be able to express their views to a commitment committee about a proposed investment banking transaction outside the presence of investment bankers working on the deal.⁵³

While the court maintained these terms in the modified Global Settlement, the court's March 15, 2010, order provided that the parties expected SEC would agree to further modification of the Global Settlement's terms at the earlier of March 15, 2011, or the effective date of the consolidated research rule proposed by FINRA in October 2008 (if such rules addressed the Global Settlement's remaining terms), unless SEC believes such amendment or modification would not be in the public interest. Any such amendment or modification would be subject to court approval. To date, the Global Settlement firms have not requested any further modification of the settlement. See figure 4 for a summary of events relating to the Global Settlement and SRO research analyst rules.

⁵³A commitment committee generally reviews and approves all proposed securities offerings to investment banking clients to determine whether the broker-dealer will act as lead underwriter or otherwise participate in the offering.

Figure 4: Significant Developments in Oversight of Research Analyst Conflicts, Including the Global Settlement and SRO Research Analyst Rules, 2001 through 2011



Source: GAO analysis of SEC, FINRA, and federal court documents.

Certain SEC staff and FINRA officials have different views about whether the remaining Global Settlement's terms should be codified. According to SEC staff, the reference to FINRA's consolidated rule proposal was included in the modified Global Settlement because of the possibility that FINRA would amend its rule proposal to include the remaining terms. According to FINRA officials, FINRA does not plan to state that its consolidated rule, when finalized, would supersede the Global Settlement. FINRA officials said the Global Settlement serves to address bad behavior in which the Global Settlement firms allegedly engaged; thus, some of the Global Settlement's terms are more stringent than the SRO research analyst rules and should not apply to firms that did not engage in such behavior. FINRA officials said that the decision to modify

or terminate the Global Settlement should not be done through a FINRA rulemaking; rather, it should be determined by the court based on whether the remedial actions required under the Global Settlement have reached their finality. SEC staff told us that any rulemaking to codify the provisions of the Global Settlement would be most appropriate as SRO rules. SEC staff continue to work with FINRA to achieve this goal.

According to FINRA officials, they have carefully considered the appropriateness and impact of codifying the Global Settlement's remaining terms. They are concerned that some of the remaining terms are potentially costly and burdensome and would affect unfairly those firms that were not alleged to have engaged in wrongful conduct, particularly some small firms that provide both research and investment banking services. As discussed, NASD and NYSE staff conducted a section-by-section review of the research analyst rules in 2005, which included comparing the rules to the Global Settlement's terms, and recommended codifying one of the terms not already in the rules. For FINRA's consolidated equity rule proposal, FINRA officials told us that they recently analyzed and discussed the Global Settlement's remaining terms with SEC staff and conveyed to the SEC staff their position on which ones should be codified.⁵⁴ According to the FINRA officials, their analysis considered the investor protection benefits of adopting the Global Settlement's remaining terms and the costs and burdens that such action would impose on non-Global Settlement firms. The officials told us that their analysis largely was done through internal discussions and was not documented.

According to SEC staff, it is incumbent on the Global Settlement firms to initiate action to repeal or modify any of the Global Settlement's terms (as provided in the modified Global Settlement), and none of the firms have contacted SEC to discuss further modifications since 2009. The staff said that if the firms requested that the Global Settlement be modified, SEC would have to find that the modifications were counter to the public interest for SEC to oppose the request. Moreover, SEC staff said that the

⁵⁴Although FINRA does not anticipate that its consolidated rule would supersede the Global Settlement, FINRA officials told us that they are considering modifying FINRA's proposed consolidated research rule to include two of the remaining Global Settlement's terms: (1) express restrictions on investment banking input into research coverage decisions and (2) restrictions on communications between research and investment banking when conducting due diligence on an investment banking mandate.

Global Settlement firms continue to be subject to the Global Settlement, because the related enforcement actions found them to be allegedly engaged in a litany of misconduct. They told us that the Global Settlement was not intended to create a competitive disadvantage for the Global Settlement firms, but rather to address their conduct. At the same time, the SEC staff said that the Global Settlement's terms provide useful protections that could benefit all investors if applied more broadly. According to SEC staff, the Global Settlement firms account for the vast majority of the U.S. investment banking business, and other broker-dealers have opted to comply voluntarily with the Global Settlement. As a result, SEC staff said that the majority of research produced by broker-dealers also engaged in investment banking is, in effect, affording investors the protections provided under the Global Settlement's terms.

Although SEC staff and FINRA officials periodically have discussed and analyzed the Global Settlement's terms, they have not formally determined and documented the benefits and costs of adopting rules based on the Global Settlement's remaining terms. Such analysis would serve to determine and make transparent whether the benefits of such action would likely justify the costs. However, as long as the Global Settlement remains in effect, the Global Settlement firms continue to be subject to the requirements of the Global Settlement and the SRO research analyst rules, while other firms that provide the same services are subject only to the SRO research analyst rules. As a result, investors may not be provided the same level of protection. We have previously reported that a regulatory framework should include investor protection as part of its mission to ensure that market participants receive consistent, useful information, as well as consistent legal protections for similar financial products and services.⁵⁵ To the extent that any of the Global Settlement's remaining terms provide a cost-effective way of furthering investor protection, by not formally assessing their codification SEC may be missing an opportunity to provide consistent investor protection.

⁵⁵To help Congress and others evaluate proposals for financial regulatory reform, we developed a framework comprised of nine characteristics that a regulatory regime should reflect. See GAO, Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System, [GAO-09-216](#) (Washington, D.C.: Jan. 8, 2009).

FINRA Has Been Drafting a Rule to Address Conflicts of Interest Faced by Fixed-Income Research Analysts

FINRA has been drafting a rule to address longstanding concerns about conflicts of interest that fixed-income analysts face.⁵⁶ Although fixed-income research analysts, like equity research analysts, face conflicts of interest, fixed-income research conflicts were not addressed in the SRO research analyst rules. For instance, Enron Corporation's (Enron) bankruptcy in the early 2000s drew attention to the harm that could result from fixed-income analysts' conflicts. In particular, a sell-side fixed-income analyst assigned to cover Enron's debt securities testified in 2001 that she perceived pressure from her superiors not to issue negative public comments on Enron because of Enron's importance as an investment banking client of the broker-dealer.⁵⁷ When NASD and NYSE initially adopted their research analyst rules in 2002, the rules did not cover fixed-income analysts. And neither the Global Settlement nor the research-related provisions of the Sarbanes-Oxley Act (which resulted in subsequent amendments to the SRO research analyst rules in 2004) apply to fixed-income research. However, in 2003, SEC adopted Regulation Analyst Certification to require both equity and fixed-income analysts to certify that the views expressed in their research reports accurately reflected their personal views and disclose whether they received compensation or other payments in connection with their views.

