

Regulators Recognize Technical Analysts' Examination

The New York Stock Exchange ("NYSE") and NASD¹ have filed rule changes with the Securities and Exchange Commission (the "SEC" or the "Commission") recognizing an alternative examination for technical analysts. The changes, which are effective on filing with the Commission, reflect the differences in approach between technical and fundamental analysis.²

Background

After the bursting of the "tech bubble" of the late 1990s, critics looked to ascribe blame for the falling stock prices. Although there was plenty of blame to go around, many critics pointed to investment banks' research analysts as partially responsible. As one sensationalist account describes it:

Ostensibly, the job of the analysts was to recommend what stocks investors

¹ Referred to jointly as the "self-regulatory organizations" or the "SROs."

² SR-NYSE-2005-12 and SR-NASD-2005-022, Rel 34-51240, 70 FR 10451 (March 3, 2005). The Commission notes that the rules changes:

have become effective pursuant to section 19(b)(3)(A) of the [Securities Exchange] Act [of 1934] and Rule 19b-4(f)(1) thereunder.

At any time within 60 days of the filing of the proposed rule changes, the Commission may summarily abrogate these proposals if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the [Securities Exchange] Act [of 1934].

70 FR at 10455.

should purchase. But through the 1990s, they gave credibility to the overvalued markets to millions of new investors, who were largely unaware that the analyst had taken on a more conflicted role of recommending stocks and helping their firms win the lucrative investment banking deals from the same companies that helped pay their outsized salaries.³

Although the securities industry adopted "best practices" in an effort to address these concerns⁴, self-regulators stepped in and adopted rules that had the force of law.⁵

³ Gasparino, *Blood on the Street*, (2005) at 8. See also, "Analyzing the Analysts," Hearings before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services, June 14 and 31, 2001, Serial No. 107-25.

⁴ Securities Industry Association ("SIA"), *Best Practices for Research*. SIA's Best Practices foreshadowed many aspects of the subsequent legal requirements, such as providing that a research department at a broker-dealer should not report to the investment banking department.

⁵ In addition, the Commission, NASD, NYSE, the New York Attorney General, and other state regulators reached a global settlement with ten investment banks and two individual analysts arising from an investigation of research analyst conflicts of interest. <http://www.sec.gov/news/speech/factsheet.htm> See Spotlight on The Global Research Analyst Settlement <http://www.sec.gov/spotlight/globalsettlement.htm> and materials reference therein. See also Spitzer, *Merrill Lynch Reach Unprecedented Agreement to Reform Investment Practices*, May 21, 2002 http://www.oag.state.ny.us/press/2002/may/may_21a_02.html and materials cited therein.

The NASD⁶ and NYSE⁷ instituted rules to ensure greater separation of research analysts from investment bankers to improve their independence.⁸ The SROs defined the term “research report,” but excluded certain types of analytical discussions from their definition.⁹

⁶ NASD Rule 2711. See also NASD *Notice to Members 02-39*.

⁷ NYSE Rules 351 and 472. See also NYSE *Information Memos 02-24; 02-26; and 02-30*.

⁸ Release No. 34-45908; File No. SR-NASD-2002-21; SR-NYSE-2002-09 (May 10, 2002), Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the National Association of Securities Dealers, Inc. and the New York Stock Exchange, Inc. and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. and Amendment No. 1 to the Proposed Rule Change by the New York Stock Exchange, Inc. Relating to Research Analyst Conflicts of Interest.

⁹ Under the SRO Rules [citing NASD Rule 2711(a)(8) and NYSE Rule 472.10(2)] the term “research report” has four components. A “research report” is (i) written or electronic communication, (2) that includes an analysis of equity securities of individual companies or industries, (3) that provides information reasonably sufficient upon which to base an investment decision, and (4) that includes a recommendation.



Member communications that mention or discuss particular equity securities come in a variety of forms, and it is not possible to provide a complete list of all types of communications that fall or do not fall within this definition. The issue of whether a particular communication constitutes a “research report” for purposes of the SRO Rules will turn on the individual facts and circumstances surrounding that communication. The SROs generally would not consider the following communications to be “research reports”:

- Reports discussing broad-based indices, such as the Russell 2000 or S&P 500 index, that do not recommend or rate individual securities.
- Reports commenting on economic, political or market conditions that do not recommend or rate individual securities.
- Technical analysis concerning the demand and supply for a sector, index or industry based on trading volume and price.
- Statistical summaries of multiple companies’ financial data (including listings of current ratings) that do not include any narrative discussion or analysis of individual companies’ data.

