

Notice to Members

JANUARY 2007

SUGGESTED ROUTING

Executive Representatives
Investment Banking
Legal & Compliance
Operations
Research
Senior Management

KEY TOPICS

Communications with the Public
Investment Banking
Research Analysts
Rule 2711

GUIDANCE

Research Analysts and Research Reports

Codification of Interpretations to Rule 2711;

Implementation Date: September 27, 2006

Executive Summary

NASD has filed for immediate effectiveness a proposed rule change to codify certain interpretations under Rule 2711 (Research Analysts and Research Reports). The interpretations include many that previously were set forth in two joint interpretive memoranda. The proposed rule changes also include additional interpretations regarding the definition of research report, the distribution of third-party research through soft-dollar arrangements, and the supervisory requirements with respect to the distribution of both member research and third-party research. This *Notice* also contains two additional interpretations of the Rule 2711 provisions that prohibit research analysts from participating in the solicitation of investment banking business and road show presentations.

Questions/Further Information

Questions or comments concerning this *Notice* may be directed to Philip Shaikun, Associate Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8451.

Background and Discussion

On September 27, 2006, NASD filed for immediate effectiveness a proposed rule change to amend Rule 2711 (Research Analysts and Research Reports) to codify certain interpretations of the rule. Most of the interpretations had previously been set forth in two joint interpretive memoranda from NASD and the New York Stock Exchange (NYSE) (NASD *Notices to Members 02-39* (July 2002) and *04-18* (March 2004)) and include those related to the definitions of "research report" and "public appearance" and disclosure requirements when distributing third-party research.

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The rule change codifies an interpretation not contained in the joint interpretive memoranda that communications that constitute statutory prospectuses filed as part of the registration statement are not considered “research reports,” even if they meet the definitional elements.

Additionally, the rule change does not incorporate language from previous interpretive guidance that exempted independent third-party research provided through a soft dollar arrangement from the third-party research rules. The new rule language treats such soft dollar research the same as any other third-party research. A member is not considered to have “distributed” such research where a member makes an independent third-party research report available to its customers either upon request or through a member-maintained Web site; however, this exception does not apply to non-member *affiliate* research that is either requested by a customer or made available on a member-maintained web site. NASD understands that generally member firms that distribute independent third-party research through a soft dollar arrangement do so only upon customer request. Thus, the new language does not represent any practical change from the previous interpretation. However, in the event that arrangements exist where a member “distributes” research pursuant to a soft dollar arrangement, then the same obligations would apply as with any other third-party research.

The rule change also clarifies the supervisory responsibilities when distributing third-party research. All third-party research distributed by a member must be reviewed by a designated principal (either a Series 24 or a Series 16 Supervisory Analyst) to determine that the third-party disclosures required by Rule 2711, if applicable, are complete and accurate. Consistent with Rule 2210(d)(1)(B), no member may distribute any third-party research that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading. A member’s obligation to review the content of a third-party research report in this regard extends to any untrue statement of a material fact or any false or misleading information that (1) should be known from reading the report or (2) is known based on information otherwise possessed by the member. A member is not required to validate the preparing firm’s methodologies, analysis or judgment or, where the preparing firm is an NASD or NYSE member, to verify the completeness and accuracy of that firm’s disclosures. For the purposes of this requirement, the term “distributed” has the same meaning as set forth above. Thus, the supervisory requirement does not apply to research reports prepared by an independent third party that the member makes available to its customers either upon request or through a member-maintained Web site.

