

**Best Practices in the Identification and Disclosure
of Conflicts of Interest
in Equities Research Reports**

October 2005

by

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May 31, 2004

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Attention: Mr. Tim Moseley
Head of Compliance

Dear Mr. Moseley,

Please find enclosed our report on best practices in disclosure of conflicts of interest in equities research reports in Canada.

We wish to acknowledge and express our appreciation for the assistance and insight provided by the investment dealers that participated in our review, management of CIBC World Markets Inc., and staff at the SEC, NYSE, NASD, OSC, AMF, IDA and FSA.

Sincerely,

Robert Chambers, LL.B., FCA
President

RWC/hs
Enc.

cc: Autorité des marchés financiers
Ontario Securities Commission

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Executive Summary

In February 2003, settlement agreements with CIBC World Markets Inc. (**CIBC World Markets**) were approved by the Ontario Securities Commission (**OSC**) and Commission des valeurs mobilières du Québec (**CVMQ**) (referred to together as '**the Commissions**'). CIBC World Markets agreed that it had not adequately disclosed the full nature of the relationship between itself and its affiliated companies and Shoppers Drug Mart Corporation (**Shoppers**) in equities research reports issued on Shoppers during the period from November 21, 2001 to February 2002.

Pursuant to the settlements, CIBC World Markets agreed to submit to a review of its practices relating to the identification and disclosure of potential conflicts of interest in equities research reports and institute such changes as may be ordered by the Commissions.

AssetRisk Advisory Inc. was retained by CIBC World Markets to determine industry best practices in the area of identification and disclosure of potential conflicts of interest. The methodology entailed the review of practices of seven major investment dealers, interviews of regulators, compliance officers and investors, inspection of documents, and review of literature.

Data on existing practices in the industry was organized into a framework under the following headings:

1. Definition of conflict of interest,
2. Analyst conduct,
3. Supervision,
4. Identification, and
5. Disclosure.

Each of the five headings was broken down into categories for a total of twenty potential best practices. The best practices for the identification and disclosure of conflicts of interest in equities research reports were drawn from existing industry practices in Canada. However, the designation of 'best practice' does not preclude improvement of current standards in the industry.

CIBC World Markets requested insight to the best practices as they were identified during the course of our assessment with the objective of making changes before our draft report

was released for comment and improvements to practices of CIBC World Markets were implemented throughout the review.

Our first draft report was issued in August 2003 and joint comments were received from CIBC World Markets and the Commissions in February 2004. New Policy No. 11 of the Investment Dealers Association of Canada (**IDA**) became effective on February 1, 2004 and therefore we updated our research on dealer practices to May 2004. During the update, we found that several of the recommended best practices contained in our first draft report had been adopted by dealers including those required by IDA Policy No. 11.

CIBC World Markets meets best practice in seventeen of the twenty areas identified, and our recommendations to meet the remaining best practices are summarized below. It is our opinion that following best practices reduces the risk of failure to identify and disclose conflicts of interest in equities research reports.

1. **Prohibited Conflicts** - Amend the Canadian Equities Research Policy of CIBC World Markets regarding ownership of shares in the issuer or acting as a director, officer, employee, consultant or adviser in the industry sector covered. Specifically, an analyst will not be permitted to issue research where:
 - a. The analyst or a member of his/her household owns shares in the covered issuer,
 - b. The analyst acts as a director, officer, employee, consultant or adviser to a company within the analyst's industry sector, or
 - c. The firm and its affiliates beneficially own 10% or more of a class of equity securities issued by the company.
2. **Professional Qualifications** - Require that new analysts obtain, within a reasonable time, the Chartered Financial Analyst designation or other appropriate qualifications.
3. **Tools to Identify and Quantify Conflicts** - Implement automated processes for gathering information on conflicts to minimize reliance on manually maintained spreadsheets.

Introduction

Background

Shoppers is a New Brunswick corporation that operates a chain of drug stores and pharmacies across Canada. Shoppers completed an initial public offering of common shares in November 2001 (the **IPO**) where CIBC World Markets acted as the lead underwriter of the IPO that closed on November 21, 2001. At the time of the IPO, and as disclosed in the IPO prospectus, CIBC Capital (SD Holdings) Inc., an affiliate of CIBC World Markets, held 7,000,000 shares of Shoppers. CIBC World Markets purchased a further 450,000 shares of Shoppers pursuant to the IPO. CIBC World Markets and CIBC Capital continued to hold these shares during the period between November 21, 2001 and February 8, 2002 and, as disclosed in the IPO prospectus, Shoppers was indebted to CIBC. The amount of that debt varied from \$59.51 million to \$67.39 million.

CIBC World Markets published five equity research reports recommending the purchase of securities of Shoppers dated December 17, 2001, December 18, 2001, December 19, 2001, January 10, 2002 and February 8, 2002. These reports were intended for general circulation, being distributed both internally at CIBC World Markets and to its institutional and retail clients located throughout Canada, including the Provinces of Ontario and Québec, upon request. The research reports all stated that shares of Shoppers were rated as a '*strong buy*'.

In the research reports, CIBC World Markets did not adequately disclose the full nature of the relationship between itself and its affiliated companies and Shoppers. CIBC World Markets thus failed to adequately disclose the potential conflicts of interest inherent in its recommendation of the purchase of Shoppers shares.

Pursuant to settlement agreements with staff at the Commissions, CIBC World Markets agreed to submit to a review of its practices relating to the identification and disclosure of potential conflicts of interest in its equities research reports, and institute such changes as may be ordered by the Commissions. The purpose of the report is to enable CIBC World Markets to be cognizant of industry best practices with regard to the identification and disclosure of potential conflicts of interest in its equities research reports including the types of conflicts of interest identified in the settlement agreements.

Methodology

Our approach included the following procedures:

- A. Design, and validation with CIBC World Markets and the Commissions, of a framework to gather and organize information on best practices,
- B. Assembly of industry practices for the identification and disclosure of conflicts of interest of sell-side analysts employed by full-service investment firms in Canada,
- C. Determination of best practices among the existing practices,
- D. Assessment of whether CIBC World Markets practices currently meet or fall short of best practices, and
- E. Recommendation of improvements.

The methodology included the following research:

1. Interviews of staff and management at the following organizations:
 - a. CIBC World Markets,
 - b. The Commissions,
 - c. Market Regulation Services Inc. (**RS**) and the Investment Dealers Association of Canada (**IDA**),
 - d. Investors,
 - e. United States regulator (i.e., the United States Securities and Exchange Commission (**SEC**)) and SROs (i.e., NASD Inc. (**NASD**)) and the New York Stock Exchange (**NYSE**),
 - f. Financial Services Authority (**FSA**) in the United Kingdom, and
 - g. Selected investment dealers in Canada.
2. Inspection of documents of CIBC World Markets,
3. Review of IDA Policy No. 11 (see Appendix B) and NASD Rule 2711 (see Appendix C), and
4. Review of published articles and papers.

A glossary of terms used in the report is attached as Appendix A.

Our draft report was issued in August 2003 and we received joint comments from CIBC World Markets and the Commissions on February 15, 2004. In the intervening period, IDA Policy No. 11 became effective on February 1, 2004. We therefore updated our research for dealer practices in Canada at May 2004 and we found that dealers had implemented a number of best practices including those required by Policy No. 11. The firms submitted their revised policies to the IDA for review and approval but the IDA's feedback was not available at the date of our second draft report.

Framework for Practices

The focus of the report is conflict of interest of sell-side analysts employed in the research departments of full-service (or integrated) dealers with operations in Canada. The analysts publish equities research reports on the securities of issuers or industries that they cover and the reports often contain a recommendation for buy, hold or sell and a price expectation or target. The firms provide a variety of services to corporate clients that give rise to potential conflicts of interest for sell-side analysts, unlike buy-side and independent analysts that typically have few conflicts that could threaten the objectivity of their research.

Based on our preliminary research and interviews, we designed a framework for the collection of information about practices among integrated investment dealers in Canada. The practices are those that were deemed relevant to the identification and disclosure of conflicts of interest based on the following five questions:

1. Definition - What guidance is provided by a dealer to its management and employees about the nature of conflict of interest of an analyst and the firm?
2. Conduct - What requirements are in place to help avoid and manage conflicts?
3. Supervision - What procedures exist for review and approval of disclosure in research reports?
4. Identification - How is information about potential conflicts identified and verified?
5. Disclosure - What are a dealer's guidelines on prominence and content of disclosure of conflicts in equities research reports?

Within each heading are categories, together with a brief description, which formed the basis of our data collection through interviews, inspection of documents and review of literature. The framework is as follows:

Framework for Investment Dealer Practices	
Heading and Category	Description
Definition of Conflict of Interest	
1. Definition and examples of conflict of interest of a firm	Guidance for management on the identification and disposition of conflicts of interest of the investment dealer and its affiliates.
2. Definition and examples of conflict of interest of a research analyst	Written guidance for research analysts on the identification and treatment of their personal conflicts of interest (i.e., maintaining objectivity).
3. Scope of conflict of interest	Whether conflicts of interest subject to disclosure are actual, perceived and/or potential.
4. Materiality	Written guidance on the materiality of conflicts of interest for the purposes of disclosure in research reports (or withholding research).
5. Conflicts discloseable	Definition of the conflicts of interest that must be disclosed in research reports regardless of materiality.
6. Conflicts prohibited	Conflicts of interest where a research analyst will not be permitted to issue research.
Analyst Conduct	
7. Code of conduct	A code of conduct that research analysts are required to observe as a condition of employment.
8. Professional qualifications	Professional qualifications required of a research analyst as a condition of employment. Many professionals are subject to codes of conduct that govern independence and objectivity.
9. Periodic certification of compliance	To what extent the research analyst and/or members of research management must certify compliance with a code of conduct or other standard.

Heading and Category	Description
Supervision	
10. Process for review and approval of research reports	Sign-off on or provision of disclosure of conflicts of interest in equities research reports.
11. Reliance on watch/grey lists, restricted lists, quiet periods, and information barriers	Internal processes designed to prevent conflicts of interest from occurring are also of assistance in identification of conflicts of interest where they occur.
12. Compliance manual content	The compliance (or policies and procedures) manual's approach to management of conflicts of interest including statement of principles.
Identification	
13. Threat assessment	Identification and evaluation of systemic and specific threats to objectivity including safeguards to mitigate the risk.
14. Methods and tools used to identify and quantify conflicts specified in rules	The processes and information technology relied on to identify conflicts of interest for the purposes of disclosure in an equities research report.
15. Methods used to identify and quantify other potential conflicts	The processes relied on to identify those conflicts of interest not listed specifically in IDA Policy No. 11 or SRO rules in the United States. (i.e., conflicts governed by the 'basket clause').
16. Audit	Periodic review and testing by internal audit, or otherwise, designed to ensure the completeness and accuracy of disclosure processes.
Disclosure	
17. Content and wording	The nature of the disclosure in terms of meaningfulness and plain language.
18. Positioning	The prominence of the disclosure in the report, including front-page reference to disclosures in the body of the report or elsewhere.
19. Type size	Printing in type size comparable to the body of the research report.

Heading and Category	Description
20. Statistics on analyst performance	Disclosure of the performance of the analyst in the research report with respect to distribution of ratings across reports and performance in assessing future values.

