

COMPANIES, ANALYSTS AND INVESTMENT BANKERS: WHO CAN TALK TO WHOM ABOUT WHAT?

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I. RESTRICTIONS ON THE COMPANY'S DISCLOSURES TO ANALYSTS

A. SEC Regulation FD

1. Applies only to communications by senior officials of the company to securities market professionals (and to shareholders, when it is reasonably foreseeable they will trade on the information).
2. Prohibits selective disclosure of material non-public information by company senior officials to analysts.
3. If the company discovers a non-intentional disclosure of material information, it cures the problem by "filing" the information under Item 5, or "furnishing" it under Item 9, of Form 8-K (or by press release or posting on its website).
4. SEC recommended procedure for planned disclosures:
 - a. Issue a press release
 - b. Give adequate notice of a scheduled conference call to discuss announced results
 - c. Permit investor attendance at conference call
5. Many lawyers are recommending that the Audit Committee review earnings press releases before they are released.
6. No law requires a company to provide earnings guidance, but approximately 80% of them do. Studies show that the variation in analyst forecasts is wider for companies that do not provide guidance.
7. The SEC's FD release says that a private discussion by a company official with an analyst seeking guidance about earnings estimates is extremely risky.
 - a. The SEC also cautions that a company which changes its accustomed method of releasing earnings – *i.e.*, changing from a

regularly scheduled press release to an analyst call – will raise eyebrows at the SEC.

8. Regulation FD carves out – *i.e.*, does not apply to – disclosures made by a company in connection with a public offering. It does apply, however, to a regularly scheduled conference call with analysts while the company is in registration. SEC Release No. 33-7881, Part II B 6 a i, Note 82 (August 15, 2000).
 - a. Regulation FD also carves out disclosures made in confidence to an analyst who has been brought “over the wall” to assist investment bankers in a registered offering.

B. SEC Regulation G

1. This regulation, effective March 28, 2003, published in SEC Release No. 33-8176, January 22, 2003, limits the use by companies of non-GAAP financial measures in all disclosures, including orally, telephonically, or by webcast.
2. A “non-GAAP financial measure” is a numerical measure of historical or future financial performance, financial position, or cash flow that excludes amounts included in, or includes amounts excluded from, the most directly comparable measure presented in accordance with GAAP in the financial statements.
 - a. Examples of “non-GAAP financial measures” are EBITDA and “operating income excluding non-recurring items.”
 - b. Examples excluded are sales per square foot, store sales, *etc.* (assuming they were calculated in accordance with GAAP).
3. Regulation G does not prohibit the use of non-GAAP financial measures, it only requires that they be accompanied by a presentation of the same data in accordance with GAAP, together with a reconciliation of the differences from GAAP.
4. Regulation G also prohibits the disclosure by a company of non-GAAP financial information that contains an untrue statement of a material fact or omits to state a material fact necessary to make the non-GAAP measure not misleading.
5. Regulation G does not apply to non-GAAP financial measures that are included in disclosures related to a proposed business combination.

C. Item 12 of Form 8-K

1. The same SEC release that promulgated Regulation G also promulgated an amendment to Form 8-K adding Item 12 to it.
 2. Item 12 has a narrow focus. It requires a company to furnish an 8-K within five days after the release identifying any public announcement or release disclosing material non-public information regarding results of operations or financial condition for a *completed* quarterly or fiscal period.
 - a. There is an exception in Item 12 for analyst conference calls within 48 hours after the company has made a related written release that was required by Item 12 to be filed on Form 8-K.
 - b. Any press release required by Item 12 to be filed on Form 8-K must present the most directly comparable GAAP financial measures with equal prominence to non-GAAP financial measures and must disclose the utility of the non-GAAP financial measures to investors and why management uses that measure for its own purposes.
- D. The good news for analysts is that SEC Regulations FD and G and Item 12 of Form 8-K only restrict what the company can disclose, not what the analyst can publish, if he learns of it during a conference call with a group of analysts.