There are separate requirements for those persons that approve a member's own research reports, depending on the scope of the review. Research reports prepared by a member still must be approved by an individual who has passed either (1) the Series 24 and the Series 87 or (2) the Series 16. A member may elect to have a Series 16 approve the content of research, and then a Series 24 principal who has also passed either the Series 87 or the Series 16 must supervise the conduct of both the Series 16 Supervisory Analyst and the research analyst. See Rule 1022(a)(5) and NASD *Notice to Members 04-81* (November 2004). Similar to the approach set forth above regarding the approval of third-party research, NASD will permit any registered principal or a Series 16 Supervisory Analyst to supervise for compliance with the disclosure provisions (only) of Rule 2711. All other content of the research report must continue to be approved by an individual who has passed either the Series 24 and the Series 87, or the Series 16. NASD reminds members that in accordance with Rule 3010 (Supervision), all personnel reviewing both member and third-party research must be qualified by virtue of experience and training to carry out such review.

The new rule language is set forth in Attachment A to this *Notice* and became effective upon filing on September 27, 2006.

Additional Interpretations Not Contained in the Rule Filing

NASD also is setting forth two additional interpretations regarding the provisions of Rule 2711 that prohibit research analyst participation in the solicitation of investment banking business and road shows presentations.

Solicitation of Investment Banking Business

Rule 2711(c)(4) provides that "[n]o research analyst may participate in efforts to solicit investment banking business. Accordingly, no research analyst may, among other things, participate in any "itches" for investment banking business to prospective investment banking clients or have other communications with companies for the purpose of soliciting investment banking business." Members have inquired whether this provision bans all research-related references in a pitch book or related presentation materials. NASD interprets the provision to prohibit in pitch materials any information about a member's research capacity in a manner that suggests, directly or indirectly, that the member might provide favorable research coverage. For example, NASD would consider the publication in a pitch book or related materials of an analyst's industry ranking to imply the potential outcome of future research because of the manner in which such rankings are compiled. On the other hand, a member would be permitted to include in the pitch materials the fact of coverage and the name of the research analyst because such information alone does not imply favorable coverage.¹

Road Show Participation

Rule 2711(c)(5) and (6) prohibit research analysts from participating in road shows related to investment banking services transactions and from engaging in any communications regarding investment banking services transactions with current or prospective customers or internal sales personnel in the presence of investment banking personnel or company management. Investment banking personnel also are prohibited from directing a research analyst to engage in sales or marketing efforts or to engage in any communication with a current or prospective customer related to investment banking transactions.

NASD interprets this provision to permit research analysts to listen to (in “listen-only” mode, not identified as being present), or view a live webcast of a road show or other widely attended presentation to investors or the sales force, so long as access is from a remote location (*i.e.*, not at the same address as investment banking, investors or the sales force). Further, if the road show or other widely attended presentation to investors or the sales force is conducted at the firm’s offices, research personnel may listen from the same address as investment banking but may not be in the same room as investment banking, investors or the sales force.

Endnotes

- 1 Members must consider whether the facts and circumstances of any solicitation or engagement would warrant disclosure under Section 17(b) of the Securities Act of 1933.

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ATTACHMENT A

New language is underlined; deletions are in brackets.

2711. Research Analysts and Research Reports

(a) Definitions

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

(1) “Equity security” has the same meaning as defined in Section 3(a)(11) of the Securities Exchange Act of 1934.

(2) No Change.

[(2)] (3) “Investment banking services” include, without limitation, acting as an underwriter or participating in a selling group in an offering for the issuer; acting as a financial adviser in a merger or acquisition; providing venture capital, equity lines of credit, private investment, public equity transactions (PIPEs) or similar investments; or serving as placement agent for the issuer.

[(3)] (4) “Member of a research analyst's household” means any individual whose principal residence is the same as the research analyst's principal residence. This term does not include an unrelated person who shares the same residence as a research analyst provided that the research analyst and unrelated person are financially independent of one another.

[(4)] (5) “Public appearance” means any participation in a conference call, seminar, forum (including an interactive electronic forum) or other public speaking activity before 15 or more persons or before one or more representatives of the media, 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. This term does not include a password protected Webcast, conference call or similar event with 15 or more existing customers, provided that all of the event participants previously received the most current research report or other documentation that contains the required applicable disclosures, and that the research analyst appearing at the event corrects and updates during the public appearance any disclosures in the research report that are inaccurate, misleading or no longer applicable.