Investment Dealer Practices

Scope

Seven leading investment dealers in Canada including CIBC World Markets participated in our confidential survey of existing policies and practices in the identification and disclosure of conflicts of interest in equities research. As a major dealer, CIBC World Markets has extensive resources and, to ensure comparability, the other dealers were invited to participate based on the size and sophistication of their compliance processes as demonstrated by the survey of major dealers by the OSC in 2002 on management of analyst conflicts.¹

The dealers provided unrestricted access to their policies, procedures and research reports. We wish to acknowledge and express our appreciation to the following firms for sharing their knowledge, experience and insights:

- CIBC World Markets Inc.
- Merrill Lynch Canada Inc.
- National Bank Financial Inc.
- RBC Dominion Securities Inc.
- Scotia Capital Inc.
- TD Securities Inc.
- UBS Securities Canada Inc.

We provide a brief summary of each dealer's practices below without attribution.

¹ The responses of the dealers are available on the OSC's website at www.osc.gov.on.ca.

Chart - Summary of Practices

	CIBC World Markets	Major Dealer	Major Dealer				
<i>Definition of Conflict of Interest</i>							
<p>1. Definition and examples of conflict of interest of a firm.</p> <p>Guidance for management on the identification and disposition of conflicts of interest of the investment dealer and its affiliates.</p>	SRO rules in Canada and the United States and other regulatory requirements.	SRO rules in Canada and the United States and other regulatory requirements.	SRO rules in Canada and the United States and other regulatory requirements.	SRO rules in Canada and the United States and other regulatory requirements.	SRO rules in Canada and the United States and other regulatory requirements.	SRO rules in Canada and the United States and other regulatory requirements.	SRO rules in Canada and other regulatory requirements.

	CIBC World Markets	Major Dealer	Major Dealer	Major Dealer	Major Dealer	Major Dealer	Major Dealer
<p>2. Definition and examples of conflict of interest of a research analyst.</p> <p>Written guidance for research analysts on the identification and treatment of their personal conflicts of interest (i.e., maintaining objectivity).</p>	<p>Conflict of interest is defined. Potential and apparent conflicts are subject to a standard of <i>‘might reasonably be perceived by others to interfere’</i>.</p>	<p>Code of conduct and policies and procedures manual contain guidance on trading, outside business, and private investment activity (including family).</p>	<p>Code of conduct and policies and procedures manual contain guidance on trading, outside business, and private investment activity (including family). Examples are provided.</p>	<p>Code of conduct and policies and procedures manual contain guidance on trading, outside business, and private investment activity (including family). Examples include trading, family, gifts, business, litigation.</p>	<p>Code of conduct and policies and procedures manual contain guidance on trading, outside business, and private investment activity (including family).</p>	<p>Code of conduct and policies and procedures manual contain guidance on trading, outside business, and private investment activity (including family). Trading by family is implied but not explicit.</p>	<p>Code of conduct and policies and procedures manual contain guidance on trading, outside business, and private investment activity (including family).</p>
<p>3. Scope of conflict of interest.</p> <p>Whether conflicts of interest subject to disclosure are actual, perceived and/or potential.</p>	<p>Actual, perceived and potential.</p>	<p>Actual, perceived and potential.</p>	<p>Actual, perceived and potential.</p>	<p>Actual and perceived.</p>	<p>Not specified but complies with IDA Policy No. 11.</p>	<p>Actual material conflicts of interest of which the analyst knows or has reason to know.</p>	<p>Actual and perceived.</p>

	CIBC World Markets	Major Dealer					
<p>4. Materiality.</p> <p>Written guidance on the materiality of conflicts of interest for the purposes of disclosure in research reports (or withholding research).</p>	<p>No written guidelines. Based on judgment based on a standard of reasonable perception.</p>	<p>No written guidelines. Based on judgment.</p>					
<p>5. Conflicts discloseable.</p> <p>Definition of the conflicts of interest that must be disclosed in research reports regardless of materiality.</p>	<p>Policies and procedures account for SRO rules in Canada and the United States.</p>	<p>Policies and procedures account for SRO rules in Canada and the United States.</p>	<p>Policies and procedures account for SRO rules in Canada and the United States.</p>	<p>Policies and procedures account for SRO rules in Canada and the United States.</p>	<p>Policies and procedures account for SRO rules in Canada and the United States.</p>	<p>Policies and procedures account for SRO rules in Canada and the United States.</p>	<p>Policies and procedures account for SRO rules in Canada. Includes any lending relationship with banking affiliate.</p>

	CIBC World Markets	Major Dealer	Major Dealer	Major Dealer	Major Dealer	Major Dealer	Major Dealer
<p>6. Conflicts prohibited.</p> <p>Conflicts of interest where a research analyst will not be permitted to issue research.</p>	<p>Restricted list. Analyst <i>'over the wall'</i>. Cannot act as officer, director, employee, adviser to the issuer.</p>	<p>Restricted list. Analyst <i>'over the wall'</i>. Director, officer, employee, adviser, consultant to any company in the industry sector covered by the analyst. Cannot hold or trade securities of issuers covered or expected to be covered.</p>	<p>Restricted list. Analyst <i>'over the wall'</i>. Director or activity related to covered issuer.</p>	<p>Restricted list. Analyst <i>'over the wall'</i>. Cannot act as officer, director, adviser or otherwise provide service to issuer. Avoid involvement that could compromise Independence. No coverage of issue where analyst holds pre-IPO securities. Will not issue research where more than 10% of shares are held by the firm.</p>	<p>Restricted list. Analyst <i>'over the wall'</i>. Director, officer, employee or adviser of covered issuer.</p>	<p>Restricted list. Analyst <i>'over the wall'</i>. Director, officer, employee or advisor of covered issuer.</p>	<p>Restricted list. Analyst <i>'over the wall'</i>. Director, officer, employee or adviser to any public or private company in the industry sector covered by the analyst.</p>

	CIBC World Markets	Major Dealer	Major Dealer	Major Dealer	Major Dealer	Major Dealer	Major Dealer
<i>Analyst Conduct</i>							
<p>7. Code of conduct.</p> <p>A code of conduct that research analysts are required to observe as a condition of employment.</p>	Code of conduct, AIMR Code of Ethics and Standards of Professional Conduct, policies and procedures manual.	Code of conduct, policies and procedures manual.	AIMR Code of Ethics and Standards of Professional Conduct. Policies and procedures manual including principles.	Policy and procedures manual includes a code of conduct. Has ethics whistle-blowing hotline.	Research principles, policy and procedures manual.	Code of conduct, AIMR Code of Ethics and Standards of Professional Conduct, policies and procedures manual.	Code of conduct, policies and procedures manual.
<p>8. Professional qualifications.</p> <p>Professional qualifications required of a research analyst as a condition of employment. Many professionals are subject to codes of conduct that govern independence and objectivity.</p>	CFA (or 'other appropriate qualifications') is encouraged but not required.	Where practicable, research analysts are required to obtain the CFA designation or other appropriate qualifications.	None	None for existing analysts. New associates are expected to obtain the CFA designation.	CSC, CPH or CFA is encouraged but not required.	New analysts are required to have an MBA or CFA.	CFA is encouraged but not required.

	CIBC World Markets	Major Dealer	Major Dealer	Major Dealer	Major Dealer	Major Dealer	Major Dealer
<p>9. Periodic certification of compliance.</p> <p>To what extent the research analyst and/or members of research management must certify compliance with a code of conduct or other standard.</p>	Annual certification of compliance with the institution and AIMR codes of conduct.	Annual certification.	Annual certification of compliance with the institution and AIMR codes of conduct.	Annual certification.	Annual certification.	Annual sign off on AIMR code of conduct.	Annual certification.
<i>Supervision</i>							
<p>10. Processes for review and approval of disclosure in research reports.</p> <p>Sign-off on or provision of disclosure of conflicts of interest in equities research reports.</p>	Approved by Director of Research or designate. Periodic review by Compliance.	Approved by head of research and/or supervisory analyst. Periodic review by Compliance and Internal Audit.	Head of research and supervisory analyst approve. Copy of report goes to Compliance.	Approved by supervisory analyst.	Approved by designated reviewer.	Approved by designated reviewer.	Approved by head of research and Compliance.

	CIBC World Markets	Major Dealer	Major Dealer	Major Dealer	Major Dealer	Major Dealer	Major Dealer
<p>11. Reliance on watch/grey lists, restricted lists, quiet periods, and information barriers.</p> <p>Internal processes designed to prevent conflicts of interest from occurring are also of assistance in identification of conflicts of interest where they occur.</p>	Yes. Includes training of analysts on standards, procedures and laws.	Yes. Includes training of analysts on standards, procedures and laws.	Yes. Includes training of analysts on standards, procedures and laws.	Yes	Yes	Yes	Yes
<p>12. Compliance manual content.</p> <p>The compliance (or policies and procedures) manual's approach to management of conflicts of interest including statement of principles.</p>	Integrated written procedures including principles.	Written procedures.	Written procedures.	Integrated written procedures including principles.	Integrated written procedures including principles.	Written procedures that refer to specific SRO rules in Canada and the United States.	Integrated written procedures including principles.

	CIBC World Markets	Major Dealer	Major Dealer	Major Dealer	Major Dealer	Major Dealer	Major Dealer
<i>Identification</i>							
<p>13. Threat assessment.</p> <p>Identification and evaluation of systemic and specific threats to objectivity including safeguards to mitigate the risk.</p>	Yes. Unstructured.	Yes. Unstructured.	Yes. Unstructured.	Yes. Unstructured.	Yes. Unstructured.	Yes. Unstructured.	Yes. Unstructured.
<p>14. Methods and tools used to identify and quantify conflicts specified in rules.</p> <p>The processes and information technology relied on to identify conflicts of interest for the purposes of disclosure in an equities research report.</p>	Databases with manual input to spreadsheet.	Database with input directly from the applicable business units.	Databases with manual review of output of dealer and bank information. Development of integrated reporting systems is in process.	Automated and semi-automated tracking system. Integrated databases linked to publishing system. Currently being upgraded to further automate checks.	Partly automated tracking system with exceptions. Integrated databases linked to publishing system.	Databases with manual input to spreadsheet. There is a master disclosure file with 19 disclosures that is accumulated manually by issuer.	Databases on lending, trading, investment banking, shareholdings with manual input to master spreadsheet by Compliance.