Attachment B, Joint Memorandum of NASD and The New York Stock Exchange, Discussion and Interpretation of

Congress did not believe that these efforts went far enough and enacted Section 501 of the Sarbanes-Oxley Act¹⁰ to address concerns about analysts. Section 501(a) of Sarbanes Oxley added Section 15D of the Securities Exchange Act of 1934 (the “Exchange Act”), which provides that:

the Commission, or upon the authorization and direction of the Commission, a registered securities association or national securities exchange, shall have adopted, not later than 1 year after the date of enactment of this section, rules reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances, in order to improve the objectivity of research reports and provide investors with more useful and reliable information....

Among other things, Congress directed that such rules should insulate research analysts from investment banking activities, including preventing investment bankers from “prepublication clearance and approval” of research reports¹¹, and “limiting the supervision and compensatory evaluation of securities analysts to officials employed by the broker or dealer who are not engaged in investment banking activities....”¹² Congress defined a “research report” as 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.”¹³

In response to this provision and at the urging of the Commission, the NYSE and NASD proposed further amendments to their rules to strengthen their restrictions on analysts and the Commission approved those changes.¹⁴ For example, the SROs amended their

Rules Governing Research Analysts and Research Reports (NASD Rule 2711 and NYSE Rule 351 and 472), as printed in NASD *Notice to Members 02-39*, at 367.

¹⁰ Pub. L. 107-204 (July 30, 2002).

¹¹ Section 15D(a)(1)(A) of the Exchange Act.

¹² Section 15D(a)(1)(B) of the Exchange Act.

¹³ Section 15D(c) of the Exchange Act.

¹⁴ Release No. 34-48252; File No. SR-NASD-2002-154; SR-NYSE-2002-49 July 29, 2003, Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc. Relating to Exchange Rules 344 (“Supervisory Analysts”), 345A (“Continuing

definitions of “research reports” adopting verbatim the definition of Section 15B(c) of the Exchange Act and deleting the requirement that a research report include a recommendation.¹⁵

Examination Requirement

Although not a requirement of Sarbanes-Oxley, the SROs instituted a requirement that research analysts must pass an examination to demonstrate their competence.¹⁶ The SROs required that all analysts had to pass the exams by March 30, 2004. The SROs permitted people who were functioning as research analysts a one year grace period and did not force them to stop writing research reports until they completed the exam. But they did not “grandfather” practicing analysts. With limited exceptions, the SROs required every person associated with a broker-dealer functioning as a research analyst to pass the exams.¹⁷

Education for Registered Persons”), 351 (“Reporting Requirements”) and 472 (“Communications with the Public”) and by the National Association of Securities Dealers, Inc. Relating to Research Analyst Conflicts of Interest and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3 to the Proposed Rule Change by the New York Stock Exchange, Inc and Amendment No. 3 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Research Analyst Conflicts of Interest; *see also* NYSE *Information Memo 03-36* and NASD *Notice to Members 03-44*.

¹⁵ *E.g.*, NASD Rule 2711(a)(8). provides that:

“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.

See n. 13 *supra* and accompanying text.

¹⁶ Rel. No. 34-49464; File Nos. SR-NYSE 2004-03; SR-NASD-2004-020; March 24, 2004 -- Self-Regulatory Organizations; Order Granting Accelerated Approval of Proposed Rule Changes by the New York Stock Exchange, Inc. and the National Association of Securities Dealers, Inc. Relating to Certain Prerequisites to and Exemptions from Taking the Research Analyst Qualification Examination (“Series 86/87”).

¹⁷ NASD stated that after March 30, 2004,

any associated person who functions as a research analyst must pass the new Research Analyst Qualification Examination (Series 86/87) or qualify for an exemption or waiver. The examination consists of an analysis part (Series 86) and

There are two parts to the SROs’ analyst exams:

The qualification exam consists of two parts. Part I – Analysis (Series 86) consists of 100 multiple-choice questions that primarily test fundamental analysis and valuation of equity securities. Part II – Regulatory Administration and Best Practices (Series 87) consists of 50 multiple-choice questions that cover relevant federal and industry rules and regulations.¹⁸