In the absence of specific SRO research analyst rules covering fixed-income research conflicts, NASD and NYSE generally relied on antifraud statutes and SRO rules prohibiting fraud and requiring ethical conduct and a comprehensive supervisory scheme to oversee a firm's securities business. In addition, NASD and NYSE encouraged firms to consider adopting industry-developed principles to address such conflicts. In 2004, to promote the integrity of fixed-income research, the Bond Market Association (BMA), an industry association, issued voluntary, principle-based guidelines designed to help firms manage potential conflicts faced by fixed-income analysts.⁵⁸ At the time, BMA did not support the adoption

⁵⁶FINRA, Debt Research Reports: FINRA Requests Comment on Concept Proposal to Identify and Manage Conflicts Involving the Preparation and Distribution of Debt Research Reports, Regulatory Notice 11-11 (March 2011).

⁵⁷Final Report of Neal Batson, Ct.-Appointed Examiner, App. F (Role of CSFB and Its Affiliates) to Final Report of Neal Batson, Ct.-Appointed Examiner at n. 101, In re Enron Corp., et al., No. 01-16034 (AJG) (Bankr. S.D.N.Y., November 24, 2003).

⁵⁸The Bond Market Association, Guiding Principles to Promote the Integrity of Fixed-Income Research: A Global Approach to Managing Potential Conflicts of Interest.

of SRO rules designed to address fixed-income conflicts. The industry maintained that the nature and intensity of the conflicts fixed-income analysts faced differed from those equity analysts faced. For example, industry participants held that prices of debt securities were relatively less sensitive to the views of research analysts, credit rating agencies played an important role in the debt markets by providing investors with independent information, and users of fixed-income research typically were sophisticated investors presumed to be less in need of protection. In a December 2005 report on the effectiveness of the SRO research analyst rules, NASD and NYSE staff concluded that it was not appropriate at the time to amend the rules to cover fixed-income analysts or codify BMA's guiding principles. Instead, staff noted that the SROs were monitoring the extent to which firms adopted the BMA principles and would consider rulemaking after assessing the effectiveness of voluntary compliance with the principles. NASD and NYSE staff further noted that the existing antifraud statutes and SRO rules could cover any egregious conduct involving fixed-income research.⁵⁹

To encourage adoption of the BMA principles or other policies and procedures to manage debt research conflicts, the SROs issued guidance and conducted examinations that included a review of issues relating to fixed-income analyst conflicts. In July 2006, NASD and NYSE issued joint interpretive guidance on fixed-income research to prompt better management of fixed-income-research conflicts.⁶⁰ The SROs developed the guidance based on their examinations of how some firms addressed conflicts faced by fixed-income analysts. Through their examinations, the SROs found many instances in which firms had failed to adhere to BMA's principles. The examinations also found several instances in which firms failed to establish, maintain, and enforce written supervisory procedures in the fixed-income research area—a fundamental obligation under the SRO rules—or comply with SEC's Regulation Analyst Certification. In considering whether to engage in more definitive rulemaking, the SROs stated in their guidance that they would continue to monitor the extent to which firms adopted and adhered to BMA principles or other supervisory

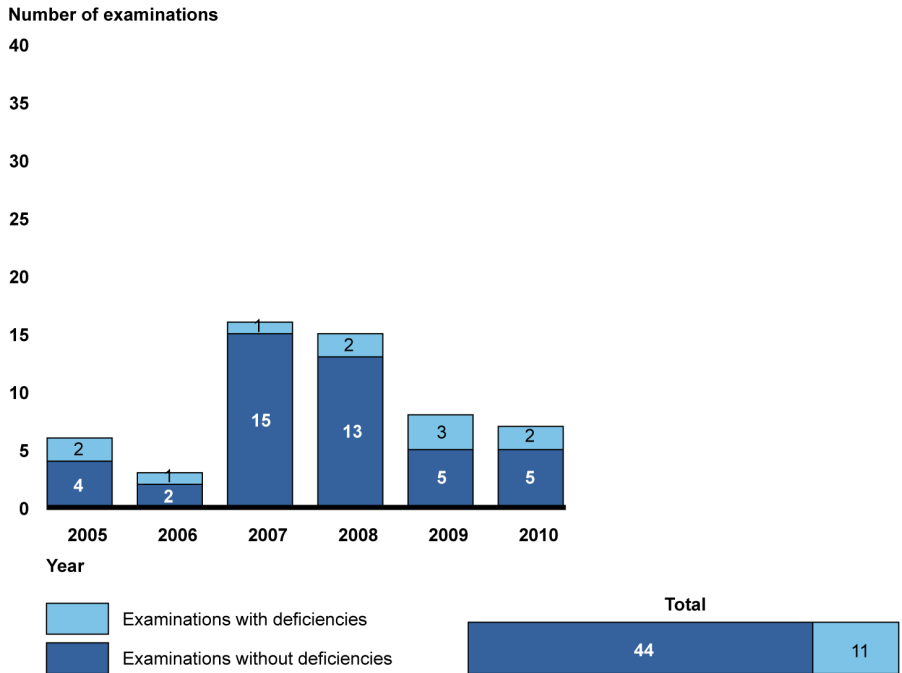
⁵⁹See, for example, NASD Rule 2110's requirement that members "observe high standards of commercial honor and just and equitable principles of trade" and similar obligations under NYSE Rules 401 and 476(a)(6). These rules have been consolidated into FINRA Rule 2010.

⁶⁰NASD, Research Analysts and Research Reports: NASD and NYSE Joint Interpretive Guidance on Fixed Income Research, Notice to Members 06-36 (July 2006).

systems reasonably designed to achieve compliance with applicable SRO rules and securities laws and regulations. According to FINRA officials, the joint interpretative guidance served as a “warning shot” to the firms.

Following NASD and NYSE’s 2006 interpretive guidance, FINRA continued to examine its member firms for compliance with the BMA principles and find instances of noncompliance. Based partly on BMA’s guiding principles, FINRA developed an examination module to assess whether a firm’s fixed-income research supervisory procedures, policies, and processes promote the integrity of fixed-income research and address potential conflicts of interest. According to FINRA officials, FINRA has included a review of fixed-income research in some of its cycle examinations. As shown in figure 5, between 2005 and 2010, FINRA (or its predecessors) conducted 55 cycle examinations that covered fixed-income research and found related deficiencies in 11 examinations. The deficiencies generally involved inadequate supervisory procedures for managing fixed-income analyst conflicts or inadequate disclosures of such conflicts. Although none of the examinations resulted in a formal disciplinary action, one examination found that the firm lacked procedures not only to prohibit staff from directly or indirectly offering favorable fixed-income research coverage to issuers but also to prevent nonresearch staff from attempting to coerce fixed-income analysts to alter their views on the content of a research report. Finally, the examinations included eight Global Settlement firms; deficiencies were found in one of these eight firms.

Figure 5: FINRA Cycle Examinations That Included Reviews of Fixed-Income Research and Number of Deficiencies, 2005 through 2010



Source: GAO analysis of FINRA data.