	CIBC World Markets	Major Dealer	Major Dealer	Major Dealer	Major Dealer	Major Dealer	Major Dealer
<p>15. Methods used to identify and quantify other potential conflicts.</p> <p>The processes relied on to identify those conflicts of interest not listed specifically in IDA Policy No. 11 or SRO rules in the United States (i.e., conflicts governed by the ‘basket clause’).</p>	<p>Informal. Analyst is required to identify any conflicts of which he/she is aware.</p>	<p>Informal</p>	<p>Informal</p>	<p>Informal. Analyst is required to identify any conflicts of which he/she is aware.</p>	<p>Informal</p>	<p>Informal</p>	<p>Informal</p>
<p>16. Audit.</p> <p>Periodic review and testing by internal audit, or otherwise, designed to ensure the completeness and accuracy of disclosure processes.</p>	<p>Review by Internal Audit.</p>	<p>Review by Internal Audit.</p>	<p>Review by Internal Audit.</p>	<p>Review by Internal Audit.</p>	<p>Review every two years by Internal Audit.</p>	<p>Periodic checks by Compliance.</p>	<p>Periodic checks by Compliance. Analysts sometimes call with corrections.</p>
<p><i>Disclosure</i></p>							
<p>17. Content and wording.</p> <p>The nature of the disclosure in terms of meaningfulness and plain language.</p>	<p>Standard disclosures. Tailored wording for non-listed disclosures.</p>	<p>Standard disclosures. Tailored wording for non-listed disclosures.</p>	<p>Standard disclosures. Tailored wording for non-listed disclosures.</p>	<p>Standard disclosures. Tailored wording for non-listed disclosures.</p>	<p>Standard disclosures. Tailored wording for non-listed disclosures.</p>	<p>Standard disclosures. Tailored wording for non-listed disclosures.</p>	<p>Standard disclosures. Tailored wording for non-listed disclosures.</p>

	CIBC World Markets	Major Dealer	Major Dealer	Major Dealer	Major Dealer	Major Dealer	Major Dealer
<p>18. Positioning.</p> <p>The prominence of the disclosure in the report, including front-page reference to disclosures in the body of the report or elsewhere.</p>	End of report with highlighted reference on cover.	Generally, end of report with a highlighted reference on the cover, except for unusual items that appear on the first page.	Disclosures in one location. Reference inside front cover.	End of report with highlighted reference on cover.	End of report with highlighted reference on cover.	End of report with small-type bold reference on cover.	Inside back cover with no reference on cover.
<p>19. Type size.</p> <p>Printing in type size comparable to the body of the research report.</p>	Normal text size in report body. Small or normal text size for reference on cover highlighted in red.	Normal type size.	Type size smaller than body.	Normal type size.	Normal type size.	Type size smaller than body.	Type size smaller than body.
<p>20. Statistics on analyst performance.</p> <p>Disclosure of the performance of the analyst in the research report with respect to distribution of ratings across reports and performance in assessing future values.</p>	Disclosed	Disclosed	Disclosed	Disclosed	Disclosed	Disclosed	Not disclosed

Definition of Conflict of Interest

Objectivity is a state of mind that results in the application of unbiased judgment in arriving at an opinion or decision in a given situation. Conflict of interest can impair the ability of a professional to express, or appear to express, an objective opinion. As discussed later in this report, conflict of interest may result from:²

- Financial interest,
- Excessive sympathy towards an issuer,
- Reviewing and commenting on the firm's own work,
- Advocacy or promotion on behalf of an issuer, and
- Intimidation of the analyst by an issuer or firm management.

Conflict of interest can be 'actual', 'perceived' or 'potential', and there are four documents that are relevant to the definition of conflict of interest for the purposes of our report. These are the Crawford Report, IDA Policy No. 11, and NASD Rule 2711 (and the equivalent NYSE rules) and the settlement agreements entered by CIBC World Markets with staff of the Commissions.

Guidance on Conflict of Interest

Crawford Report

In '*Setting Analyst Standards: Recommendations for the Supervision and Practice of Canadian Securities Industry Analysts*'³ dated October 2001 by the Securities Industry Committee on Analyst Standards (**Crawford Committee**), the results of a review of the then current practices of the Canadian securities industry in analyst standards were presented. The

² The Public Interest and Integrity Committee of the Canadian Institute of Chartered Accountants. The findings of the Committee are discussed under 'Risk Assessment' in this report.

³ The Crawford Report is available at <http://www.tsx.com/en/pdf/SICAS-FinalReport.pdf>.

Crawford Report made recommendations for industry-wide initiatives to improve the independence and professionalism of Canadian securities industry analysts.

Conflict of interest was defined by the Crawford Committee to include all three variations (i.e., actual, perceived and potential) for the purposes of disclosure, but did not go so far as to define the three individual variations. The IDA relied heavily upon the recommendations of the Crawford Report in the design of Policy No. 11 that became effective February 1, 2004.

IDA Policy No. 11

IDA Policy No. 11 lists specific disclosure requirements and also has a ‘basket clause’ that requires disclosure of ‘*any information regarding its, or its analyst's business with or relationship with any issuer which is the subject of the report which might reasonably be expected to indicate a potential conflict of interest on the part of the Member or the analyst in making a recommendation with regard to the issuer.*’ The language that ‘any information...which might reasonably be expected to indicate a potential conflict...on the part of the Member or the analyst’ is broad and goes beyond actual conflict of interest to include appearance of conflict and potential conflict. It also encompasses conflicts of the firm of which the analyst may have no personal knowledge.

The wording of IDA Policy No. 11 might be inferred to mean that all potential conflicts need to be disclosed regardless of materiality. However, we believe that the reference to ‘reasonably be expected’ means that conflicts that are immaterial are not covered by the disclosure requirement. Policy No. 11 therefore deals with actual, perceived and potential conflicts of interest of both the member firm and the individual research analyst that are material, which is still a much wider requirement than that contained in the basket clause of NASD Rule 2711.

NASD Rule 2711

NASD Rule 2711 (and the corresponding NYSE rules) lists specific disclosure requirements and has a basket clause that refers to ‘*any other actual, material conflict of interest of the research analyst of which the research analyst or member knows or has reason to know at the time of publication of the research report or at the time of the public appearance.*’⁴ In other words, under the basket clause of Rule 2711 NASD members are not required to disclose:

⁴ NASD Rule 2711(h)(1)(C).

- Conflicts of the firm,
- Perceived or potential conflicts of the analyst, and
- Immaterial actual conflicts of the analyst.

The NYSE rules contain equivalent requirements for their members.

The majority of the dealers that we reviewed had adopted the disclosure requirements of NASD Rule 2711 by 2003.

Settlement Agreements

The settlement agreements between CIBC World Markets and staff of the Commissions contain guidance as to what may be considered to be a conflict of interest that requires disclosure.

The settlement agreements state that CIBC World Markets failed to adequately disclose the full nature of the relationship between itself and its affiliated companies and Shoppers. CIBC World Markets ‘thus failed to adequately disclose the potential conflicts of interest inherent in its recommendation of the purchase of Shoppers shares’.

Specific disclosure failures issues listed in the settlement agreements⁵ include:

- a. Failure to adequately disclose an underwriting liability to Shoppers,
- b. Failure to adequately disclose that CIBC World Markets and an affiliate owned 7,450,000 shares of Shoppers, which was more than the 7,000,000 shares disclosed, and
- c. Failure to disclose that Shoppers was indebted to Canadian Imperial Bank of Commerce (**CIBC**), the parent company (i.e., an affiliate) of CIBC World Markets.

In addition to the above concerns, the disclosures that were made by CIBC World Markets were printed in type less legible than that used in the body of the report.

⁵ The text of the two settlement agreements differs and reference should be made to the actual wording. The respective settlement agreements are available on the Commissions’ websites at www.cvmq.com and www.osc.gov.on.ca.

Conclusions on Conflict of Interest

The wording of the Crawford Report, IDA Policy No. 11, NASD Rule 2711 and the Shoppers settlement agreements do not directly correspond, and none of the documents provides a detailed definition of conflict of interest. Therefore, for the purposes of this report, we rely on IDA Policy No. 11 regarding information that should be identified and disclosed in an equities research report in Canada in our assessment of best practices. In other words, actual, perceived and potential conflicts of interest that are material are to be identified and disclosed in analyst research reports.

For the purposes of this report, the definition of conflict of interest is ‘a situation where the analyst or the firm is in a position to gain or lose from the conclusions reached in the research report’. The three subcategories of conflict of interest are defined as follows:

- i. *Actual* conflict of interest is where the analyst or firm is in a position where issuing research could directly influence their financial position.
- ii. *Perceived (or apparent)* conflict of interest arises when an analyst or firm is in a position where a consumer of research in possession of all relevant facts would have reasonable cause to doubt the objectivity of the analyst.
- iii. *Potential* conflict of interest is a situation that may develop into an actual or perceived conflict of interest.

Materiality is discussed below under ‘Risk Assessment’.

Best Practices

We were instructed to identify best practices based on current industry practices in Canada and the resulting best practices are summarized below with our observations. The identification of ‘best practice’ is based only on current practice and does not preclude the improvement of existing standards in the industry.

It is our opinion that meeting best practices reduces the risk of failure to identify and disclose conflicts of interest in equities research reports.

Definition of Conflict of Interest

BP 1. Compliance makes management aware of the SRO rules and other regulatory requirements for the identification and disposition of conflicts of interest of the firm.

Observations – IDA Policy No. 11 is silent on the nature of conflict of interest of the firm for the purposes of basket-clause disclosure and the NASD Rule 2711 basket clause only addresses ‘*actual, material conflict of interest of the analyst*’ (emphasis added) and does not consider potential conflicts of the firm. Therefore, in Canada and the United States, it is left entirely up to the firm to define conflict of interest for the purposes of disclosure under the basket clauses. Firms deal with the basket clause disclosure on an *ad hoc* basis without written guidance to management on definition and disposition.

BP 2. Written guidance is provided to research analysts on their objectivity, including the identification and disposition of potential personal conflicts of interest with examples, and includes written acknowledgement by the analyst that the guidance has been read and understood.

Observations – IDA Policy No. 11 requires written conflict of interest policies and procedures but does not mandate examples or acknowledgement by analysts.

BP 3. The definition of conflict of interest includes actual, perceived and potential conflicts, with perceived conflicts being based on perception of a reasonable consumer of equities research.

Observations – IDA Policy No. 11 refers to actual, perceived and potential conflicts but does not provide a standard such as a ‘reasonable cause to doubt’. NASD Rule 2711 is concerned only with actual conflicts and therefore a standard for perception is irrelevant except with respect to judging materiality.

BP 4. Materiality of actual, perceived and potential conflicts is assessed on a case-by-case basis based on what would be considered important to a reasonable consumer of equities research.

Observations – IDA Policy No. 11 does not refer to materiality although it is specifically stated in NASD Rule 2711. Neither the IDA nor NASD provides guidance as to how to judge materiality.

BP 5. The minimum definition of conflicts of interest that will be disclosed in research reports regardless of materiality complies with SRO rules both in Canada and the United States.

Observations – SRO rules in Canada and the United States provide for minimum disclosures and best practice is to make sufficient disclosure to meet the rules of both jurisdictions in all research issued in Canada.

BP 6. An analyst is not permitted to issue research where:

- i. The analyst or a member of his/her household owns shares in the covered issuer,
- ii. The analyst is ‘over the wall’ (i.e., may be in possession of material undisclosed information),
- iii. The analyst acts as a director, officer, employee, consultant or adviser to a company within the analyst’s industry sector, or
- iv. The firm and its affiliates beneficially own 10% or more of a class of equity securities issued by the company.

Observations – The above best practices exceed the requirements of IDA Policy No. 11. For the purposes of 6(iii), ‘company’ is not limited to a reporting issuer. ‘Consultant’ and ‘adviser’ refer to an expert who charges a fee for providing advice or services in a particular field.