The Series 86 examination is designed to measure understanding of fundamental analysis. Fundamental analysts make judgments about the prospects for a stock after examining information about that company. Fundamental analysts will examine a company’s underlying financial statements, business risks, and other economic conditions. For example, a description of the 86 Exam states that analysts should:

Gather information about individual companies to understand the company’s financial status, structure, supply chain, costs of production, sources of revenue, sources of economic growth, risk tolerance, quality of management, new product development, business plan, and how the business plan will be implemented.¹⁹

regulatory part (Series 87). Prior to taking either the Series 86 or 87, a candidate must also have passed the General Securities Registered Representative Examination (Series 7), the Limited Registered Representative (Series 17), or the Canada Module of Series 7 (Series 37 or 38). Persons who are functioning as research analysts on the effective date will be granted a one-year grace period within which to meet the registration requirements, provided the member firm with which they are associated applies for the research analyst registration within **60** days of the effective date of the rule. There is no “grandfather” provision for this new qualification requirement.

NASD *Notice to Members 04-25*, March 2004

¹⁸ NASD *Notice to Members 04-25*, March 2004.

¹⁹ NASD/NYSE Study Outline for the Research Analyst Qualification Examination (Series 86 / 87) (“Study Outline”) http://www.nasd.com/web/groups/reg_systems/documents/regulatory_systems/nasdw_005456.pdf at 1.3.

The description further provides that analysts should:

conduct fundamental analysis based on the company's financial statements and supplemental information, including all footnotes.²⁰

By contrast, technical analysts make judgments about the prospect for a stock after examining stock price, trading volume, and investor psychology. Although the two disciplines are equally valid, they take intrinsically different approaches.

Fundamental Analysts

The SROs did grant a limited exception to a portion of the analyst examination requirement. The SROs were willing to exempt from the Series 86 Exam persons who had passed Levels I and II of the Charter Financial Analyst ("CFA") Examination.²¹ The CFA Institute

²⁰ Study Outline at 2.2.2.

²¹ NASD Rule 1050(c) provided:

Upon written request pursuant to the Rule 9600 Series, NASD will grant a waiver from the analytical portion of the Research Analyst Qualification Examination (Series 86) upon verification that the applicant has passed Levels I and II of the Charter Financial Analyst Examination and has either (1) functioned as a research analyst continuously since having passed the Level II examination or (2) applied for registration as a research analyst within two years of having passed the Level II examination. An applicant who has been granted such an exemption still must become registered as a General Securities Representative and then complete the regulatory portion of the Research Analyst Qualification Examination (Series 87) before that applicant can be registered as a Research Analyst.

Similarly, NYSE *Information Memo 04-16* (April 1, 2004) states that:

The interpretation to Rule 344 also allows a research analyst candidate that has passed both Level I and Level II of the Chartered Financial Analyst ("CFA") Examination that is administered by the Association for Investment Management and Research ("AIMR"), to request an exemption from Part I (Series 86) of the Research Analyst Qualification Examination. Candidates who receive an exemption from the Series 86 must still satisfy the Series 7, 17, 37, or 38 prerequisite and pass the Series 87 before becoming qualified as research analysts. To qualify for the CFA exemption to the Series 86 examination requirement, a research analyst candidate must have: (i) completed the CFA Part II within 2 years of application or registration or (ii) functioned as a

(formerly known as "AIMR"), administers this exam. The SROs considered analysts who pass the Levels I and II of the CFA as equivalent to having passed the Series 86 exam.

Technical Analysts

The SROs did not provide for any exemption for technical analysts from the Series 86 Exam. The SROs' willingness to exempt individuals who had passed the CFA exam did little to help the technical analysts who would need to take the Series 86 Exam. The SROs designed the Series 86 to test understanding of fundamental analysis, not technical analysis. Moreover, if a technical analyst writes research reports about specific companies, as distinguished from writing about the economy at large, the SROs specifically required that analyst to take the Series 86 Exam. The NASD explained in a "frequently asked question" as follows:

- Q. Is a "technical analyst" who does not rely on fundamental research to prepare his or her research reports on companies required to register as a research analyst and take the qualification examinations?
- A. As explained in the joint memoranda issued by NASD and the NYSE in *Notice to Members 02-39* and *04-18*, a communication that consists of "technical analysis concerning the demand and supply for a sector, index, or industry based on trading volume and price" falls outside the definition of a "research report" under Rule 2711(a)(8). Accordingly, a person who produces only such technical research would not be required to become registered as a research analyst. However, the exclusion does not extend to technical analysis of individual securities. Thus, an associated person who produces technical research on individual companies would be required to become registered as a research analyst pursuant to Rule 1050.²²

research analyst continuously since having passed the CFA Part II.