In March 2011, FINRA issued a regulatory notice to explore and obtain public comment on the concept of adopting a rule to address conflicts of interest faced by fixed-income analysts. In its release, FINRA noted that it long had been monitoring broker-dealers' management of conflicts of interest in fixed-income research and that it was an appropriate time to engage in rulemaking to address such conflicts because, among other things, FINRA staff had observed increased retail investment risk in complex debt securities, such as auction rate securities.⁶¹ Specifically, the staff noted that the allegations of misconduct in the sale of auction rate securities illustrated this risk and provided a concrete example that potential conflicts of interest in the publication and distribution of debt research existed just as they did for equity research. FINRA officials told

⁶¹ Auction rate securities are municipal and corporate bonds, as well as preferred stocks, with interest rates or dividend yields that are periodically reset through auctions, typically every 7, 14, 28, or 35 days. The alleged misconduct did not involve conflicts between research and investment banking but between research and sales and trading.

us that SEC staff also encouraged FINRA to adopt a rule to address fixed-income analyst conflicts.

According to FINRA officials, the primary purpose of the fixed-income research rule is to protect retail investors. To that end, the majority of the existing structural safeguards and disclosures in NASD's research analyst rule would apply to retail debt research. Similarly, the disclosures applicable to equity research largely should apply to debt research and would include the disclosure of personal and firm financial interests and the receipt of compensation for investment banking services from companies covered by fixed-income analysts. However, the scope of the safeguards would be expanded to cover conflicts between debt research and sales and trading personnel. Specifically, a firm's sales and trading staff would be prohibited from attempting to influence a fixed-income analyst's opinion or views for the purpose of benefiting the trading position of the firm—which allegedly occurred in certain firms engaged in auction rate securities—or a customer or class of customers. For example, in 2008, a state securities regulator alleged that a broker-dealer permitted its sales and trading managers to unduly influence and pressure its fixed-income research department. The managers did not agree with the tone or context of a published research report and allegedly insisted that the report be retracted and replaced with a more sales-friendly report.

FINRA officials told us they faced challenges in balancing the benefits of the rule in providing protections for retail investors with the cost and burden of the rule for institutional investors. According to the officials, institutional investors use the analytics, not the recommendations, generated by fixed-income analysts and do not want rules that would restrict the flow of timely information. Moreover, institutional investors trading debt securities generally tend to interact with broker-dealers more as counterparties than customers and are aware of potential conflicts faced by fixed-income analysts. FINRA's concept proposal exempts fixed-income research that is disseminated solely to institutional investors from some of the structural safeguards and most of the disclosures that would be applicable to retail debt research. Firms operating under the exemption would have to clearly distinguish such research from research disseminated to retail investors. The proposal noted that not all institutional investors are necessarily alike; therefore, institutional investors would be allowed to opt out of the exemption and be treated like retail investors.

Another challenge in developing a fixed-income research rule is separating fixed-income research from sales and trading, according to FINRA. FINRA officials told us that it was easier to describe the conflicts between fixed-income research and sales and trading than to craft communication firewalls to separate the two departments. The officials said that broker-dealers maintain that sales and trading should not be wholly prohibited from communicating with research, because sales and trading staff need information from research regarding the creditworthiness of an issuer and other information reasonably related to the price or performance of a debt security. In turn, debt analysts need information from sales and trading to help, among other things, determine the coverage universe and to assess current prices, spreads, and liquidity of debt securities.

Most market participants and observers we interviewed generally supported the adoption of a FINRA rule to address conflicts faced by fixed-income research analysts. Stakeholders cited the lack of transparency in the fixed-income markets as the primary reason for the need for a fixed-income research rule. Some said that investors lack sufficient information about the securities in which they sought to invest, because no regulations require broker-dealers to disclose potential conflicts. Similarly, FINRA received six comment letters about the concept proposal, all of which generally supported FINRA's efforts to develop the proposal.⁶² However, all of the letters expressed concerns, including that the communication restrictions were unclear and could limit fixed-income analysts' ability to support sales and trading.

As previously discussed, FINRA officials told us that they plan to submit a proposed fixed-income rule to FINRA's Board of Governors for its review and approval in December 2011. The officials said that FINRA then

⁶²The six letters were from a broker-dealer industry association, a broker-dealer compliance consulting firm, two public investor arbitration groups, and four full service broker-dealers. Comments from the public investor arbitration groups and investment banking firms were each represented by two separate letters. Four of the letters noted that the institutional investor exemption creates the potential for (1) retail investors to mistakenly obtain research without the appropriate disclosures, (2) reduction in retail investors' access to research, (3) increased costs and burden for firms to identify which clients have opted out of the disclosure requirements, (4) firms to relax efforts to disclose any conflicts to institutional investors because of the assumption that they were sophisticated investors; or (5) conflict and fraud. In addition, two letters noted that the communication restrictions were unclear and could limit the ability of fixed-income analysts' to support the sales and trading departments.

tentatively plans to file the proposed rule, assuming its board approves it, with SEC in the first half of 2012. While antifraud statutes and existing SRO rules serve to protect investors from abuse arising from fixed-income analyst conflicts, SEC and FINRA staff, as well as most market participants and observers we interviewed, acknowledged that additional rulemaking is needed to protect investors, particularly retail investors. In that regard, until FINRA adopts a fixed-income research rule, investors continue to face a potential risk.

Conclusions

Since the early 2000s, SEC and the SROs have taken and continue to take a variety of actions to address conflicting interests between research analysts and investment bankers and, in turn, protect investors. Principal actions include Regulation Analyst Certification, the SRO research analyst rules, and the Global Settlement—which include similar structural requirements designed to separate research from investment banking and thereby insulate research analysts from investment banking pressure and influence. The Global Settlement imposes, in some areas, more stringent requirements on the Global Settlement firms than the SRO rules impose on other broker-dealers engaged in research and investment banking, because the Global Settlement resulted from enforcement actions involving analyst conflicts. Nonetheless, the structural requirements in the SRO rules and the Global Settlement were developed, in part, based on similar findings and generally seek to achieve the same fundamental objective—to enhance the integrity and independence of securities research. But unlike the SRO rules, the Global Settlement was not intended to be permanent.

By establishing, in effect, separate but different requirements for addressing analyst conflicts, the SRO research analyst rules and the Global Settlement raise the question of whether any of the Global Settlement's remaining terms need to be adopted as SEC or SRO rules to better protect investors. While SEC staff and FINRA officials have discussed this issue, they have not reached a consensus or formally determined and documented whether any of the Global Settlement's remaining terms should be codified. Through some of its more stringent requirements, the Global Settlement potentially affords greater protections to investors in some areas than the SRO rules but imposes greater burdens on broker-dealers. Whether these burdens are appropriate in comparison to the greater protections of the requirements has yet to be determined and documented. However, an analysis as to whether the Global Settlement's remaining terms should be codified would provide SEC with a basis for reconciling the differences between

the SRO rules and the Global Settlement. To the extent that any of the Global Settlement's remaining terms provide an effective way of furthering investor protection, by not assessing their codification SEC may be missing an opportunity to provide consistent investor protection.