Analyst Conduct

BP 7. Analysts must comply with the firm’s code of conduct and the AIMR Code of Ethics and Standards of Professional Conduct as conditions of employment.

BP 8. New analysts are required to obtain within a reasonable time the designation of Chartered Financial Analyst (CFA) or other appropriate qualifications.

Observations – IDA Policy No. 11 states that members should require their analyst employees to obtain the CFA or other appropriate designation but it is a non-binding Guideline only.

BP 9. Analysts are required to certify annually in writing that they have complied with the firm’s code of conduct and AIMR Code of Ethics and Standards of Professional Conduct, and provide details where they have not complied.

Observations – IDA Policy No. 11 requires certification of the head of research and chief executive officer to the effect that analysts are familiar with and have complied with the AIMR Code of Ethics and Standards of Professional Conduct but does not require confirmation by the analyst.

Supervision

BP 10. The disclosure of conflicts of interest in a research report is reviewed and approved by the head of research and/or a qualified supervisory analyst, and Compliance monitors quality by performing reviews on a test basis following issuance.

Observations – IDA Policy No. 11 provides a non-binding Guideline that a head of research or supervisory analyst be responsible for approving research reports.

BP 11. Training is provided to the research analysts on policies and procedures including watch/grey lists, restricted lists, quiet periods, information barriers, and regulatory requirements.

Observations – Training of analysts is not required by IDA Policy No. 11 or NASD Rule 2711.

BP 12. The policies and procedures manual is an integrated written or electronic document that explicitly states the objective of investor protection.

Observations – We found that the overall quality and completeness of policies and procedures manuals improved substantially between the issuance of our first draft report in 2003 and second draft report in 2004. This is related to the introduction of the new IDA Policy No. 11 that became effective February 1, 2004.

Identification

BP 13. Identification and assessment of threats to objectivity are conducted with the input of business managers who have knowledge of the business, the nature of potential material conflicts, and safeguards.

Observations – ‘Independence’ is not defined in IDA Policy No. 11 or NASD Rule 2711 and therefore risk assessment by dealer varies. The approaches to threat analysis are informal and inconsistent between dealers, as are the definitions of conflict of interest, and a structured approach to threat assessment is provided below under the heading ‘Risk Assessment’.

BP 14. The processes relied on to identify conflicts of interest for the purposes of disclosure are automated in order to minimize the possibility of error from manual manipulation of data in spreadsheets. Information technology to identify and quantify conflicts of interest consists of the following:

- a. Data on specifically listed disclosures pursuant to SRO rules originates from management information systems that are subject to checks and balances in departments that rely on the systems,
- b. Data is transferred automatically to a publishing system, and

- c. Identified potential conflicts pursuant to the basket clause of IDA Policy No. 11 (e.g., credit exposure to issuers) are collected in a database to permit management to consider whether the conflict is material and disclosure is warranted and to allow Compliance to perform reviews of appropriate disclosure.

Observations – In a major dealer, Compliance does not have sufficient information to judge disclosure in the absence of an appropriate database management system to collect and quantify enumerated disclosures required by IDA Policy No. 11 and NASD Rule 2711.

- BP 15. The analyst is required to identify any potential personal or firm conflicts of which he/she is aware before research is issued.

Observations – In a major dealer that is affiliated with a bank, there can be a variety of potential conflicts of interest that range from credit risk on loans to exposure to loss on derivative instruments. The analyst is well situated to identify potential conflicts of interest in light of his/her familiarity with the firm and the issuer.

- BP 16. The processes relied on by the dealer to identify conflicts of interest are periodically reviewed by internal audit for completeness and accuracy.

Observations – All major dealers have internal audit departments that are available to perform independent reviews of key processes.

Disclosure

- BP 17. Standardized disclosures are used for basic conflicts (i.e., those specifically listed in NASD Rule 2711 or IDA Policy No. 11) in order to ensure consistency and plain meaning of disclosure among research reports. Custom wording with plain meaning is used for disclosure of other conflicts of interest.

Observations – Specific wording is not mandated by SROs in Canada or the United States and therefore the wording of disclosures varies by dealer. The disclosures used by CIBC World Markets are listed in ‘Standardized Disclosures’ below.

BP 18. Disclosure is in one location in the research report with a highlighted reference on the front cover.

Observations – IDA Policy No. 11 requires that information about conflicts of interest be ‘disclosed prominently’ but this term is not defined. NASD Rule 2711 requires that disclosures be presented on the front page of research reports or the front page must refer to the page on which disclosures are found in a manner that is ‘clear, comprehensive and prominent.’

BP 19. The text size of the disclosures in the body of the report is the same as the text in the body of the report or within two points provided legibility is maintained.

Observations – Text size is not prescribed by SRO rules.

BP 20. Statistics on analyst performance with respect to distribution of ratings and assessment of future values is disclosed in the research report as evidence of objectivity.

Observations – A price chart is required under NASD Rule 2711 but not under IDA Policy No. 11. Statistics are helpful in identifying possible bias in research.

Gap Analysis and Recommendations

In this section of the report, we identify those CIBC World Markets conflict identification and disclosure practices that fall short of industry best practice and we make recommendations for improvement. Best practices are drawn from current industry practices and this does not preclude improvement of existing standards.

CIBC World Markets requested insight to best practices during the course of our assessment with the objective of making changes before our report was released for comment. A number of improvements were approved and fully implemented during the review.

Meeting Best Practices

The three areas where CIBC World Markets practices fall short of industry best practice are summarized below, together with our recommendations for improvement.

Best Practice No. 6 - Conflicts Prohibited

An analyst is not permitted to issue research where:

- i. The analyst or a member of his/her household owns shares in the covered issuer,
- ii. The analyst acts as a director, officer, employee, consultant or adviser to a company within the analyst's industry sector, or
- iii. The firm and its affiliates beneficially own 10% or more of a class of equity securities issued by the company.

Current Practice

CIBC World Markets permits an analyst to own a position in an issuer being covered provided the analyst owned such position ninety days prior to initiating coverage and the analyst maintains the position until coverage is dropped. The existence and nature of such position must be disclosed in all research reports. However, best practice is that an analyst will not own shares in a covered issuer.

Although an analyst cannot act as a director, officer, employee, consultant or adviser of any issuer being covered, CIBC World Markets does not prohibit the analyst from taking on such a role in an issuer in the industry sector covered by the analyst. Best practice is that the analyst will avoid this conflict of interest.

CIBC World Markets has no prohibition on issuing research on an issuer where the firm holds a material interest in the equity shares of the issuer and therefore is in a position to benefit or lose from the research. Best practice is that a firm will avoid this conflict of interest.

Recommendation

Amend the Canadian Equities Research Policy of CIBC World Markets regarding ownership of shares in the issuer or acting as a director, officer, employee, consultant or adviser in the industry sector covered. Specifically, an analyst will not be permitted to issue research where:

- a. The analyst or a member of his/her household owns shares in the covered issuer,
- b. The analyst acts as a director, officer, employee, consultant or adviser to a company within the analyst's industry sector, or
- c. The firm and its affiliates beneficially own 10% or more of a class of equity securities issued by the company.

Best Practice No. 8 - Professional Qualifications

New analysts are required within a reasonable time to obtain the designation of Chartered Financial Analyst (CFA) or other appropriate qualifications.

Current Practice

CIBC World Markets encourages all analysts to obtain the CFA designation or other appropriate qualifications. However, there is no requirement that new analysts have professional qualifications.

Recommendation

Require that new analysts obtain, within a reasonable time, the Chartered Financial Analyst designation or other appropriate qualifications.

Best Practice No. 14 - Methods and Tools

The processes relied on to identify conflicts of interest for the purposes of disclosure are automated in order to minimize the possibility of error from manual manipulation of data in spreadsheets. Information technology to identify and quantify conflicts of interest consists of the following:

- a. Data on specifically listed disclosures pursuant to SRO rules originates from management information systems that are subject to checks and balances in departments that rely on the systems,
- b. Data is transferred automatically to a publishing system, and
- c. Identified potential conflicts pursuant to the basket clause of IDA Policy No. 11 (e.g., material credit exposure to issuers) are collected in a database to permit management to consider whether the conflict is material and disclosure is warranted and to allow Compliance to perform reviews of appropriate disclosure.

Current Practice

CIBC World Markets presently relies on manual accumulation of information for disclosure from a variety of data bases for inclusion in a conflicts spreadsheet, from which disclosures are automatically transferred to the publishing system. The manual accumulation entails a high risk of error in accuracy and completeness compared to best practice in the industry.

Recommendation

Implement automated processes for gathering information on conflicts to minimize reliance on manually maintained spreadsheets.

Response of CIBC World Markets

CIBC World Markets has advised us that they are proceeding to make improvements to their data-accumulation processes to implement the above recommendation by introducing the following.

- Reliance on a trusted third-party source to provide issuer information,
- Centralized database to store conflict information,
- Common tool across regional Compliance offices to access and share conflict information,
- Addition of an auditable process to verify footnotes transmitted to Research,
- Improved reporting capability including pre-defined queries and reports together with a report generator to permit real-time report creation based on current data,
- Automation of collection of underlying transaction data,
- Search tool to identify footnotes for a particular issuer,
- Web-based tool to search for or input data regarding conflicts,
- Flexible application that is quickly adaptable to changing regulatory requirements,
- Hosting on a network that integrates with existing CIBC systems, and
- Robust security of data together with failover capability (i.e., ability to switch to a standby system in the event of failure).

The current processes of CIBC World Markets rely heavily on the manual creation of spreadsheets within the business units and transmission of this information to Compliance (usually via e-mail with the spreadsheets as attachments). All subsequent data manipulation within Compliance is manual. With the new application, integration with some key business systems will result in data feeds that permit elimination of some manually prepared spreadsheets that have a high risk of error. Other business spreadsheets will be uploaded directly into the database to eliminate the risk of human error in Compliance after the data has left the business area. Disclosure will be transferred automatically to the publishing system.

In the first version of the application, CIBC World Markets will integrate with critical Canadian and U.S. investment banking systems that track and manage investment banking activity. These systems will provide conflict information on investment banking services provided, revenue earned, and public offerings managed or co-managed by the firm. This integration will facilitate the near-real-time capture and disclosure of this information. Integration will also be achieved with an Equity Trading system to facilitate the daily capture of market-making positions for CIBC.

The 'owner' of the database management system will be Compliance, and each region will have a Compliance administrator who will oversee the day-to-day operation and integrity of the database management system.

It is our opinion that the introduction of the above system will meet the standard of best practice. However, the timing of implementation has not yet been determined.

Standardized Disclosures

As is the case with other major dealers, CIBC World Markets has developed standardized conflict disclosure notes as set out below, and the listed disclosures exceed the standard disclosures enumerated in IDA Policy No. 11 and NASD Rule 2711.⁶ The entire list of disclosures appears in each research report issued by CIBC World Markets, and the list is keyed to the disclosures that apply in the situation.