²² See n. 9 *supra*. See also NASD *Notice to Members 04-18*, March 2004.

NASD *Notice to Members 04-25*, March 2004

Market Technicians Association

The Market Technicians Association (“MTA”) is a professional association of technical analysts.²³ They have operated a sophisticated program for testing technical analysts and granting those who pass the designation Chartered Market Technician or CMT.SM The MTA petitioned the SROs and asked them to grant an exception from the Series 86 Exam similar to the exception that the SROs granted for the CFA examination.

In discussions with the SROs, MTA made the following points:

- Technical analysis is a recognized academic discipline that has existed for literally hundreds of years.
- Both buy and sell side use technical analysis extensively. Technical analysts are well-known to the general public.
- MTA began developing its rigorous testing program in 1985 and administered its first test in 1988. The MTA regularly has modernized its examination program over the years.
- MTA’s testing program indicates whether technical analysts have sufficient expertise in their chosen field. Requiring technical analysts to take the Series 86 Examination is like requiring lawyers to pass the medical boards.

MTA requested that the SROs treat successful completion of its Level 1 and 2 examinations as testing an equivalent level of knowledge as either the Series 86 Exam or the CFA Level I and II. MTA did not request an exemption from the Series 87 Exam, which tests knowledge of the rules that protect the integrity of the research function at broker-dealers.

²³ The MTA incorporated in 1973, is the national organization of market analysis professionals in the United States. This not-for-profit association has this mission: (1) Educate the public and the investment community to the value and universality of technical analysis; (2) Attract and retain a membership of professionals devoting their efforts to using and expanding the field of technical analysis and sharing their body of knowledge with their fellow members; and (3) Establish, maintain and encourage the highest standards of professional competence and ethics among technical analysts. MTA’s membership reaches from the U.S. to Toronto, Montreal, London, and Tokyo.

SROs Recognize MTA Exams

The NYSE²⁴ and the NASD²⁵ filed essentially similar rule changes with the SEC to recognize the MTA’s exams. The SROs granted an exemption from the Series 86 for an analyst who prepares only technical research reports and has passed the CMT Level 1 and 2, and has functioned as a research analyst continuously since having passed the Level 2 CMT examination or has applied for registration as a research analyst within two years of having passed the CMT Level 2.

The NYSE notes that the NYSE and NASD staffs developed the Series 86 exam in conjunction with a committee of fundamental analysts and “is intended to test fundamental analysts. *** Technical analysis is quite different than fundamental and therefore such analysts should not unnecessarily be subjected to taking an examination, when there is a superior alternative to demonstrate competency.”²⁶

The SROs reviewed the MTA’s testing program and concluded:

In sum, the MTA with its professional consultants have subjected the examination to standard testing practices that the Exchange believes sufficient to allow it to be used to provide an exemption from the Series 86 examination. This is evidenced by the fact that the MTA has been conducting job analysis studies, updating the CMT examinations periodically, and involving content experts in such studies and updates of the examination.²⁷

The NYSE further states that “the Exchange believes that investors will be better served by proposing a qualification standard directly applicable to persons preparing technical research reports, which will demonstrate their competency based on the work functions and knowledge needed to perform such functions.”²⁸

²⁴ SR-NYSE-2005-12. See also NYSE *Information Memo 05-09*, Jan. 31, 2005.

²⁵ SR-NASD-2005-022.

²⁶ SR-NYSE-2005-12.

²⁷ SR-NYSE-2005-12 at 20. The NASD made essentially the same comment at SR-NASD-2005-022 at 17.

²⁸ SR-NYSE-2005-12 at 19. The NASD made essentially the same comment in SR-NASD-2005-022 at 18.

The SROs used a definition of “technical research report” that is based on the definition in the Global Research Analyst Settlement.²⁹ That definition is:

For the purposes of paragraph (c)(2), a “technical research report” shall mean a research report, as that term is defined in Rule 2711(a)(8), that is based solely on stock price movement and trading volume and not on the subject company’s financial information, business prospects, contact with subject company’s management, or the valuation of a subject company’s securities.³⁰

Both SROs note that the exemption is limited to persons who write technical research reports only. For example the NASD cautions:

Importantly, the exemption is available only to research analysts who *exclusively* prepare technical research reports. An associated

²⁹ SR-NYSE-2005-12 at 17, citing SEC Litigation Release No 18438 (Oct. 31, 2003). See also n. 5 *supra*.