Recommendation for Executive Action

To help ensure that investors consistently are protected from potential conflicts of interest between research analysts and investment bankers employed by the same broker-dealers, the Chairman of SEC should direct the appropriate divisions or offices to formally assess and document in a recommendation whether any of the Global Settlement's remaining terms should be codified.

Agency Comments and Our Evaluation

We provided a copy of this draft report to SEC and FINRA for their review and comment. In its comment letter, which is reprinted in appendix III, SEC generally agreed with our findings and recommendation. SEC staff noted that the agency has been working to promote the objectivity and independence of securities research analysts. They agreed that the appropriate SEC staff should assess whether any of the remaining Global Settlement provisions should be codified and applied to the entire industry. SEC and FINRA also provided technical comments that we have incorporated as appropriate.

We are sending copies of this report to SEC, FINRA, interested congressional committees and members, and others. The report also is available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (202) 512-8678 or clowersa@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix IV.



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Appendix I: Objectives, Scope, and Methodology

Section 919A of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires us to identify and examine potential conflicts of interest between investment banking and research staff in the same firm.¹ To address this mandate, we examined (1) what is known about the effectiveness of the regulatory actions taken to address research analyst conflicts of interest and (2) what additional actions, if any, could regulators take to further address research analyst conflicts.

To understand the nature of research analyst conflicts and identify regulatory actions taken to address them, we reviewed financial journal articles as well as industry, GAO, and other studies; a congressional hearing that included testimonies by the Securities and Exchange Commission (SEC), National Association of Securities Dealers (NASD), and North American Securities Administrators Association (NASAA); SEC and state attorney general enforcement actions taken against broker-dealers involving analyst conflicts; SEC and SRO proposed and final rules and related releases; and Global Research Analyst Settlement (Global Settlement) documents, including the addendum and independent monitor reports. To help evaluate the effectiveness of the regulatory actions taken to address research analyst conflicts, we reviewed and analyzed academic studies that empirically examined the effects of the regulatory reforms—SEC and SRO research analyst rules and the Global Settlement—on analyst research and recommendations. We limited our review to studies issued after January 1, 2005, because of the time frames in which the regulatory reforms were adopted. (See the end of the report for a bibliography listing the studies included in our review.) We included published and working papers in our review.² Although we found these studies to be sufficiently reliable for the purposes of our report, attributing effect to any particular regulatory reform is difficult. Therefore, we interpret the literature more broadly as gauging the effect of the

¹Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub.L. No. 111-203, 124 Stat. 1837-1838 (July 21, 2010).

²Note that working papers are subject to revision, and some include additional limitations in areas on which we do not report.

collective reforms and do not believe the evidence can be used to selectively attribute causality to any specific reform.³

To evaluate the effectiveness of the regulatory reforms, we also reviewed data provided by the Financial Industry Regulatory Association (FINRA) from its electronic system used to track the lifecycle of FINRA's regulatory matters, including examinations and investigations. Specifically, FINRA provided us with data on examinations and investigations that were conducted between 2005 and 2010; covered its member broker-dealers; and a review of research practices and compliance with the Global Settlement, NASD 2711, or New York Stock Exchange (NYSE) Rule 472. To assess the reliability of the data that we used to help support one of our findings, we reviewed relevant documentation about the system's operation and administration and interviewed knowledgeable FINRA officials about the system and integrity of the data. Based upon our review, we found the data sufficiently reliable for our purposes. In addition, we discussed with SEC staff the nature and findings of their broker-dealer examinations conducted between 2005 and 2010 and involving conflicts between research analysts and investment bankers.⁴ We also reviewed enforcement actions taken by SEC between 2005 and 2010 involving conflicts between research analyst and investment bankers, and reports prepared by independent, or third-party, monitors that assessed the settlement firms' compliance with the Global Settlement.

To gain insights on the effectiveness of the regulatory actions taken to address analyst conflicts and to identify additional actions that could be taken to address such conflicts, we interviewed officials from SEC, FINRA, and NASAA, including its members from the state securities commissions of Florida, Illinois, Washington state, Texas, and Connecticut. NASAA officials identified these states as appropriate to

³The inclusion of a particular finding for a given study does not imply we found other portions of the study to be equally reliable. Given the difficulty in disentangling the effect of the regulatory reforms from other important causal forces and computing estimates of fundamental value, as well as other limitations, the findings should be interpreted with some caution.

⁴SEC staff told us that the agency's examination database does not have an electronic search capability that can be used to identify which broker-dealer examinations included a review of which specific SRO rules. According to SEC staff, the agency is currently developing a new examination database with improved search capabilities and plans for the system to be online as early as 2012.

contact because of their involvement in the investigations that led to the Global Settlement. We also interviewed representatives from 20 broker-dealers, including 10 of the settlement broker-dealers, and their industry association, the Securities Industry and Financial Markets Association. With the Securities Industry and Financial Markets Association's logistical assistance, we interviewed 1 broker-dealer separately and the other 19 broker-dealers in two separate groups. In addition, we spoke with four law or economics professors; two money managers; four independent research firms; a securities research consultant; and various organizations representing retail investors, institutional investors, or other investment professionals, including AARP, the American Association of Individual Investors, the American Federation of Labor and Congress of Industrial Organizations, the Association of Institutional Investors, the CFA institute, the Consumer Federation of America, the Investment Company Institute, the National Association of Shareholder and Consumer Attorneys, and the National Investor Relations Institute. Finally, we contacted several state attorney general offices and the National Association of Attorneys General to gain their perspectives; however, these organizations either declined to participate because the staff involved in the Global Settlement or related investigations no longer worked there or they deferred to officials from their state securities commissions.

To identify additional actions that regulators could take to further address research analyst conflicts, we also reviewed SRO concept proposals, proposed rules, and related comment letters and Global Settlement documents, including the settlement firms' 2009 request to modify the Global Settlement's addendum and the federal court's 2010 order approving modifications to the addendum. In addition, we reviewed recent enforcement actions involving fixed-income research conflicts; academic, industry, and GAO reports; and commentaries from market observers.

We conducted this performance audit from September 2010 to January 2012 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Original and Modified Global Settlement Addendum Compared with NASD Rule 2711

In April 2003, the SEC, National Association of Securities Dealers, New York Stock Exchange, North American Securities Administrators Association, the New York Attorney General and other state authorities announced that the enforcement actions against 10 of the largest broker-dealers had been completed and the terms of the agreement had been finalized (the Global Settlement). The Global Settlement relates to charges that the firms had 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. The Global Settlement was approved by the U.S. District Court for the Southern District of New York on October 31, 2003.¹ In August 2009, the Global Settlement firms submitted a motion proposing certain modifications for the court's consideration and SEC did not oppose this motion. In March 2010, the court entered an order approving all but one of the requested modifications. The order provided that the parties expected SEC would agree to further modification of the Global Settlement's terms at the earlier of March 15, 2011, or the effective date of the consolidated research rule proposed by FINRA in October 2008 (if such rules addressed the Global Settlement's remaining terms), unless SEC believes such amendment or modification would not be in the public interest. Any such amendment or modification would be subject to court approval. To date, the Global Settlement firms have not requested any further modification of the settlement.