1. CIBC World Markets Corp. makes a market in the securities of this company.
- 2.(a) This company is a client for which a CIBC World Markets company has performed investment banking services in the past 12 months.
- 2.(b) CIBC World Markets Corp. has managed or co-managed a public offering of securities for this company in the past 12 months.
- 2.(c) CIBC World Markets Inc. has managed or co-managed a public offering of securities for this company in the past 12 months.
- 2.(d) CIBC World Markets Corp. has received compensation for investment banking services from this company in the past 12 months.
- 2.(e) CIBC World Markets Inc. has received compensation for investment banking services from this company in the past 12 months.
- 2.(f) CIBC World Markets Corp. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months.
- 2.(g) CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months.
- 3.(a) This company is a client for which a CIBC World Markets company has performed non-investment banking, securities-related services in the past 12 months.

⁶ Staff of the Commissions have not expressed an opinion on the legal sufficiency of the standardized disclosure language used by CIBC World Markets.

- 3.(b) CIBC World Markets Corp. has received compensation for non-investment banking, securities-related services from this company in the past 12 months.
- 3.(c) CIBC World Markets Inc. has received compensation for non-investment banking, securities-related services from this company in the past 12 months.
- 4.(a) This company is a client for which a CIBC World Markets company has performed non-investment banking, non-securities-related services in the past 12 months.
- 4.(b) CIBC World Markets Corp. has received compensation for non-investment banking, non-securities-related services from this company in the past 12 months.
- 4.(c) CIBC World Markets Inc. has received compensation for non-investment banking, non-securities-related services from this company in the past 12 months.
- 5.(a) The CIBC World Markets Corp. analyst(s) who covers this company also has a long position in its common equity securities.
- 5.(b) A member of the household of a CIBC World Markets Corp. research analyst who covers this company has a long position in the common equity securities of this company.
- 6.(a) The CIBC World Markets Inc. analyst(s) who covers this company also has a long position in its common equity securities.
- 6.(b) A member of the household of a CIBC World Markets Inc. research analyst who covers this company has a long position in the common equity securities of this company.
- 7. CIBC World Markets Corp., CIBC World Markets Inc., and their affiliates, in the aggregate, beneficially own 1% or more of a class of equity securities issued by this company.
- 8. A partner, director or officer of CIBC World Markets Inc. or any analyst involved in the preparation of this research report has provided services to this company for remuneration in the past 12 months.
- 9. A senior executive member or director of Canadian Imperial Bank of Commerce ("CIBC"), the parent company to CIBC World Markets Inc. and CIBC World

Markets Corp., or a member of his/her household is an officer, director or advisory board member of this company or one of its subsidiaries.

10. Canadian Imperial Bank of Commerce ("CIBC"), the parent company to CIBC World Markets Inc. and CIBC World Markets Corp., has a significant credit relationship with this company.
11. The equity securities of this company are restricted voting shares.
12. The equity securities of this company are subordinate voting shares.
13. The equity securities of this company are non-voting shares.
14. The equity securities of this company are limited voting shares.

There are no standardized disclosures for other potential conflicts of interest, which fall in the basket clause of IDA Policy No. 11, and the nature of this disclosure will vary with the matter. Considerations for disclosure are discussed in the next section of this report, 'Risk Assessment'.

Risk Assessment

Each of the dealers that participated in our survey is determined to meet emerging standards for disclosure in equities research reports. There is little guidance available on disclosures that are not specifically listed in SRO rules in Canada and the United States (i.e., disclosures required by the so-called basket clauses), and therefore judgment is required of Compliance and management. The most challenging situations involve integrated dealers that are affiliated with a bank because of the scope of the bank's products and services that can lead to potential conflicts.

Adequate identification and disclosure of conflicts of interest requires:

- Identification of potential threats to objectivity in light of the business of the firm and its affiliates. Identification involves the input of business managers who are knowledgeable about the customers of the firm, relationships, and products. Although compliance departments generally have excellent insight to the business of the firm, this insight is often not sufficient for the purposes of identifying potential threats in an integrated dealer with banking or other financial-services affiliates.
- Quantification of potential threats. Quantification requires processes and systems to gather information on an ongoing basis for disclosure purposes after potential threats have been identified.
- Judgment as to materiality for disclosure (i.e., is a threat significant enough to require disclosure?).

Identification, quantification and materiality are discussed further below.

Identification of Potential Risks

Threats to objectivity and safeguards vary depending on the attributes of the firm and the circumstances, even though there is substantial overlap of these issues among dealers. A structured approach to threat analysis and safeguard assessment assists dealers in determining those circumstances where objectivity may be impaired or perceived to be impaired.

The Public Interest and Integrity Committee of the Canadian Institute of Chartered Accountants published an exposure draft, *Independence Standards*, for public comment in 2002 and the new independence standards became effective in 2004. In their research into objectivity, the Committee identified five categories of threats (or risks) to independence as follows:

1. Self-interest threat,
2. Self-review threat,
3. Advocacy threat,
4. Familiarity threat, and
5. Intimidation threat.

In the context of a research analyst, the threats to independence are described below:

- A '*self-interest threat*' occurs when a firm or an analyst could benefit from a financial interest in, or another self-interest conflict with, a covered issuer. Circumstances that may create a self-interest threat include the firm or analyst having a direct financial interest or material indirect financial interest in the issuer that is subject to research.
- A '*self-review threat*' occurs when any transaction or advice from a previous transaction in which the firm participated needs to be evaluated in reaching conclusions in the research report. Circumstances that may create a self-review threat include a previous investment banking transaction where the firm provided an opinion as to value.
- An '*advocacy threat*' occurs when a firm or an analyst promotes an issuer's position or opinion to the point that objectivity may be, or may be perceived to be, impaired. This would occur if the judgment of the analyst were to be subordinated to that of the issuer. Circumstances that may create an advocacy threat include analyst participation in marketing of securities including participating in road shows.
- A '*familiarity threat*' occurs when, by virtue of a close relationship with an issuer, its directors, officers or employees, a firm or analyst becomes too sympathetic to the client's interests. Circumstances that may create a familiarity threat include the analyst having an immediate or close family member who is a director or officer of the issuer being covered.

- An ‘*intimidation threat*’ occurs when the analyst may be deterred from acting objectively and exercising professional judgment by threats, actual or perceived, from the directors, officers or employees of the issuer, institutional investors or Investment Banking. Circumstances that may create an intimidation threat include Investment Banking input to analyst compensation.

In this section of the report, we present recommended frameworks for identification of risks a) firm-wide and b) by research report.

Firm-Wide Identification of Risk

A risk framework for a firm entails a staged process of identification and assessment of firm-wide threats to objectivity by management, including preparation of a documented response. The major steps in the process are summarized in the table below:

Risk Assessment for Firm	
Step	Action
1	Establish categories of threats to objectivity in analyst research reports based on: <ul style="list-style-type: none"> a. Self interest, b. Self review, c. Advocacy, d. Familiarity, and e. Intimidation.
2	Identify all potential threats to objectivity by category on a firm-wide basis taking into account affiliates of the dealer.
3	Identify safeguards to the potential threats (e.g., information barriers).
4	Determine whether the threats can be quantified in terms of dollars.

We recommend that the overall threat assessment be tailored to the operations of the dealer and that the assessment be updated periodically and kept on file as evidence of prudent business practice.

Research Report Assessment

The threat assessment for each research report has the same categories as the firm-wide assessment, but takes into account the specific circumstances of the analyst, dealer, and issuer at the date of the research report. The assessment forms two parts, with the first part completed by the analyst based on his/her knowledge of the dealer, the issuer and personal circumstances, and the second part is approval by a designated person who has access to databases of potential conflicts.

Quantification of Potential Risks

The quantification of risks relates to a) required disclosures under SRO rules (e.g., beneficial ownership of 1% or more of any class of an issuer's equity securities) and b) to basket clause disclosures (e.g., a large credit risk exposures with an issuer that is subject to research).

As discussed above, the processes relied on to identify conflicts of interest for the purposes of disclosure should be automated to the extent possible in order to minimize the possibility of error due to manual manipulation of spreadsheets that are not controlled by any other system relied on by management. Systems that rely solely on manual accumulation require additional testing and oversight to ensure that information is up to date, accurate and consistent, and this is not always possible in light of the volumes of transactions and the amount of research being issued at a large dealer.

Bank-owned dealers find data accumulation to be challenging because database management systems often do not 'talk to each other'. Furthermore, the databases may not contain sufficient fields (i.e., types of data) because they were designed for another purpose or are not updated on a real-time basis. Therefore, an appropriate database management system needs to be custom-designed for each dealer.

Data on potential conflicts that is gathered will be the same for each major dealer for the specific disclosures required by SROs in the relevant jurisdictions. However, the data for potential conflicts under the basket clause disclosure will differ by dealer based on the business, risk assessment and materiality. Some possible examples of basket clause disclosure of conflicts of interest are:

- Credit arrangements (e.g., bank loans, guarantees, and undrawn lines of credit),

- Exposure to risk on securitizations and derivative instruments directly or indirectly,
- Unusual business relationships (e.g., joint venture, leases, alternative risk financing) with the covered issuer in Canada or offshore,
- Principal and agent relationships,
- Exposure to gain or loss when investing as a principal in a competitor of the covered issuer,
- Exposure to gain or loss when investing as a principal in the industry of the covered issuer,
- Major positions of an officer, director or employee in the covered issuer,
- Major positions of an investment banking client in the covered issuer,
- Litigation between the firm and the covered issuer,
- Exposure to loss due to underwriting, and
- Cross directorships between the firm and the covered issuer.

Materiality

SROs in Canada and the United States do not provide guidance to their members on what constitutes objectivity and conflict of interest for the purposes of disclosure in analyst research reports, and there is no generally accepted definition of stakeholder (e.g., a ‘reasonable investor’) for the purposes of targeting disclosure. Regulators rely on dealers to apply judgment in the specific circumstances when making meaningful disclosure of conflicts of interest in equities research reports.

Judgment is particularly important when assessing materiality⁷ for the purposes of Requirement 2(a) of IDA Policy No. 11 (i.e., the basket clause) that reads in part as follows:

⁷ ‘Materiality is the quality of being important. In the context of financial reporting, materiality may be judged in relation to the reasonable prospect of an

Each Member shall prominently disclose in any research report: (a) any information regarding its, or its analyst's business with or relationship with any issuer which is the subject of the report which might reasonably be expected to indicate a potential conflict of interest on the part of the Member or the analyst in making a recommendation with regard to the issuer.

The size of the firm and the nature of the business or relationship with the covered issuer will affect the type and degree of threats to independence and, consequently, the materiality of potential conflicts of interest will vary from situation to situation. A quantitative assessment can be performed where 'materiality' is capable of being measured in monetary units (e.g., credit arrangements or exposure to loss or gain on derivative instruments).

IDA Policy No. 11 requires disclosure where 'the Member and its affiliates own 1% or more of any class of the issuer's equity securities'⁸ and it may be implied that 1% is a meaningful proportion for helping determine whether disclosure is needed. If 1% is a meaningful quantity to investors who rely on research, the percentage can be applied elsewhere as an initial step in judging materiality in dollar terms. For example, where the firm and its affiliates have annual net income of \$1 billion, the 1% guideline would initially indicate that disclosure is required wherever the firm's exposure to gain or loss is equal to or greater than \$10 million (being 1% of \$1 billion). However, this threshold must be considered in the context of all relevant circumstances by individuals who have full knowledge of the facts, and the facts may dictate disclosure at lesser or greater amounts.⁹

In a large integrated dealer, there is a question as to who has sufficient knowledge of the business of the firm and its affiliates to identify potential conflicts and make judgments about materiality, and this makes the risk-assessment and information-gathering processes

item or aggregate of items being significant to users in making decisions.'