II. GENERAL RESTRICTIONS ON ANALYSTS' COMMUNICATIONS WITH SUBJECT COMPANIES AND WITH INVESTMENT BANKERS

- A. NASD Rule 2711/NYSE Rule 472
1. Rule 2711(b). No NASD firm research analyst may be subject to the supervision or control by any employee of the firm's investment banking department.
 - a. No investment banker may review or approve a research report before its publication, except for factual accuracy or to identify a potential conflict of interest, and only if the communication is made through or with a copy to a compliance officer.
 - b. Any oral communication between investment banking and research personnel concerning a research report must be documented and made through or with a compliance officer present.
 2. Rule 2711(c). An NASD firm analyst may not submit a research report to the subject company before publication, except that sections of the report may be submitted, without a recommendation, if necessary for the verification of historical facts.

- a. An analyst may, however, notify the company after the close of business that the analyst's firm intends to change its rating on the company the next day.
 3. Rule 2711(e). No NASD firm analyst may directly or indirectly offer favorable research to a company as consideration for the receipt of business or for compensation.
 4. Rule 2711(h). NASD firm research reports must disclose, and an NASD firm analyst must disclose in public appearances (which includes a conference call or webcast in which an analyst offers an opinion concerning an equity security):
 - a. Whether the analyst has a financial interest in the company's securities, and whether his firm owns 1% or more of the company's stock,
 - b. Any conflict of interest to which the analyst or his firm is subject,
 - c. Whether the company is a client of the analyst's firm, and
 - d. Whether the analyst is an officer or director of the company.
- B. SEC Regulation AC
1. SEC Regulation AC, effective April 14, 2003, requires analysts to include in their reports a certification that the report accurately reflects the analyst's personal views, and that no part of his compensation is or will be directly or indirectly related to the recommendations or views in the report.
 2. SEC Regulation AC also requires analysts to certify in writing periodically to their firm that the views about the company's securities expressed in any public appearance by him accurately reflected his personal views at that time.
 3. Regulation AC warns that where the analysis in a report contradicts the stated rating in the same report, the analyst is in violation of the anti-fraud provisions of the federal securities laws.

III. RESTRICTIONS ON ANALYSTS' REPORTS AND ACTIVITIES IN CONNECTION WITH REGISTERED PUBLIC OFFERINGS

- A. If the analyst's firm is not a member of the underwriting syndicate, then Rule 137 affords him an exception from any violation of Section 5 of the Securities Act, so as to permit him to continue to publish research during the pendency of the offering.

- B. If the analyst's firm is a member of the underwriting syndicate, *but is not a manager or co-manager*, then:
1. If (x) the analyst's firm has never previously published research on the company, or (y) the company has a public float of less than \$75MM, then the Rule 139 exemption does not apply, and the conservative position is for the analyst not to publish until 30 days after completion of the offering.
 2. If (x) the analyst's firm has recently published at least one report on the company, and (y) the company has a public float of at least \$75MM, then Rule 139 allows the analyst to publish, notwithstanding his firm's participation in the syndicate.
 - a. Even if the Rule 139 exemption is available, many NASD firms will block the release of a research report on a company during the Regulation M restricted period of one day or five days, as the case may be, before pricing that applies in a case of companies with a public float of less than \$150MM and an ADTV of less than \$1MM.
- C. If the analyst's firm *is a manager or co-manager of the syndicate*, then in addition to the restrictions mentioned in paragraph B above:
1. If the analyst is brought over the wall, he cannot publish a research report until after the offering is completed. A widespread industry practice has been not to permit an analyst to release a report in this situation until 30 days after the offering has been completed.
 - a. The good news is that if the analyst is brought over the wall, he becomes a temporary insider and is free to share his views of the company with investment bankers and to receive material undisclosed information from them. Regulation FD does not apply to registered public offerings. FD Rule 100(b)(2)(iv).
 2. NASD Rule 2711(f) imposes a ten-day moratorium after the offering on the issuance of analyst reports by an NASD member firm that was a manager or co-manager of a syndicate, except where the company has a public float in excess of \$150MM.