¹The Global Settlement firms and Regulators subsequently agreed to amend certain provisions of the Global Settlement, which amendments were approved by the district court on September 24, 2004.

Appendix II: Original and Modified Global Settlement Addendum Compared with NASD Rule 2711

Table 1: Sections I and II of the Global Settlement’s Addendum and Modified Addendum, and a Crosswalk between the Global Settlement’s Addendum to NASD Rule 2711

Topic	Section	Original provision	Modified provision following the 2010 Order	Alternative SRO provision provided for judicial consideration^a
Section I of the addendum: structural reforms				
Reporting lines	I.1 ^b	Research ^c and Investment Banking ^d will be separate units with entirely separate reporting lines within the firm.	Removed entire provision.	<i>NASD 2711(b)(1)</i> . No research analyst may be subject to the supervision or control of any employee of the firm’s investment banking department.
Legal/compliance	I.2	Research will have its own dedicated legal and compliance staff, who may be part of the firm’s overall compliance/legal infrastructure.	Removed entire provision.	No similar requirement. ^e
Budget	I.3 Budget Allocation	The Research budget and allocation of Research expenses will be determined by the firm’s senior management without input from Investment Banking and without regard to specific revenues or results derived from Investment Banking.	Unchanged.	No similar requirement.
	I.3 Budget Review	Annually, the Audit Committee of the firm’s holding/parent company will review the budgeting and expense allocation process with respect to Research to ensure compliance with the Global Settlement requirements.	Removed provision.	No similar requirement. ^f
Physical Separation	I.4	Research and Investment Banking will be physically separated in a way designed to prevent intentional and unintentional flow of information between the two groups.	Unchanged.	No similar requirement considered by the court.

Appendix II: Original and Modified Global Settlement Addendum Compared with NASD Rule 2711

Topic	Section	Original provision	Modified provision following the 2010 Order	Alternative SRO provision provided for judicial consideration^a
Compensation	1.5	Professional Research personnel compensation must be determined exclusively by Research management and the firm's senior management—excluding Investment Banking personnel—using set principals including: (i) Investment Banking has no input; (ii) compensation will not be based directly or indirectly on Investment Banking revenue, but may relate to the revenues or results of the entire firm; (iii) compensation must be significantly based on a lead analyst's accuracy of research and analysis, in part relying on evaluations by the firm's investing customers and the firm's sales personnel, and rankings in independent surveys; and (iv) other criteria. All criteria must be set in advance in writing. Compensation decisions must be documented for: (i) anyone who, in the last 12 months, has been required to certify a research report; and (ii) generally, anyone who is a member of Research management.	Removed entire provision.	<p><i>NASD 2711(b)(1.)</i> No person engaged in investment banking activities may have influence or control over the compensatory evaluation of a research analyst.</p> <p><i>NASD 2711(d).</i> (1) No bonus, salary or other form of compensation may be paid to a research analyst that is based on a specific investment banking services transaction. (2) 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 that reports to the board of directors, or if none, to a senior executive officer. The committee may not have representation from the firm's investment banking department. The committee must consider factors including: (i) the research analyst's individual performance including productivity and quality; (ii) the correlation between the analyst's recommendations and stock price performance; and (iii) overall ratings received from clients, sales force, and peers independent of the investment banking department. The committee may not consider as a factor the analyst's contributions to the firm's investment banking business. The basis for the decision must be documented and an attestation must certify that the committee reviewed and approved the compensation and documented the basis.</p> <p><i>NASD 2711(i).</i> The firm must adopt and implement a written supervisory procedure reasonably designed to ensure that the firm and its employees comply with NASD 2711(d)(2) and a senior officer must attest by April 1 annually that the firm has adopted and implemented the procedures.</p>

Appendix II: Original and Modified Global Settlement Addendum Compared with NASD Rule 2711

Topic	Section	Original provision	Modified provision following the 2010 Order	Alternative SRO provision provided for judicial consideration^a
Evaluation	I.6	Investment Banking personnel may not do or provide input on Research personnel evaluations.	Removed entire provision.	<i>NASD 2711(b)(1)</i> and <i>NASD 2711(d)(2)</i> , as described under I.5.
Coverage	I.7	Investment Banking will have no input into company-specific coverage decisions and investment banking revenues or potential revenues will not be taken into account in making company-specific coverage decisions. The requirement does not apply to category-by-category coverage decisions.	Unchanged.	No similar requirement.
Termination of coverage	I.8	When a decision is made to terminate coverage of a particular company in the firm's research reports, the firm will make available a final research report on the company using the means of dissemination equivalent to those ordinarily used. The final report must be comparable to prior reports unless it is impracticable for the firm. The final report must disclose the firm's termination of coverage and rationale for the decision. No final report is required for a company when the firm's prior coverage was limited to quantitative or technical research reports.	Removed entire provision.	<i>NASD 2711(f)(5)</i> . A firm must give notice if it terminates its research coverage of a subject company. The firm must make available a final research report using the means of dissemination equal to those it ordinarily uses for research on the company. The report must be comparable in scope and detail to prior research reports and include a final recommendation or rating, unless it is impracticable for the firm to produce a comparable report. If it is impracticable to produce a final recommendation or rating, the final research report must disclose the firm's rationale for the decision to terminate coverage.
Prohibition on soliciting investment banking business	I.9	Research is prohibited from participating in efforts to solicit investment banking business. Research may not, among other things, participate in any "pitches" for investment banking business to prospective investment banking clients, or have communications with companies for the purpose of soliciting investment banking business.	Removed entire provision.	<i>NASD 2711(c)(4)</i> . No research analyst may participate in efforts to solicit investment banking business. No research analyst may, among other things, participate in any "pitches" for investment banking business to prospective investment banking clients, or have other communications with companies for the purpose of soliciting investment banking business.
Firewalls between Research and Investment Banking	I.10	To reduce the potential for conflicts of interest or the appearance of conflicts of interest, the firm must create and enforce firewalls between Research and Investment Banking reasonably designed to prohibit all communications between the two except as in I.10(a) through I.10(g).		