Terminology for Accountants, Fourth Edition, CICA.

⁸ IDA Policy No. 11, Requirement 2 (a) (i).

⁹ For a discussion of materiality thresholds in the context of financial statements, see SEC Staff Accounting Bulletin No. 99, August 12, 1999. Staff commented that: 'The use of a percentage as a numerical threshold, such as 5%, may provide the basis for a preliminary assumption that – without considering all relevant circumstances – a deviation of less than the specified percentage with respect to a particular item on the registrant's financial statements is unlikely to be material. The staff has no objection to such a 'rule of thumb' as an initial step in assessing materiality. But quantifying, in percentage terms, the magnitude of a misstatement is only the beginning of an analysis of materiality; it cannot appropriately be used as a substitute for a full analysis of all relevant considerations.....A matter is "material" if there is a substantial likelihood that a reasonable person would consider it important.' The OSC and CVMQ have not issued guidance similar to the SEC Bulletin.

particularly important. In the absence of a database management system, it would be challenging for any single group within the dealer (e.g., Compliance) to make reliable conclusions about the adequacy of disclosure.

Outcome of Conflict Identification

There are three possible outcomes when a conflict of interest is identified:

1. The conflict of interest is immaterial and research will be issued with only the applicable standardized disclosure,
2. The conflict of interest is material and research will be issued with additional tailored disclosure, or
3. There is an actual material conflict of interest on the part of the firm or the analyst that undermines objectivity to the extent that research will not be issued.

Conclusion

In this report, we describe industry best practices in Canada in the identification and disclosure of conflicts of interest in equities research reports, and we make recommendations as to how CIBC World Markets can improve its practices.

Over the period that our review was performed, we found that ‘the bar was raised’ by investment dealers and this included the introduction of comprehensive procedures manuals. We wish to acknowledge the assistance of the compliance officers who participated in the review by identifying practices and sharing their experiences and insights.

Appendix A – Glossary of Terms

Adviser	An expert who charges a fee for providing advice or services in a particular field. See Consultant.
AIMR	The Association for Investment Management and Research is an international non-profit organization based in the United States. Its members and candidates consist of investment analysts, portfolio managers and other investment decision-makers employed by investment management firms, banks, broker-dealers, investment company complexes and insurance companies. In 2004 AIMR announced a name change to 'CFA Institute'.
Analyst, Research Analyst	<p>Any partner, director, officer, employee or agent of an organization whose responsibilities include the preparation of a research report. For greater certainty, this includes a person who reports directly or indirectly to an analyst in connection with the preparation of a research report, whether or not such person has the title of analyst or research analyst. There are three types of analyst:</p> <ol style="list-style-type: none"> A <i>sell-side analyst</i> typically is employed in the research department of an integrated or full-service dealer. It is the sell-side analyst that is most subject to conflict of interest. A <i>buy-side analyst</i> will generally work for a manager (e.g., pension fund, hedge fund, mutual fund, investment adviser) that purchases and sells securities for its own account or for the benefit of others. An <i>independent analyst</i> works for an independent agency that sells research for a fee.
BP	Best practice.
Canadian Equities Research Policy	Guidance for management and employees of CIBC World Markets Inc. regarding the creation, publication and distribution of research reports in Canada.
CICA	Canadian Institute of Chartered Accountants

Conflict of interest	<p>In the context of analyst research, a situation where the analyst or firm is in a position to gain or lose from the conclusions reached in a research report:</p> <ol style="list-style-type: none"> <i>Actual</i> conflict of interest is where the analyst or firm is in a position where issuing research could directly influence their financial position. <i>Perceived</i> (or apparent) conflict of interest arises when an analyst or firm is in a position where a reasonable consumer of research in possession of all relevant facts would question the objectivity of the analyst. <i>Potential</i> conflict of interest is a situation that may develop into an actual or perceived conflict of interest.
Consultant	An expert who charges a fee for providing advice or services in a particular field. See Adviser.
Dealer, Investment Dealer	Firm that is registered to trade in securities and act as agent and principal in primary market distributions or in secondary market trading as well as investing its own capital in the market. Investment dealers in Canada are members of the IDA and may be members of other organizations.
Equities	Equity securities consisting of common and preferred stocks which represent a share in the ownership of a company.
Firm, Member Firm	See Dealer.
Materiality	The quality of being important.
NASD	NASD Inc., the self-regulatory organization for securities dealers in the United States. NASD also has members in Canada.
Objectivity	A state of mind that results in the application of unbiased judgment in arriving at an opinion or decision in a given situation.
Research, Research Report	Any written or electronic communication that contains an analyst's opinion or recommendation concerning the future prospects of an industry or security including purchase, sale or holding.

SRO	Self-regulatory organization recognized by securities administrators as having powers to establish and enforce industry regulations to protect investors and to maintain fair, equitable and ethical practices in the securities industry.
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Appendix B – IDA Policy No. 11, Research Restrictions and Disclosure Requirements

Introduction

This Policy establishes requirements that analysts must follow when publishing research reports or making recommendations. These requirements represent the minimum procedural requirements that Members must have in place to minimize potential conflicts of interest. The Disclosure required under Policy No. 11 must be clear, comprehensive and prominent. Boilerplate disclosure is not sufficient.

These requirements are based on the recommendations of the Securities Industry Committee on Analyst Standards with input from both industry and non-industry groups.

Definitions

“advisory capacity” means providing advice to an issuer in return for remuneration, other than advice with respect to trading and related services.

“analyst” means any partner, director, officer, employee or agent of a Member who is held out to the public as an analyst or whose responsibilities to the Member include the preparation of any written report for distribution to clients or prospective clients of the Member which includes a recommendation with respect to a security.

"equity related security" means a security whose performance is based on the performance of an underlying equity security or a basket of income producing assets. Securities classified as an equity related security include, without limitation, convertible securities and income trust units.

“investment banking service” includes, without limitation, acting as an underwriter in an offering for the issuer; acting as a financial adviser in a merger or acquisition; providing venture capital, lines of credit, or serving as a placement agent for the issuer.

"research report" means any written or electronic communication that the Member has distributed or will distribute to its clients or the general public, which contains an analyst's

recommendation concerning the purchase, sale or holding of a security (but shall exclude all government debt and government guaranteed debt).

“remuneration” means any good, service or other benefit, monetary or otherwise, that could be provided to or received by an analyst.

“supervisory analyst” means an officer of the Member designated as being responsible for research.

Requirements

1. Each Member shall have written conflict of interest policies and procedures, in order to minimize conflicts faced by analysts. All such policies must be approved by and filed with the Association.
2. Each Member shall prominently disclose in any research report:
 - (a) any information regarding its, or its analyst's business with or relationship with any issuer which is the subject of the report which might reasonably be expected to indicate a potential conflict of interest on the part of the Member or the analyst in making a recommendation with regard to the issuer. Such information includes, but is not limited to:
 - (i) whether, as of the end of the month immediately preceding the date of issuance of the research report or the end of the second most recent month if the issue date is less than 10 calendar days after the end of the most recent month, the Member and its affiliates collectively beneficially own 1% or more of any class of the issuer's equity securities,
 - (ii) whether the analyst or any associate of the analyst responsible for the report or recommendation or any individuals directly involved in the preparation of the report hold or are short any of the issuer's securities directly or through derivatives,
 - (iii) whether any partner, director or officer of a Member or any analyst involved in the preparation of a report on the issuer has, during the preceding 12 months provided services to the issuer

for remuneration other than normal course investment advisory or trade execution services,

- (iv) whether the Member firm has provided investment banking services for the issuer during the 12 months preceding the date of issuance of the research report or recommendation,
 - (v) the name of any partner, director, officer, employee or agent of the Member who is an officer, director or employee of the issuer, or who serves in any advisory capacity to the issuer, and
 - (vi) whether the Member is making a market in an equity or equity related security of the subject issuer.
- (b) the Member's system for rating investment opportunities and how each recommendation fits within the system and shall disclose on their websites or otherwise, quarterly, the percentage of its recommendations that fall into each category of their recommended terminology; and
- (c) its policies and procedures regarding the dissemination of research. A Member shall comply with subsections (b) and (c) by disclosing such information in the report or by disclosing in the report where such information can be obtained.
3. Where an employee of a Member makes a public comment (which shall include an interview) about the merits of an issuer or its securities, a reference must be made to the existence of any relevant research report issued by the Member containing the disclosure as required above, if one exists, or it must be disclosed that such a report does not exist.
4. Where a Member distributes a research report prepared by an independent third party to its clients under the third party name, the Member must disclose any items which would be required to be disclosed under requirement 2 of Policy No. 11 had the report been issued in the Member's name. This requirement does not apply to research reports issued by Members of the National Association of Securities Dealers ("NASD") or issued by persons governed by other regulators approved by the Investment Dealers Association, and does not apply if the Member simply provides to clients access to the independent third party research reports or provides independent third party research at the request of clients.

However, where this requirement does not apply, Members must disclose that such research is not prepared subject to Canadian disclosure requirements.

5. No Member shall issue a research report prepared by an analyst if the analyst or any associate of the analyst serves as an officer, director or employee of the issuer or serves in any advisory capacity to the issuer.
6. Any Member that distributes research reports to clients or prospective clients in its own name must disclose its research dissemination policies and procedures on its website or by other means.
7. Each Member who distributes research reports to clients or prospective clients shall have policies and procedures reasonably designed to prohibit any trading by its partners, directors, officers, employees or agents resulting in an increase, a decrease, or liquidation of a position in a listed security, or a derivative instrument based principally on a listed or quoted security, with knowledge of or in anticipation of the distribution of a research report, a new recommendation or a change in a recommendation relating to a security that could reasonably be expected to have an effect on the price of the security.
8. No individual directly involved in the preparation of the report can effect a trade in a security of an issuer, or a derivative instrument whose value depends principally on the value of a security of an issuer, regarding which the analyst has an outstanding recommendation for a period of 30 calendar days before and 5 calendar days after issuance of the research report, unless that individual receives the previous written approval of a designated partner, officer or director of the Member. No approval may be given to allow an analyst or any individual involved in the preparation of the report to make a trade that is contrary to the analyst's current recommendation, unless special circumstances exist.
9. Members must disclose in research reports if in the previous 12 months the analyst responsible for preparing the report received compensation based upon the Member's investment banking revenues.
10. No Member may pay any bonus, salary or other form of compensation to an analyst that is directly based upon one or more specific investment banking services transactions.