IV. PROPOSED RULES AFFECTING COMMUNICATIONS BETWEEN COMPANIES AND ANALYSTS

- A. Both the NASD and the NYSE last October proposed amendments to NASD Rule 2711 and NYSE Rules 472 and 351 that affect the regulation of analysts.
- B. The proposed amendments are generally similar and have not yet been approved by the SEC.

- C. Proposed NASD Rule 2711(a)(5) would expand the definition of “research analyst” to include other persons who have direct influence or control with respect to research reports.
- D. Proposed NASD Rule 2711(c)(4) would prohibit a research analyst from issuing a report on a company if the analyst previously attended a “bake-off” meeting with the company to pitch investment banking services, and the analyst’s firm participated in underwriting an IPO for the company.
- E. Proposed NASD Rule 2711(f)(3) would extend the existing blackout period – which is now ten days after the completion of an offering – by prohibiting an NASD firm that acted as manager or co-manager of an underwriting from publishing a research report concerning the company 15 days prior to or after the expiration, waiver, or termination of a lock-up agreement.
- F. The NASD filed a further amendment of its proposal with the SEC on December 18, 2002. The changes proposed in the amendment are essentially fine-tuning, not additional substantive requirements. The December amendment toned down certain language in the original proposal that had irritated the media.
- G. The NYSE proposed rule amendments go further than those of the NASD and are very poorly drafted. They were severely and justly criticized in the Securities Industry Association’s letter to the SEC of March 10, 2003, which identifies serious drafting problems in the NYSE proposals.
 - 1. The NYSE proposed amendments are so badly drafted that they were attacked as unconstitutional by the Newspaper Association of America, *The Wall Street Journal*, and *The New York Times*.

V. WHAT IS HAPPENING TO THE MARKET FOR ANALYST RESEARCH?

- A. It’s a field day for independent research analysts. They aren’t covered by the NASD rules, the NYSE rules, or even SEC Regulation AC.
 - 1. The definition of “covered person” in Regulation AC Rule 500 expressly excludes an investment adviser who is not, and is not required to be, registered with the SEC under the Investment Advisers Act. Independent sell-side research analysts not associated with an NASD firm are not required to register under the Advisers Act if they have less than \$25MM of assets under management and don’t advise a registered investment company. See SEC Release No. 33-8193, Part II A 2, February 20, 2003.
 - 2. Basically, independent sell-side research analysts are unregulated.
- B. During the past two years, research coverage for U.S. companies dropped by 20%. Forty-four percent of Nasdaq companies have no analyst coverage at all, and another 14% are covered by only one analyst.

- C. New research firms are springing up everywhere. The recent settlement by Wall Street firms with regulators will force those firms to purchase independent research and distribute it along with their own, thereby creating a market for new independent research firms.
- D. The fatal flaw in the reasoning of the regulators in devising new rules regulating research analysts is this. Independent research analysts, unconnected with an investment banking firm, would be unbiased and therefore less inclined to promote stocks by issuing unjustified favorable reports on them. Right? Wrong. Quite the opposite is true.
 - 1. J. M. Dutton & Associates will publish research on any company for \$25,000 a year. Eighty-six percent of Dutton's clients receive "buy" or "strong buy" ratings.
 - 2. The consensus among all analysts in January of this year was that 345 of the Standard & Poor 500 companies will increase their earnings by more than 10% a year during the next three to five years.
- E. The root problem with analysts' research is not that the analysts are unduly influenced by investment bankers to generate favorable research reports, rather it is that public companies themselves are having a hard time ratcheting down the earnings expectations they created in the minds of the analysts ten years ago.

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