**Appendix II: Original and Modified Global
Settlement Addendum Compared with NASD
Rule 2711**

Topic	Section	Original provision	Modified provision following the 2010 Order	Alternative SRO provision provided for judicial consideration^a
	I.10(a)	Investment Banking personnel may seek, through Research management or in the presence of internal legal or compliance staff, the views of Research personnel about the merits of a proposed transaction, a potential candidate for a transaction, or market or industry trends, conditions or developments. Research personnel may respond to such inquiries through Research management or an appropriate designee or in the presence of internal legal or compliance staff. Research personnel, through Research management, designee or in the presence of internal legal or compliance staff, may initiate communications with Investment Banking personnel relating to market or industry trends, conditions or developments, provided the communications are consistent in nature with the types an analyst might have with investing customers. Any communication between Research and Investment Banking personnel must not be made for the purpose of having Research personnel identify specific potential investment banking transactions.	Unchanged. ⁹	No similar requirement considered by the court.
	I.10(b)	In response to a request by a commitment or similar committee (or subgroup), Research personnel may communicate their views about a proposed transaction or potential candidate for a transaction to the committee or subgroup in connection with the review of the transaction or candidate by the committee. Investment Banking personnel working on the proposed transaction may participate with the Research personnel in these discussions. But, the Research personnel also must have an opportunity to express their views to the committee or subgroup outside the presence of the Investment Banking personnel.	Unchanged.	No similar requirement.

**Appendix II: Original and Modified Global
Settlement Addendum Compared with NASD
Rule 2711**

Topic	Section	Original provision	Modified provision following the 2010 Order	Alternative SRO provision provided for judicial consideration^a
	I.10(c)	Research personnel may assist the firm in confirming the adequacy of disclosure in offerings or other disclosure documents for a transaction based on the analysts' communications with the company and other vetting conducted outside the presence of Investment Banking personnel. However, to the extent communicated to Investment Banking personnel, the communications must only be made in the presence of underwriters' or other counsel on the transaction or internal legal or compliance staff.	Modified. The modified language states that Research personnel may assist the firm in confirming the adequacy of disclosure in offering or other disclosure documents for a transaction based on the analysts' communications with the company and other third parties (including, e.g., suppliers, customers, accountants, vendors, and regulatory authorities). However, (i) there are restrictions on the communication's purpose and those who may be present and (ii) to the extent such communications are later communicated by Research personnel to Investment Banking personnel, the communication must only be made in the presence of internal legal or compliance staff, or underwriters or other counsel on the transaction who are knowledgeable regarding Research and Investment Banking conflicts and Addendum A.	No similar requirement.

**Appendix II: Original and Modified Global
Settlement Addendum Compared with NASD
Rule 2711**

Topic	Section	Original provision	Modified provision following the 2010 Order	Alternative SRO provision provided for judicial consideration^a
	I.10(d)	After the firm receives an Investment Banking mandate or in connection with a block bid or similar transaction, Research personnel may: (i) communicate views on pricing and structuring of the transaction to the firm's equity capital market group personnel; (ii) provide equity capital markets group information obtained from investing customers relevant to pricing and structuring of the transaction; (iii) participate with the equity capital markets group, or independently, in efforts to educate the firm's sales force regarding transactions (including assisting in preparation of internal-use memos), provided that Research personnel may not appear jointly with management of the issuer or Investment Banking personnel, with some exclusions, and provided that (1) oral communications by Research personnel must have a reasonable basis; (2) oral communication to a group of ten or more of the sales force must be "fair and balanced" ⁿ and made in the presence of internal legal or compliance personnel; (3) all internal-use memos regarding the transaction that are identified as being the views of Research personnel must comply with the fair and balanced standard; (4) internal research memos distributed to a group of ten or more of the firm's sales force must be reviewed in advance by internal legal or compliance personnel; (5) a written log of all oral communications under (2) must be maintained; and (6) all written logs and internal Research memos described in (4) must be retained.	Modified. The provision becomes effective also in the case of investment banking transactions other than initial public offerings and in connection with, among those previous, a competitive secondary follow-on offering where the issuer or selling shareholder has contacted the firm to request that the firm submit a transaction proposal. In Section (iii)(2), the requirement for all oral communication to a group of ten or more of the firm's sales force to be made in the presence of internal legal or compliance personnel has been removed. Sections (iii)(4)-(6) were removed.	<i>NASD 2711(c)(7)</i> . Any written or oral communication by a research analyst with a current or prospective customer or internal personnel related to an investment banking services transaction must be fair, balanced and not misleading, taking into consideration the overall context in which the communication is made.
	I.10(e)	Research personnel may attend and participate in a widely-attended conference attended by Investment Banking personnel or in which Investment Banking personnel participate, as long as Research personnel do not participate in activities otherwise prohibited.	Modified. Research personnel may also attend an "other widely attended event," not just a "conference."	No similar requirement.

**Appendix II: Original and Modified Global
Settlement Addendum Compared with NASD
Rule 2711**

Topic	Section	Original provision	Modified provision following the 2010 Order	Alternative SRO provision provided for judicial consideration^a
	I.10(f)	Research and Investment Banking personnel may attend or participate in widely attended firm or regional meetings at which matters of general firm interest are discussed. Research and Investment Banking management may attend meetings or sit on firm management risk or compliance committees at which matters of general firm interest are discussed. Research and Investment Banking personnel may communicate with each other with respect to legal or compliance issues provided that internal legal or compliance staff is present.	Unchanged.	No similar requirement.
	I.10(g)	Research and Investment Banking personnel may communicate without restrictions on issues not related to investment banking or research activities.	Unchanged.	No similar requirement.

**Appendix II: Original and Modified Global
Settlement Addendum Compared with NASD
Rule 2711**

Topic	Section	Original provision	Modified provision following the 2010 Order	Alternative SRO provision provided for judicial consideration^a
Additional restrictions on activities by Research and Investment Banking personnel	I.11	<p>(a) Research personnel are prohibited from participating in company or Investment Banking sponsored road shows related to a public offering or other investment banking transaction.</p> <p>(b) Investment Banking personnel are prohibited from directing Research personnel to engage in marketing or selling efforts to investors with respect to an investment banking transaction.</p> <p>(c) After the firm receives an investment banking mandate relating to a public offering of securities, Research personnel may communicate with investors regarding the offering provided that Research personnel may not appear jointly with management of the issuer or Investment Banking personnel in the communications, and also: (1) oral communication by Research personnel with investors regarding the offering in which a recommendation or views (even if not labeled as such) is expressed by the Research personnel regarding the offering must have a reasonable basis; (2) oral communication to a group of 10 or more investors regarding the offering must comply with fair and balanced standards; (3) all oral communication to a group of 10 or more investors must be in the presence of internal legal or compliance personnel; (4) a written log of all oral communications in (2) must be maintained; and (5) all written logs must be retained.</p>	<p>Modified.</p> <p>Sections (a) and (b) were removed.</p> <p>Sections (c)(3)-(5) were removed.</p>	<p><i>NASD 2711(c)(5)</i>. A research analyst is prohibited directly or indirectly from participating in a road show related to an investment banking services transaction and engaging in any communication with a current or prospective customer in the presence of investment banking department personnel or company management about an investment banking services transaction.</p> <p><i>NASD 2711(c)(6)</i>. Investment banking department personnel are prohibited from directly or indirectly directing a research analyst to engage in sales or marketing efforts related to an investment banking services transaction and directing a research analyst to engage in any communication with a current or prospective customer about an investment banking services transaction.</p>
Oversight	I.12	<p>An oversight/monitoring committee(s), which will be comprised of representatives of Research management and may include others (but not Investment Banking personnel), will be created to: (a) reviews all changes in rating, and material changes in price targets contained in the firm's research reports; (b) conduct periodic reviews of research reports to determine whether changes in ratings or price targets should be considered; and (c) monitor the overall quality and accuracy of the firm's research reports. The reviews are not required for quantitative or technical research reports.</p>	<p>Unchanged.</p>	<p>No similar requirement.</p>

