

Corporate Securities

AUGUST 21, 2002

Investment Dealers Association of Canada Enacts Proposed Policy on Analyst Standards

Background

Based on the recommendations of the Securities Industry Committee on Analyst Standards established in 1999 by the Investment Dealers Association of Canada (the "IDA"), the Toronto Stock Exchange and others, the IDA has recently enacted proposed Policy No. 11 - Analyst Standards ("Policy No. 11"). Policy No. 11 is currently being considered by the Ontario Securities Commission (the "OSC") and is to become effective on a date to be determined by staff of the IDA.

The purpose of Policy No. 11 is to maintain the integrity of the capital markets and improve investor confidence through uniform minimum disclosure and supervisory requirements designed to reduce the potential for, and increase investor awareness of, the conflicts of interest that may compromise the independence of research. Policy No. 11 generally favours mandatory disclosure over outright prohibitions.

By letter dated August 15, 2002, the OSC has asked ten major investment dealers to advise the OSC on how they manage analysts' conflicts. The OSC is assessing current practices in order to determine whether additional action is necessary to address the conflicts beyond the measures proposed in Policy No. 11.

Policy No. 11 may be broadly divided into "standards", which require compliance, and "guidelines", which provide best practices that are to be complied with by IDA members ("Members") where practicable when establishing policies and procedures. Set out below is a summary of certain of the standards and guidelines contained in Policy No. 11.

Policy No. 11 Standards

- **Required Policies:** Members must design, implement and enforce policies and procedures to minimize conflicts faced by analysts, which policies must be approved by and filed with the IDA.
- **Ratings Systems:** Every research report must prominently disclose the Member's ratings system and how each recommendation fits within the system, as well as any information regarding the Member's business with, or relationship to, the subject issuer which might reasonably be expected to indicate a potential conflict of interest on the part of the Member or the analyst.
- **Reference to Full Reports:** Where a brief public comment is made about an issuer, reference must be made to whether or not a full report exists.
- **Conflicts:** Research reports must not be issued if prepared by an analyst that serves as an officer, director or employee of, or in any other advisory capacity to, the issuer.
- **Dissemination Policies:** Research reports distributed to clients or prospective clients must disclose the Member's research dissemination policies and procedures, or where such policies can be located.
- **Internal Controls:** Members who distribute research reports to clients or prospective clients must have policies and procedures to prevent

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and detect employee trading in listed securities (or derivatives) with knowledge of, or in anticipation of, the distribution of a research report, a new recommendation or a change in recommendation that could reasonably be expected to have an effect on the price of the security.

- **Trading Restrictions:** Members must ensure that analysts do not trade in securities of an issuer in respect of which the analyst has an outstanding recommendation in the absence of written approval of a designated partner, officer or director of the Member. Absent special circumstances, analysts must not trade contrary to their current recommendations.
- **Disclosure of I-Banking Fee Participation:** Research reports must disclose if the analyst responsible for preparing the report received compensation based on the Member's investment banking revenues in the previous 12 months.
- **Restrictions on Analyst Compensation:** Members must not compensate an analyst directly based on one or more specific investment banking services transactions.
- **Restricting Exercise of Influence:** Members must have policies and procedures to ensure that recommendations are not influenced by the investment banking department or the issuer.
- **Prohibition on Tied Selling:** Members must not directly or indirectly offer (or threaten to change) favourable research, a specific rating or a specific price target as consideration or inducement for the receipt of business or compensation.

Policy No. 11 Guidelines

- **Disclosure of Sources:** Members should clearly distinguish in research reports between information provided by the issuer or obtained elsewhere and the analyst's own assumptions and opinions.
- **Reliance on Third Party Sources:** Members should disclose reliance by the analyst upon third party expert reports or studies, including the identity of the third party.

- **Disclosure of Diligence:** Members should disclose if and to the extent the analyst viewed the material operations of the issuer (including any reimbursement of travel expenses).
- **Ratings Breakdown:** Members should disclose quarterly to the public the percentage of their recommendations that fall into each category of their recommendation terminology.
- **Price Targets:** Members should set price targets for recommended transactions, where practicable.
- **Broad Dissemination:** A Member should make research reports widely available at the same time through a website or otherwise for all of its clients whom the Member has determined are entitled to receive such reports.
- **CFA Designation:** Analysts, as well as persons responsible for reviewing research reports, should have the Chartered Financial Analyst designation or other appropriate qualifications.
- **Internal Reporting:** Members should have their head of research (or their analysts if there is no head of research) report to a senior officer who is not the head of the investment banking department.
- **Conflicts:** Members should not provide research on an issuer where a supervisory analyst serves as an officer or director of the issuer.

Comparison to the U.S. Model - Proposed Rule 2711

Policy No. 11 may be viewed as the Canadian equivalent of the National Association of Securities Dealers Inc. (the "NASD") new rule 2711 ("Rule 2711") in the United States. Rule 2711 was recently approved by the Securities and Exchange Commission and will be phased in during the period from July 9th to November 6th of this year (subject to certain delays in respect of small firms). The stated objective of Rule 2711, similar to that of Policy No. 11, is to address potential conflicts of interest in the issuance of research reports, improve objectivity of research and provide investors with more useful and reliable information when making invest-

ment decisions. (See our client communication of March 20, 2002 for a description of Rule 2711.) However, there are significant differences between Rule 2711 and Policy No. 11, emanating primarily from the manner in which Rule 2711 imposes prohibitions to minimize potential conflicts, compared to the approach of Policy No. 11 that for the most part favours managing conflicts of interest through disclosure while reserving prohibitions for the most serious circumstances. Rule 2711 imposes numerous restrictions on members of the NASD, while Policy No. 11 for the most part requires Members to determine their own policies and procedures based on specified guidelines (with the additional requirement of IDA approval of the policies and procedures).

By way of example, Rule 2711 prohibits the issuance of research for specified time periods surrounding the time a member has acted as manager or co-manager of an initial public offering or secondary offering of an issuer, and further prohibits an analyst from investing in shares of any security before an issuer's initial public offering if the issuer's business is similar to the business of companies followed by the analyst. Policy No. 11 does not contain similar prohibitions.

Notwithstanding the different approaches of Rule 2711 and Policy No. 11, a number of issues are addressed by disclosure under both instruments. In addition, a limited number of activities have only attracted disclosure requirements from the NASD, while attracting a prohibition from the IDA. For example, Rule 2711 requires disclosure if an analyst or a member of the analyst's household serves as an officer, director or advisory board member of a subject issuer, while Policy No. 11 prohibits the issuance of a research report in similar circumstances.

Implications

Policy No. 11, upon becoming effective, possibly as modified pursuant to the study being undertaken by the OSC, will result in significant changes to the practices of Members relating to their analysts. We would be pleased to assist Members in evaluating their current practices, as well as the development, drafting and filing of internal policies and procedures that comply

with the IDA standards and guidelines, particularly in reference to the disclosure that will be mandated by Policy No. 11. We would also be pleased to address any questions other readers may have about Policy No. 11.

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