[(5)] (6) No Change.

[(6)] (7) No Change.

[(7)] (8) No Change.

[(8)] (9) "Research Report" means [a] any written [or] (including 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. This term does not include:

(A) communications that are limited to the following:

(i) discussions of broad-based indices;

(ii) commentaries on economic, political or market conditions;

(iii) technical analyses concerning the demand and supply for a sector, index or industry based on trading volume and price;

(iv) statistical summaries of multiple companies' financial data, including listings of current ratings;

(v) recommendations regarding increasing or decreasing holdings in particular industries or sectors; or

(vi) notices of ratings or price target changes, provided that the member simultaneously directs the readers of the notice to the most recent research report on the subject company that includes all current applicable disclosures required by this rule and that such research report does not contain materially misleading disclosure, including disclosures that are outdated or no longer applicable;

(B) the following communications, even if they include an analysis of an individual equity security and information reasonably sufficient upon which to base an investment decision:

(i) any communication distributed to fewer than 15 persons;

(ii) periodic reports or other communications prepared for investment company shareholders or discretionary investment account clients that discuss individual securities in the context of a fund's or account's past performance or the basis for previously made discretionary investment decisions; or

(iii) internal communications that are not given to current or prospective customers; and

(C) communications that constitute statutory prospectuses that are filed as part of the registration statement.

[(9)] (10) No Change.

(b) through (g) No Change.

(h) Disclosure Requirements

(1) through (3) No Change.

(4) Meaning of Ratings

If a research report contains a rating, [A] the member must define in [its] the research report[s] 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) through (B) No Change.

(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) and must reflect the distribution of the most recent ratings issued by the member for all subject companies, unless the most recent rating was issued more than 12 months ago.

(D) The requirements of paragraph (h)(5) shall not apply to any research report that does not contain a rating.

(6) Price Chart

If a research report contains either a rating or a price target, and the [A] member [must present in any research report concerning an equity security on which the member] has assigned [any] a rating or price target to the subject company's securities for at least one year, the research report must include a line graph of the security's daily closing prices for the period that the member has assigned any rating or price target or for a three-year period, whichever is shorter. The line graph must:

(A) through (C) No Change.

(7) Price Targets

If a research report contains a price target, the [A] member must disclose in the research report[s] the valuation methods used to determine [a] the 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) through (10) No Change.

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

When a member distributes a research report covering six or more subject companies (a "compendium report"), for purposes of the disclosures required in paragraph (h), [such research]the compendium report may direct the reader in a clear manner as to where they may obtain applicable current disclosures [in written or electronic format]. Electronic compendium reports may include a hyperlink to the required disclosures. Paper-based compendium reports must provide either a toll-free number to call or a postal address to write for the required disclosures and may also include a web address of the member where the disclosures can be found.

(12) No Change.

(13) Third-Party Research Reports

(A) Subject to paragraph (h)(13)(B), if a member distributes or makes available any research report that is produced by another member, a non-member affiliate of the member or an independent third party, the member must accompany the research report with the current applicable disclosures, as they pertain to the member, that are required by paragraphs (h)(1)(B), (h)(1)(C), (h)(2)(A)(ii) and (h)(8) of this Rule.

(B) The requirements of paragraph (h)(13)(A) shall not apply to research reports prepared by an independent third party that the member makes available to its customers either upon request or through a member-maintained web site.

(C) A registered principal (or supervisory analyst approved pursuant to Rule 344 of the New York Stock Exchange) must approve by signature or initial any third-party research distributed by a member. All third-party research distributed by a member must be reviewed by the designated principal (or supervisory analyst approved pursuant to NYSE Rule 344) to determine that the applicable disclosures required by Rule 2711 are complete and accurate, and the content of the research report is consistent with all applicable standards regarding communications with the public.

(i) through (k) No Change.