11. Each Member shall have policies and procedures in place reasonably to prevent recommendations in research reports from being influenced by the investment-banking department or the issuer. Such policies and procedures shall, at minimum:
 - (i) prohibit any requirement for approval of research reports by the investment banking department;
 - (ii) limit comments from the investment banking department on research reports to correction of factual errors;
 - (iii) prevent the investment banking department from receiving advance notice of ratings or rating changes on covered companies; and
 - (iv) establish systems to control and keep records of the flow of information between analysts and investment banking departments regarding issuers that are the subject of current or prospective research reports.
12. No Member may directly or indirectly offer favorable research, a specific rating or a specific price target, a delay in changing a rating or price target or threaten to change research, a rating or a price target of an issuer as consideration or inducement for the receipt of business or compensation from an issuer.
13. Members must disclose in research reports if and to what extent an analyst has viewed the material operations of an issuer. Members must also disclose where there has been a payment or reimbursement by the issuer of the analyst's travel expenses for such visit.
14. No Member may issue a research report for an equity or equity related security regarding an issuer for which the Member acted as manager or co-manager of
 - (i) an initial public offering of equity or equity related securities, for 40 calendar days following the date of the offering; or
 - (ii) a secondary offering of equity or equity related securities, for 10 calendar days following the date of the offering;

but requirement 14(i) and (ii) do not prevent a Member from issuing a research report concerning the effects of significant news about or a significant event affecting the issuer within the applicable 40 or 10 day period.

- 14.1. Requirement 14 does not apply where the subject securities are exempted from restrictions under provisions relating to market stabilization in securities legislation or in the Universal Market Integrity Rules.
15. When a Member distributes a research report covering six or more issuers, such a report may indicate where the disclosures required under Policy No. 11 may be found.
16. Members must issue notice of their intention to suspend or discontinue coverage of an issuer. However, no issuance is required when the sole reason for the suspension is that an issuer has been placed on a Member's restricted list.
17. Members must obtain an annual certification from the head of the research department and chief executive officer which states that their analysts are familiar with and have complied with the AIMR Code of Ethics and Standards of Professional Conduct whether they are members of AIMR or not.
18. Where a supervisory analyst of a Member serves as an officer or director of an issuer, then the Member must not provide research on the issuer.
19. Members must pre-approve analysts outside business activities.
20. Where Members set price targets as recommended under guideline 4, Members must disclose the valuation methods used.

Guidelines

In addition to the above requirements, when establishing policies and procedures as referred to under requirement 1 of Policy No. 11, Members must comply with the following best practices, where practicable:

1. Members should distinguish clearly in each research report between information provided by the issuer or obtained elsewhere and the analyst's own assumptions and opinions.
2. Members should disclose in their research reports and recommendations reliance by the analyst upon any report or study by third party experts other than the analyst responsible for the report. Where there is such reliance, the name of the third party experts should be disclosed.

3. Members should adopt standards of research coverage that include, at a minimum, the obligation to maintain and publish current financial estimates and recommendations on securities followed, and to revisit such estimates and recommendations within a reasonable time following the release of material information by an issuer or the occurrence of other relevant events.
4. Members should set price targets for recommended transactions, where practicable, and with the appropriate disclosure.
5. Members should use specific securities terminology in research reports where required to do so by Securities Legislation. Where such terminology is not required, Members should use the specific technical terminology that is required by the relevant industry, professional association or regulatory authority or in the absence of required terminology use technical terminology that is customarily in use. Where necessary, for full understanding, a glossary should be included.
6. A Member should make its research reports widely available through its websites or by other means for all of its clients whom the Member has determined are entitled to receive such research reports at the same time.
7. Where feasible by virtue of the number of analysts, Members should appoint one or more supervisory analyst or head of research to be responsible for reviewing and approving research reports as required under By-law 29.7, who should be a partner, director or officer of the Member and should have the CFA designation or other appropriate qualifications. Members may have more than one supervisory analyst where necessary.
8. Members should require their analyst employees to obtain the Chartered Financial Analyst designation or other appropriate qualifications.
9. Members should require that the head of the research department, or in small firms where there is no head then the analyst or analysts report to a senior officer or partner who is not the head of the investment banking department. However, no policies or procedures will be approved under requirement 1 unless the Association is satisfied that they address the relationship between the investment-banking department and research department.

Appendix C – NASD Rule 2711, Research Analysts and Research Reports

(a) Definitions

For purposes of this rule, the following terms shall be defined as provided.

- (1) "Investment banking department" means any department or division, whether or not identified as such, that performs any investment banking service on behalf of a member.
- (2) "Investment banking services" include, without limitation, acting as an underwriter in an offering for the issuer; acting as a financial adviser in a merger or acquisition; providing venture capital, equity lines of credit, PIPEs or similar investments; or serving as placement agent for the issuer.
- (3) "Member of a research analyst's household" means any individual whose principal residence is the same as the research analyst's principal residence.
- (4) "Public appearance" means any participation in a seminar, forum (including an interactive electronic forum), radio, television or print media interview, or other public speaking activity, or the writing of a print media article, in which a research analyst makes a recommendation or offers an opinion concerning an equity security.
- (5) "Research analyst" means the associated person who is primarily responsible for, and any associated person who reports directly or indirectly to such a research analyst in connection with, preparation of the substance of a research report, whether or not any such person has the job title of "research analyst."
- (6) "Research analyst account" means any account in which a research analyst or member of the research analyst's household has a financial interest, or over which such analyst has discretion or control, other than an investment company registered under the Investment Company Act of 1940. This term does not include a "blind trust" account that is controlled by a person other than the research analyst or member of the research analyst's household where neither the

research analyst nor a member of the research analyst's household knows of the account's investments or investments transactions.

- (7) "Research department" means any department or division, whether or not identified as such, that is principally responsible for preparing the substance of a research report on behalf of a member.
- (8) "Research Report" means a written or electronic communication that includes an analysis of equity securities of individual companies or industries, and that provides information reasonably sufficient upon which to base an investment decision.
- (9) "Subject company" means the company whose equity securities are the subject of a research report or a public appearance.

(b) Restrictions on Relationship with Research Department

- (1) No research analyst may be subject to the supervision or control of any employee of the member's investment banking department, and no personnel engaged in investment banking activities may have any influence or control over the compensatory evaluation of a research analyst.
- (2) Except as provided in paragraph (b)(3), no employee of the investment banking department or any other employee of the member who is not directly responsible for investment research ("non-research personnel"), other than legal or compliance personnel, may review or approve a research report of the member before its publication.
- (3) Non-research personnel may review a research report before its publication as necessary only to verify the factual accuracy of information in the research report or identify any potential conflict of interest, provided that:
 - (A) any written communication between non-research personnel and research department personnel concerning the content of a research report must be made either through authorized legal or compliance personnel of the member or in a transmission copied to such personnel; and
 - (B) any oral communication between non-research personnel and research department personnel concerning the content of a research report must be documented and made either through authorized legal or compliance

personnel acting as intermediary or in a conversation conducted in the presence of such personnel.

(c) Restrictions on Communications with the Subject Company

- (1) Except as provided in paragraphs (c)(2) and (c)(3), a member may not submit a research report to the subject company before its publication.
- (2) A member may submit sections of such a research report to the subject company before its publication for review as necessary only to verify the factual accuracy of information in those sections, provided that:
 - (A) the sections of the research report submitted to the subject company do not contain the research summary, the research rating or the price target;
 - (B) a complete draft of the research report is provided to legal or compliance personnel before sections of the report are submitted to the subject company; and
 - (C) if after submitting the sections of the research report to the subject company the research department intends to change the proposed rating or price target, it must first provide written justification to, and receive written authorization from, legal or compliance personnel for the change. The member must retain copies of any draft and the final version of such a research report for three years following its publication.
- (3) The member may notify a subject company that the member intends to change its rating of the subject company's securities, provided that the notification occurs on the business day before the member announces the rating change, after the close of trading in the principal market of the subject company's securities.
- (4) No research analyst may participate in efforts to solicit investment banking business. Accordingly, 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.

(d) Restrictions on Research Analyst Compensation

- (1) No member may pay any bonus, salary or other form of compensation to a research analyst that is based upon a specific investment banking services transaction.
- (2) The compensation of a research analyst who is 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 members board' of directors, or when the member has no board of directors, to a senior executive officer of the member. This committee may not have representation from the member's investment banking department. The committee must consider the following factors when reviewing such a research analyst's compensation, if applicable:
 - (A) the research analyst's individual performance, including the analyst's productivity and the quality of the analyst's research;
 - (B) the correlation between the research analyst's recommendations and the stock price performance; and
 - (C) the overall ratings received from clients, sales force, and peers independent of the member's investment banking department, and other independent ratings services.

The committee may not consider as a factor in reviewing and approving such a research analyst's compensation his/her contributions to the member's investment banking business. The committee must document the basis upon which each such research analyst's compensation was established. The annual attestation required by Rule 2711(i) must certify that the committee reviewed and approved each such research analyst's compensation and documented the basis upon which this compensation was established.

(e) Prohibition of Promise of Favourable Research

No member may directly or indirectly offer favourable research, a specific rating or a specific price target, or threaten to change research, a rating or a price target, to a company as consideration or inducement for the receipt of business or compensation.

(f) Restrictions on Publishing Research Reports and Public Appearances; Termination of Coverage

- (1) No member may publish or otherwise distribute a research report and no research analyst may make a public appearance regarding a subject company for which the member acted as manager or co-manager of:
 - (A) an initial public offering, for 40 calendar days following the date of the offering; or
 - (B) a secondary offering, for 10 calendar days following the date of the offering; provided that:
 - (i) paragraphs (f)(1)(A) and (f)(1)(B) will not prevent a member from publishing or otherwise distributing a research report, or prevent a research analyst from making a public appearance, concerning the effects of significant news or a significant event on the subject company within such 40- and 10-day periods, and provided further that legal or compliance personnel authorize publication of that research report before it is issued or authorize the public appearance before it is made; and
 - (ii) paragraph (f)(1)(B) will not prevent a member from publishing or otherwise distributing a research report pursuant to SEC Rule 139 regarding a subject company with "actively-traded securities," as defined in Regulation M, 17 CFR 242.101(c)(1), and will not prevent a research analyst from making a public appearance concerning such a company.
- (2) No member that has agreed to participate or is participating as an underwriter or dealer (other than as manager or co-manager) of an issuer's initial public offering may publish or otherwise distribute a research report or make a public appearance regarding that issuer for 25 calendar days after the date of the offering.
- (3) For purposes of paragraphs (f)(1) and (f)(2), the term "date of the offering" refers to the later of the effective date of the registration statement or the first date on which the security was bona fide offered to the public.

- (4) No member that has acted as a manager or co-manager of a securities offering may publish or otherwise distribute a research report or make a public appearance concerning a subject company 15 days prior to and after the expiration, waiver or termination of a lock-up agreement or any other agreement that the member has entered into with a subject company or its shareholders that restricts or prohibits the sale of securities held by the subject company or its shareholders after the completion of a securities offering. This paragraph will not prevent a member from publishing or otherwise distributing a research report concerning the effects of significant news or a significant event on the subject company within such period, provided legal or compliance personnel authorize publication of that research report before it is issued. In addition, this paragraph shall not apply to the publication or distribution of a research report pursuant to SEC Rule 139 regarding a subject company with "actively traded securities," as defined in Regulation M, 17 CFR 242.101(c)(1), or to a public appearance concerning such a subject company.
- (5) If a member intends to terminate its research coverage of a subject company, notice of this termination must be made. The member must make available a final research report on the subject company using the means of dissemination equivalent to those it ordinarily uses to provide the customer with its research reports on the subject company. The report must be comparable in scope and detail to prior research reports and must include a final recommendation or rating, unless it is impracticable for the member to produce a comparable report (e.g., if the research analyst covering the subject company or sector has left the member or if the member terminates coverage of the industry or sector). If it is impracticable to produce a final recommendation or rating, the final research report must disclose the member's rationale for the decision to terminate coverage.

