THE UPDATE

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Corporate Securities

MAY 13, 2003

Wall Street Investment Firms Reach Settlement On Research Analyst Conflicts

Background

On April 28, 2003, settlements of enforcement actions in respect of research analyst conflicts of interest against ten Wall Street investment firms and two individual research analysts arising from joint investigations by the Attorney General for New York, the Securities and Exchange Commission ("SEC"), the National Association of Securities Dealers ("NASD"), the New York Stock Exchange ("NYSE") and state securities regulators were announced. The settlements of these actions include monetary penalties totalling approximately US$1.4 billion and the imposition of structural reforms designed to insulate research analysts from the influence of the investment banking arms of the ten firms.[1] The SEC intends to consider whether additional industry wide rules to deal with analyst conflicts of interest are necessary. Investment firms in Canada, as well as in the United States, should consider these structural reforms when reviewing their own practices.

Terms of the Settlements

Monetary Penalties

The monetary penalties imposed fall into two categories. The first category, compensatory and sanction-oriented, requires the firms to pay disgorgement and civil penalties totalling US$875 million. Approximately one half of this penalty will be placed into "distribution funds" to be distributed to customers of the firms who purchased the securities of companies referenced in the complaints. The remainder of this component of the monetary penalty will be paid to the states. The second category, reform-oriented, requires the firms to pay a total of US$432.5 million to fund independent research. For a five year period, each of the firms will be required to contract with no fewer than three independent research firms and must make the independent research available to its customers. An independent consultant for each firm will have final authority to procure the independent research. Additionally, seven of the firms must pay a total of US$80 million to fund and promote investor education.

Structural Reforms

The settlements require that the firms implement certain structural reforms designed to eliminate the conflicts that arise when the investment banking arm of a firm has the means to influence the objectivity of the firm's research analysts. These reforms include the following:

- The firms must separate research and investment banking, including physical separation, completely separate reporting lines,

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[1] In order to implement the settlements, the SEC has filed actions against each of the firms and the NYSE and NASD have completed disciplinary proceedings pursuant to their respective procedures. At the state level, model settlement agreements have been finalized and the board of directors of the North American Securities Administrators Association has recommended that all states accept the terms of the agreements. The proposed final judgments in the SEC actions remain subject to court approval.

separate legal and compliance staffs, and separate budgeting processes.

- Analysts' compensation cannot be based directly or indirectly upon investment banking revenues.

- Evaluations of research personnel will not be done by, nor will there be input from, investment banking personnel.

- An analyst's compensation must be based in significant part on the quality and accuracy of the analyst's research, and decisions concerning the compensation of analysts must be documented.

- Investment bankers must have no role in determining which companies are covered by the firm's analysts.

- The firms must implement policies and procedures reasonably designed to assure that their personnel do not seek to influence the contents of research reports for purposes of obtaining or retaining investment banking business.

- Research analysts must be prohibited from participating in efforts to solicit investment banking business, including pitches and roadshows.

- The firms must create and enforce firewalls between research and investment banking reasonably designed to prohibit all communications between the two relating to banking or research except as expressly described in the settlements. Communications are to be limited to those enabling research analysts to fulfill a "gatekeeper" role in the stock offering process, with analysts prevented from serving as marketers or cheerleaders for investment banking transactions.

Additional Disclosure Requirements

The settlements impose additional disclosure requirements on the firms that are designed to provide investors with information regarding research limitations. These include:

- Each firm must include disclosure on the first page of each research report stating that the firm does, and seeks to do, business with companies covered in its research reports and, as a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of its report. The disclosure must further state that investors should consider the report as only a single factor in making their investment decision.

- When a firm decides to terminate coverage of an issuer, it must issue a final research report discussing the reasons for the termination.

- Each firm must publish on its website on a quarterly basis a chart showing the performance of its analysts, including each analyst's name, ratings, price targets and earnings per share forecasts for each covered company, as well as an explanation of the firm's rating system.

Implications

Although the terms of the settlements are currently only applicable to the ten investment firms party to the settlements, the SEC intends to review the implementation of the settlements, along with reforms adopted by the SEC, NASD and NYSE over the last two years, to determine whether additional, harmonizing or superceding rules are appropriate. The industry in the United States is already being guided in the direction of these reforms as a result of the disclosure requirements of NASD Rule 2711 and, in Canada, as a result of proposed Policy No. 11 of the Investment Dealers Association of Canada (as described in our Updates of March 20 and August 21, 2002). Any new regulations could represent a significant expansion of the rules applicable to research analyst conflicts of interest in the United States, with Canada likely to follow to some extent at least. Investment firms that deliver securities research should be alert to the possibility of such further rules based on the settlements and consider, even in absence of the enactment of new rules, best practices in this important evolving area.

We would be pleased to address any questions you may have about the settlements in the United States and, if applicable, to assist you in evaluating your practices related to research analyst conflicts of interest.

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