**Appendix II: Original and Modified Global
Settlement Addendum Compared with NASD
Rule 2711**

Topic	Section	Original provision	Modified provision following the 2010 Order	Alternative SRO provision provided for judicial consideration ^a
Section II of the Addendum: disclosure reforms				
Disclosures	II.1	<p>Firms must disclose prominently on the first page of any research report and any summary or listing of recommendations or ratings contained in previously-issued research reports, in type no smaller than the type used for the text of the report or summary or listing, that:</p> <p>(a) “[Firm] does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have conflicts of interest that could affect the objectivity of this report.”</p> <p>(b) With respect to Covered Companies as to which the firm is required to make available Independent Research: “Customers of [firm] in the United States can received independent, third-party research on the company or companies covered in this report, at no cost to them, where such research is available. Customers can access this independent research at [website address/hyperlink] or can call [toll-free number] to request a copy of the research.”</p> <p>(c) “Investors should consider this report as only a single factor in making their investment decision.”</p>	<p>Unchanged, but the requirement to provide independent research has expired so the disclosure required by II.1(b) is not applicable at this time.</p>	<p>No similar requirement considered by the court.</p>

Appendix II: Original and Modified Global Settlement Addendum Compared with NASD Rule 2711

Topic	Section	Original provision	Modified provision following the 2010 Order	Alternative SRO provision provided for judicial consideration^a
Transparency of analysts' performance	II.2	The firm must make publicly available no later than 90 days after the end of each quarter specific information, if included in any research report prepared and furnished by the firm during the prior quarter: company, names of analysts responsible for certification of the report pursuant to Regulation Analyst Certification, date of report, rating, price target, period within which the price target is to be achieved, earning per share forecast for the current and next quarter and current full year, and definition/explanation of ratings used by the firm.	Removed entire provision.	<p><i>NASD 2711(h)(4)</i>. If a research report contains a rating, the firm must define in the research report the meaning of each rating used by the firm in its rating system. The definition must be consistent with its plain meaning.</p> <p><i>NASD 2711(h)(5)</i>. A firm must disclose in each research report the percentage of all securities that the firm assigned a "buy," "hold/neutral," or "sell" rating. In each report, the firm must disclose the percentage of subject companies within each of the three categories for whom the firm has provided investment banking services within the prior 12 months. The information disclosed must be current as of the end of the most recent calendar quarter and reflect the distribution of the most recent ratings issued by the firm for all subject companies, unless the recent rating was issued more than 12 months ago. But the requirement does not apply to any research report without a rating.</p> <p><i>NASD 2711(h)(6)</i>. If a research report contained a rating or a price target and the firm has assigned a rating or price target to the subject company's securities rating for at least 1 year, the research report must include a line graph of the security's daily closing price for the period that the firm has assigned any rating or price target or for a 3-year period, whichever is shorter.</p> <p><i>NASD 2711(h)(7)</i>. If a research report contains a price target, the firm must disclose in the report the valuation methods used to determine the price target. Price targets must have a reasonable basis and must be accompanied by a disclosure concerning the risks that may impede achievement of the price target.</p>

**Appendix II: Original and Modified Global
Settlement Addendum Compared with NASD
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Topic	Section	Original provision	Modified provision following the 2010 Order	Alternative SRO provision provided for judicial consideration^a
Applicability	II.3	<p>Generally, Sections I and II will only apply to a research report this is both: (i) prepared by the firm; and (ii) that relates to either (a) a U.S. company,ⁱ or (b) a non-U.S. company for which a U.S. market is the principal equity trading market.^j But the restrictions and requirements do not apply to Research activities relating to a non-U.S. company until the second calendar quarter following the calendar quarter in which the U.S. market became the principal equity trading market for the company.</p> <p>Additionally, Section I.7 will apply to any research report that has been furnished by the firm to investors in the U.S., but not prepared by the firm, but only to the extent that the report relates to either (a) a U.S. company or (b) a non-U.S. company from which a U.S. market is the principal equity trading market.</p> <p>Also, Section II.1 will apply to any research report that has been furnished by the firm to investors in the U.S., but not prepared by the firm, including a report that relates to a non-U.S. company for which a U.S. market is not the principal equity trading market, but only to the extent that the report has been furnished under the firm's name, has been prepared for the exclusive or sole use of the firm or its customers, or has been customized in any material respect for the firm or its customers.</p>	Unchanged.	No similar requirement.
General	II.4	<p>A firm may not knowingly do indirectly what it cannot do directly.</p> <p>The firm will adopt and implement policies and procedures reasonably designed to ensure that its associated persons cannot and do not seek to influence the content of a research report or activities of Research personnel for the purpose of obtaining or retaining investment banking business. Firm procedures will instruct firm personnel to immediately report to the firm's legal or compliance staff any attempt to influence the contents of a research report or activities of Research personnel for such a purpose.</p>	Unchanged.	No similar requirement considered by the court.

**Appendix II: Original and Modified Global
Settlement Addendum Compared with NASD
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Topic	Section	Original provision	Modified provision following the 2010 Order	Alternative SRO provision provided for judicial consideration^a
Timing	II.5	Provisions will generally be effective within 120 days, with some effective within 60 days and others effective within 270 days of the entry of the final judgment.	Unchanged.	No similar requirement.
Review of implementation	II.6	At their own expense, the firms retained an Independent Monitor acceptable to the staff of the SEC, NYSE, NASD, the President of NASAA and the New York Attorney General's Office to conduct a review to provide reasonable assurance of the implementation and effectiveness of the firm's policies and procedures designed to achieve compliance with the requirements. The review started 18 months after the entry of the final judgment. ^k The monitors were to produce a report including recommendations to achieve compliance with the requirements and prohibitions. The report must be produced to the agencies no later than 24 months after the final judgment. The firm could comment on the report prior to submission. The firm must adopt all recommendations, unless, after demonstration of undue burden, the agencies determine it is not necessary. The Independent Monitor is restricted from certain other employment opportunities for 3 years from the end of the engagement.	Unchanged.	No similar requirement.