³⁰ SR-NASD-2005-022 at 14. See also SR-NYSE-2005-12 at 26.

person who prepares any research report or whose name appears on a research report that does not meet this definition of a “technical research report” would be required to pass the Series 86 or qualify for another exemption or waiver.³¹

As noted, the SROs filed their respective rule changes under Section 19b(3)(a) of the Securities Exchange Act of 1934, meaning that the rule changes took effect upon filing with the Commission.

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MTA retained Dechert LLP to assist with its effort to have regulators recognize the CMT exam as an alternative to the Series 86 Exam.

For your convenience, the following page contains the text of the NYSE and NASD rule changes.

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³¹ SR-NASD-2005-022 at 19.

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Text of NYSE And NASD Rule Changes

NYSE

Rule 344/01 Qualifications (continued)

RESEARCH ANALYSTS AND SUPERVISORY ANALYSTS

Exemptions

Successful completion of Levels I and II of the Charter Financial Analyst (“CFA”) Examination administered by the CFA Institute allows a Research Analyst candidate to request an exemption from Part I (Series 86) of the Research Analyst Qualification Examination. If an exemption is granted for Part I (Series 86), a candidate will be qualified as a Research Analyst after passing Part II (Series 87) [only] and the prerequisite examination (i.e., Series 7, 17, or 37/38 examinations).

Successful completion of Levels I and II of the Chartered Market Technician Program (“CMT”) administered by the Market Technician Association (“MTA”) allows a Research Analyst Candidate who prepares only technical research reports to request an exemption from Part I (Series 86) of the Research Analyst Qualification Examination. If an exemption is granted for Part I (series 86), a candidate will be qualified as a Research Analyst only after passing Part II (Series 87) and the prerequisite examination (i.e., series 7, 17, or 37/38 examinations).

To qualify for a CFA or CMT exemption a Research Analyst candidate must have: (i) completed the CFA [Part] Level II or CMT Level II within two years of application for registration or (ii) functioned as a research analyst continuously since having passed the CFA [Part] Level II or CMT Level II. Applicants that have completed the CFA [Part] Level II or CMT Level II that do not meet criteria (i) or (ii) may where good cause is shown based upon previous related employment experience make a written request to the Exchange for an exemption.

A technical research report is a research report as defined in Rule 472.10(2) that is based solely on stock price movement and trading volume and not on the subject company's financial information, business prospects, contact with the subject company's management, or the valuation of a subject company's securities.

NYSE Rule 344/01

NASD

1050. Registration of Research Analysts

(a) All persons associated with a member who are to function as research analysts shall be registered with NASD. Before registration as a Research Analyst can become effective, an applicant shall:

(1) be registered pursuant to Rule 1032 as a General Securities Representative; and

(2) pass a Qualification Examination for Research Analysts as specified by the Board of Governors.

(b) For the purposes of this Rule 1050, “research analyst” shall mean an associated person who is primarily responsible for the preparation of the substance of a research report or whose name appears on a research report.

(c) Upon written request pursuant to the Rule 9600 Series, NASD will grant a waiver from the analytical portion of the Research Analyst Qualification Examination (Series 86) upon verification that the applicant has passed:

(1) Levels I and II of the Charter Financial Analyst (“CFA”) Examination; or

(2) if the applicant functions as a research analyst who prepares only technical research reports as defined in paragraph (e), Levels I and II of the Chartered Market Technician (“CMT”) Examination; and

(3) has either [(1)] functioned as a research analyst continuously since having passed the Level II CFA or CMT examination or [(2)] applied for registration as a research analyst within two years of having passed the Level II CFA or CMT examination.

(d) An applicant who has been granted [such] an exemption pursuant to paragraph (c) still must become registered as a General Securities Representative and then complete the regulatory portion of the Research Analyst Qualification Examination (Series 87) before that applicant can be registered as a Research Analyst.

(e) For the purposes of paragraph (c)(2), a “technical research report” shall mean a research report, as that term is defined in Rule 2711(a)(8), that is based solely on stock price movement and trading volume and not on the subject company's financial information, business prospects, contact with subject company's management, or the valuation of a subject company's securities.