(g) Restrictions on Personal Trading by Research Analysts

- (1) No research analyst account may purchase or receive any securities before the issuer's initial public offering if the issuer is principally engaged in the same types of business as companies that the research analyst follows.
- (2) No research analyst account may purchase or sell any security issued by a company that the research analyst follows, or any option on or derivative of such security, for a period beginning 30 calendar days before and ending five calendar days after

the publication of a research report concerning the company or a change in a rating or price target of the company's securities; provided that:

- (A) a member may permit a research analyst account to sell securities held by the account that are issued by a company that the research analyst follows, within 30 calendar days after the research analyst began following the company for the member;
 - (B) a member may permit a research analyst account to purchase or sell any security issued by a subject company within 30 calendar days before the publication of a research report or change in the rating or price target of the subject company's securities due to significant news or a significant event concerning the subject company, provided that the legal or compliance personnel pre-approve the research report and any change in the rating or price target.
- (3) No research analyst account may purchase or sell any security or any option on or derivative of such security in a manner inconsistent with the research analyst's recommendation as reflected in the most recent research report published by the member.
- (4) Legal or compliance personnel may authorize a transaction otherwise prohibited by paragraphs (g)(2) and (g)(3) based upon an unanticipated significant change in the personal financial circumstances of the beneficial owner of the research analyst account, provided that:
- (A) legal or compliance personnel authorize the transaction before it is entered;
 - (B) each exception is granted in compliance with policies and procedures adopted by the member that are reasonably designed to ensure that these transactions do not create a conflict of interest between the professional responsibilities of the research analyst and the personal trading activities of a research analyst account; and
 - (C) the member maintains written records concerning each transaction and the justification for permitting the transaction for three years following the date on which the transaction is approved.

- (5) The prohibitions in paragraphs (g)(1) through (g)(3) do not apply to a purchase or sale of the securities of:
 - (A) any registered diversified investment company as defined under Section (5)(b)(1) of the Investment Company Act of 1940; or
 - (B) any other investment fund over which neither the research analyst nor a member of the research analyst's household has any investment discretion or control, provided that:
 - (i) the research analyst accounts collectively own interests representing no more than 1% of the assets of the fund;
 - (ii) the fund invests no more than 20% of its assets in securities of issuers principally engaged in the same types of business as companies that the research analyst follows; and
 - (iii) if the investment fund distributes securities in kind to the research analyst or household member before the issuer's initial public offering, the research analyst or household member must either divest those securities immediately or the research analyst must refrain from participating in the preparation of research reports concerning that issuer.
- (6) Legal or compliance personnel of the member shall pre-approve all transactions of persons who oversee research analysts to the extent such transactions involve equity securities of subject companies covered by the research analysts that they oversee. This pre-approval requirement shall apply to all persons, such as the director of research, supervisory analyst, or member of a committee, who have direct influence or control with respect to the preparation of the substance of research reports or establishing or changing a rating or price target of a subject company's equity securities.

(h) Disclosure Requirements

(1) Ownership and Material Conflicts of Interest

A member must disclose in research reports and a research analyst must disclose in public appearances:

- (A) if the research analyst or a member of the research analyst's household has a financial interest in the securities of the subject company, and the nature of the financial interest (including, without limitation, whether it consists of any option, right, warrant, future, long or short position);
- (B) if, as of the end of the month immediately preceding the date of publication of the research report or the public appearance (or the end of the second most recent month if the publication date is less than 10 calendar days after the end of the most recent month), the member or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company. Computation of beneficial ownership of securities must be based upon the same standards used to compute ownership for purposes of the reporting requirements under Section 13(d) of the Securities Exchange Act of 1934;
- (C) any other actual, material conflict of interest of the research analyst of which the research analyst or member knows or has reason to know at the time of publication of the research report or at the time of the public appearance.

(2) Receipt of Compensation

- (A) A member must disclose in research reports:
 - (i) if the research analyst received compensation:
 - (a.) based upon (among other factors) the member's investment banking revenues; or
 - (b.) from the subject company in the past 12 months.
 - (ii) the member or affiliate:

- (a.) managed or co-managed a public offering of securities for the subject company in the past 12 months;
 - (b.) received compensation for investment banking services from the subject company in the past 12 months; or
 - (c.) expects to receive or intends to seek compensation for investment banking services from the subject company in the next 3 months.
- (iii) if (1) as of the end of the month immediately preceding the date of publication of the research report (or the end of the second most recent month if the publication date is less than 30 calendar days after the end of the most recent month) or (2) to the extent the research analyst or an employee of the member with the ability to influence the substance of the research knows:
- (a.) the member received any compensation for products or services other than investment banking services from the subject company in the past 12 months; or
 - (b.) the subject company currently is, or during the 12-month period preceding the date of distribution of the research report was, a client of the member. In such cases, the member also must disclose the types of services provided to the subject company. For purposes of this Rule 2711(h)(2), the types of services provided to the subject company shall be described as investment banking services, non-investment banking securities-related services, and non-securities services.
- (iv) if, to the extent the research analyst or an employee of the member with the ability to influence the substance of the research report knows an affiliate of the member received any compensation for products or services other than investment banking services from the subject company in the past 12 months.
- (v) if, to the extent the research analyst or member has reason to know, an affiliate of the member received any compensation for products or services other than investment banking services from the subject company in the past 12 months.

- a. This requirement will be deemed satisfied if such compensation is disclosed in research reports within 30 days after completion of the last calendar quarter, provided that the member has taken steps reasonably designed to identify any such compensation during that calendar quarter. This requirement shall not apply to any subject company as to which the member initiated coverage since the beginning of the current calendar quarter.
 - b. The research analyst and the member will be presumed not to have reason to know whether an affiliate received any compensation for products or services other than investment banking services from the subject company in the past 12 months if the member maintains and enforces policies and procedures reasonably designed to prevent the research analysts and employees of the member with the ability to influence the substance of research reports from, directly or indirectly, receiving information from the affiliate concerning whether the affiliate received such compensation.
- (vi) For the purposes of this Rule 2711(h)(2), an employee of the member with the ability to influence the substance of the research report is an employee who, in the ordinary course of that person's duties, has the authority to review the particular research report and to change that research report prior to publication.
- (B) A research analyst must disclose in public appearances:
- (i) if, to the extent the research analyst knows or has reason to know, the member or any affiliate received any compensation from the subject company in the past 12 months;
 - (ii) if the research analyst received any compensation from the subject company in the past 12 months; or
 - (iii) if, to the extent the research analyst knows or has reason to know, the subject company currently is, or during the 12-month period preceding the date of distribution of the research report, was, a client of the member. In such cases, the research analyst also must disclose the types of

services provided to the subject company, if known by the research analyst.

- (C) A member or research analyst will not be required to make a disclosure required by paragraphs (h)(2)(A)(ii)(b) and (c), (h)(2)(A)(iii)(b), or (h)(2)(B)(i) and (iii) to the extent such disclosure would reveal material non-public information regarding specific potential future investment banking transactions of the subject company.

(3) Position as Officer or Director

A member must disclose in research reports and a research analyst must disclose in public appearances if the research analyst or a member of the research analyst's household serves as an officer, director or advisory board member of the subject company.

(4) Meaning of Ratings

A member must define in its research reports the meaning of each rating used by the member in its rating system. The definition of each rating must be consistent with its plain meaning.

(5) Distribution of Ratings

- (A) Regardless of the rating system that a member employs, a member must disclose in each research report the percentage of all securities rated by the member to which the member would assign a "buy," "hold/neutral," or "sell" rating.
- (B) In each research report, the member must disclose the percentage of subject companies within each of these three categories for whom the member has provided investment banking services within the previous twelve months.
- (C) The information that is disclosed under paragraphs (h)(5)(A) and (h)(5)(B) must be current as of the end of the most recent calendar quarter (or the second most recent calendar quarter if the publication date is less than 15 calendar days after the most recent calendar quarter).

(6) Price Chart

A member must present in any research report concerning an equity security on which the member has assigned any rating for at least one year, a line graph of the security's daily closing prices for the period that the member has assigned any rating or for a three-year period, whichever is shorter. The line graph must:

- (A) indicate the dates on which the member assigned or changed each rating or price target;
- (B) depict each rating and price target assigned or changed on those dates; and
- (C) be current as of the end of the most recent calendar quarter (or the second most recent calendar quarter if the publication date is less than 15 calendar days after the most recent calendar quarter).

(7) Price Targets

A member must disclose in research reports the valuation methods used to determine a 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.

(8) Market Making

A member must disclose in research reports if it was making a market in the subject company's securities at the time that the research report was published.

(9) Disclosure Required by Other Provisions

In addition to the disclosure required by this rule, members and research analysts must provide disclosure in research reports and public appearances that is required by applicable law or regulation, including NASD Rule 2210 and the antifraud provisions of the federal securities laws.

(10) Prominence of Disclosure

The disclosures required by this paragraph (h) must be presented on the front page of research reports or the front page must refer to the page on which disclosures are found. Disclosures and references to disclosures must be clear, comprehensive and prominent.

(11) Disclosures in Research Reports Covering Six or More Companies

When a member distributes a research report covering six or more subject companies, for purposes of the disclosures required in paragraph (h), such research report may direct the reader in a clear manner as to where they may obtain applicable current disclosures in written or electronic format.

(12) Records of Public Appearances

Members must maintain records of public appearances by research analysts sufficient to demonstrate compliance by those research analysts with the applicable disclosure requirements under paragraph (h) of this Rule. Such records must be maintained for three years from the date of the public appearance.

(i) Supervisory Procedures

Each member subject to this rule must adopt and implement written supervisory procedures reasonably designed to ensure that the member and its employees comply with the provisions of this rule (including the attestation requirements of Rule 2711(d)(2)), and a senior officer of such a member must attest annually to NASD by April 1 of each year that it has adopted and implemented those procedures.

(j) Prohibition of Retaliation Against Research Analysts

No member and no employee of a member who is involved with the member's investment banking activities may, directly or indirectly, retaliate against or threaten to retaliate against any research analyst employed by the member or its affiliates as a result of an adverse, negative, or otherwise unfavourable research report or public appearance written or made by the research analyst that may adversely affect the member's present or prospective investment banking relationship with the subject company of a research report. This prohibition shall not limit a member's authority to discipline or terminate a

research analyst, in accordance with the member's policies and procedures, for any cause other than the writing of such an unfavourable research report or the making of such an unfavourable public appearance.

(k) Exceptions for Small Firms

The provisions of paragraph (b) shall not apply to members that over the previous three years, on average per year, have participated in 10 or fewer investment banking services transactions as manager or co-manager and generated \$5 million or less in gross investment banking services revenues from those transactions. For purposes of this paragraph (k), the term "investment banking services transactions" includes the underwriting of both corporate debt and equity securities but not municipal securities. Members that qualify for this exemption must maintain records for three years of any communication that, but for this exemption, would be subject to paragraph (b) of this Rule.