**Appendix II: Original and Modified Global
Settlement Addendum Compared with NASD
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Topic	Section	Original provision	Modified provision following the 2010 Order	Alternative SRO provision provided for judicial consideration^a
Superseding rules and amendments	II.7	If the SEC adopts a rule or approves an SRO rule or interpretation with the stated intent to supersede any of the settlement provisions, the SEC or SRO rule or interpretation will govern and the settlement will be superseded. Amendments are permitted with appropriate court and agency permissions. With respect to Sections I and II that have not been superseded within 5 years of the final judgment, it is the expectation of all parties that the SEC would agree to an amendment or modification of terms, subject to court approval, unless the SEC believes they would not be in the public interest.	Modified. In addition to the original language, additional language was added that in the event of provisions remaining after the five year period, then upon the earlier of (i) 1 year following the court approval; or (ii) the effective date of new research rules proposed by FINRA (08-55), if such rules address the remaining provisions of the modified Addendum A, it is the expectation of the parties that the SEC would agree to a further amendment or modification of the agreement, subject to court approval, unless the SEC believes the amendment or modification is not in the public interest.	No similar requirement.
Other obligations and requirements	II.8	Except as otherwise specified, the requirements and prohibitions of the agreement must not relieve the firm of any other applicable legal obligation or requirement.	Unchanged.	No similar requirement.

Source: GAO analysis of court documents.

^aOn August 3, 2009, the Defendants made parties to Addendum A of SEC v. Bear, Stearns & Co (03 Civ. 2937) and its associated cases (the "Case"), filed a letter brief requesting amendments and modifications to the Addendum A (the "Letter Brief"). The Defendants provided detailed rationale for each request including citing the pertinent NASD or FINRA rule which the Defendants proposed was applicable to the same topic. On March 15, 2010, Judge William H. Pauley III "revised Addendum A as proposed by the parties ..." except for a requested change in Section I.10(a) which was declined. See SEC v. Bear, Stearns & Co. Order.

^bSection I.1 includes a definition section which was not altered by the 2010 Order revising Addendum A. The definitions will not be discussed within this chart except where pertinent to explain another requirement.

^c"Research" means all firm personnel engaged principally in the preparation or publication of research reports, including firm personnel who are directly or indirectly supervised by such persons and those who directly or indirectly supervise such persons, up to and including research management. Addendum A at Section I.1(d).

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^d“Investment banking” means all firm personnel engaged principally in investment banking activities, including the solicitation of issuers and structuring of public offering and other investment banking transactions. It also includes all firm personnel who are directly or indirectly supervised by such persons and all personnel who directly or indirectly supervise such persons, up to and including Investment Banking management. Addendum A at Section I.1(c).

^eThe Case Letter Brief stated that the firms “now have legal and compliance personnel who are experienced in monitoring compliance with the Addendum.” SEC v. Bear, Stearns & Co. Letter Brief at p. 5.

^fThe Case Letter Brief stated that the parties to the settlement have “agreed that it would be consistent with the public interest to eliminate the annual Audit Committee review requirement” SEC v. Bear, Stearns & Co. Letter Brief at p. 5.

^gThe Case Letter Brief requested changes to Section I.10(a) to provide that “research personnel and investment banking personnel may communicate with each other, outside the presence of the internal legal or compliance staff, regarding market or industry trends, conditions or development, provided that such communications are consistent in nature with the types of communications that an analyst might have with investing customers.” SEC v. Bear, Stearns & Co. Letter Brief (Aug. 3, 2009) at p. 5. However, the court determined that the proposed modification “would be inconsistent with the final judgment and contrary to the public interest” and therefore, denied the request. SEC v. Bear, Stearns & Co. Order (Mar. 15, 2010) at p. 2.

^h“Fair and balanced” as defined in NASD Rule 2210(d)(1).

ⁱA “U.S. company” means any company incorporated in the United States or whose headquarters is in the U.S. Addendum A at Section II.3(b).

^jThe “principal equity trading market” becomes the U.S. market in a quarter when more than 50 percent of the worldwide trading in the company’s common stock and equivalents takes place in the U.S. Addendum A at Section II.3(c).

^kThe “final judgment” is the date of the entry of judgment in the SEC’s action against the Defendants. The court entered final judgments against the defendant investment banks in all but two cases (against Deutsche Bank Securities Inc. and Thomas Weisel Partners LLC) on October 31, 2003. The court entered final judgment against the remaining two on September 27, 2004.

Appendix III: Comments from the Securities and Exchange Commission



DIVISION OF
TRADING AND MARKETS

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

January 6, 2012

Orice Williams Brown
Managing Director
Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Ms. Brown:

Thank you for providing the Securities and Exchange Commission with the opportunity to respond to the draft report prepared by the Government Accountability Office ("GAO") entitled *Securities Research: Additional Actions Could Improve Regulatory Oversight of Analyst Conflicts of Interest* dated January 17, 2012 ("Report"). As part of its mission to protect investors, the Securities and Exchange Commission ("Commission") has been working to promote the objectivity and independence of securities research analysts.

The Commission staff appreciates the GAO's recommendation that the appropriate divisions or offices of the Commission formally assess and document whether any of the remaining terms of the Global Research Analyst Settlement ("Global Settlement") should be codified. The Global Settlement enforcement actions, announced on April 28, 2003, were the culmination of examinations and investigations by the Commission and other regulators into the influence of investment banking on securities research. The Commission's actions alleged that the settling firms engaged in acts and practices that enabled investment banking to exert inappropriate influence over research analysts, which created conflicts of interest for research analysts that the firms failed to manage appropriately. The actions also alleged that certain of the settling firms issued fraudulent research, and that other settling firms issued research reports that did not meet principles of fair dealing and good faith, did not provide a sound basis for evaluating facts, contained exaggerated claims about covered companies, and/or contained opinions for which there was no reasonable basis. The actions also alleged supervisory failures at each of the settling firms.

The Global Settlement imposed significant structural reforms to address these issues. As you note in the Report, on March 15, 2010 the court that oversees the Global Settlement issued an order approving certain modifications to the final judgments entered against the settling firms. The Commission staff agrees with your recommendation that the appropriate divisions or offices of the Commission assess the Global Settlement provisions that remain after these March 2010 amendments as to whether any of those provisions should be codified and applied to the entire industry.

Orice Williams Brown
U.S. Government Accountability Office
January 6, 2012
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If you have any questions, please feel free to contact me at (202) 551-5500, or contact the Associate Director in the Division of Trading and Markets with responsibility for this area, Brian Bussey, at (202) 551-5571.¹

Sincerely,



Robert W. Cook
Director
Division of Trading and Markets

¹ Commission staff is separately providing technical comments on the Report to GAO staff.

Appendix IV: GAO Contact and Staff Acknowledgments

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Staff Acknowledgments

In addition to the contact named above, Richard Tshara, Assistant Director; Rachel DeMarcus; Lawrance Evans Jr.; Tiffani Humble; Jim Lager; Marc W. Molino; Angela Pun; Barbara Roesmann; Jessica Sandler; and Cynthia Saunders made key contributions to this report.

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