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July 29, 2003

James A. Brigagliano
Assistant Director, Trading Practices
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: **SR-NASD-2002-154, Amendment No. 3** – Proposed Amendments to Rules Governing
Research Analyst Conflicts of Interest

Dear Mr. Brigagliano:

NASD hereby submits Amendment No. 3 to SR-NASD-2002-154, Proposed Amendments to Rules Governing Research Analyst Conflicts of Interest, which was originally filed with the Securities and Exchange Commission (“Commission”) on October 9, 2002 and first amended on December 4, 2002. The proposal as amended was published for comment in the Federal Register on January 7, 2003.¹ On May 20, 2003, NASD filed with the SEC Amendment No. 2 to the proposal, which implemented certain changes to comply with the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”). Amendment No. 2 was published for comment in the Federal Register on May 29, 2003.² The May 29, 2003 Federal Register notice also sought comment on whether the proposal should be amended in light of the April 28, 2003 settlement among the SEC, NASD, NYSE, state regulators, and a number of the nation’s largest investment banking firms (the “Global Settlement”).

We are amending the rule change proposal in response to comments received and pursuant to discussions with the Commission staff and the New York Stock Exchange (“NYSE”), which we understand has filed a similar amendment. NASD intends for its rule change proposal to operate substantially the same as comparable rules promulgated by NYSE. A discussion of our response to comments has been filed with the Commission separately. We have attached as Exhibit A hereto the entire proposed rule change with changes shown from current NASD rules. The amendments, which are marked to show changes from Amendment No. 2, are as follows:

¹ SEC Release No. 34-47110 (Dec. 31, 2002), 68 Fed. Reg. 826 (Jan. 7, 2003).

² SEC Release No. 34-47912 (May 22, 2003), 68 Fed. Reg. 32148 (May 29, 2003).

1. Proposed new Rule 1050 would create a new registration category for research analysts who are directly responsible for the preparation of research reports. Proposed amendments to Rule 1120 would impose both the regulatory element and the firm element of NASD's continuing education requirements on registered research analysts.

Commenters requested clarification as to which research analysts would be subject to registration. In response to these comments, NASD is revising proposed Rule 1050 to specify that only research analysts who are primarily responsible for the substance of research reports or whose names appear on research reports will be required to register with NASD. Accordingly, proposed Rule 1050 is revised as follows (new text is underlined; deletions are bracketed):

Rule 1050. Registration of Research Analysts

All persons associated with a member who are to function as research analysts [as that term is defined in Rule 2711]shall be registered with NASD. Before their registrations can become effective, they shall pass a Qualification Examination for Research Analysts as specified by the Board of Governors. For purposes of this Rule 1050, "research analyst" shall mean an associated person who is [directly] primarily responsible for the preparation of the substance of a research report[s] or whose name appears on a research report.

We are also clarifying that supervisors of research analysts are subject to the firm element of a registered person's continuing education requirements. Accordingly, we are revising proposed Rule 1120(b) as follows:

(b) Firm Element

(1) Persons Subject to the Firm Element

The requirements of this subparagraph shall apply to any person registered with the member who has direct contact with customers in the conduct of the member's securities sales, trading and investment banking activities, any person registered as a research analyst pursuant to Rule 1050, and to the immediate supervisors of such persons, [and to any person registered as a research analyst pursuant to Rule 1050](collectively, "covered registered persons"). "Customer" shall mean any natural person and any organization, other than another broker or dealer, executing securities transactions with or through or receiving investment banking services from a member.

(2) Standards for the Firm Element

(A) No change.

(B) Minimum Standards for Training Programs – Programs used to implement a member's training plan must be appropriate for the business of the

member and, at a minimum must cover the following matters concerning securities products, services, and strategies offered by the member:

(i) General investment features and associated risk factors;

(ii) Suitability and sales practice considerations;

(iii) Applicable regulatory requirements; and

(iv) With respect to registered research analysts and their immediate supervisors, training in ethics, professional responsibility and the requirements of Rule 2711.

(C) No change.

(3) through (4) No change.

2. As originally filed with the Commission, the proposal would have expanded the definition of “research analyst” in Rule 2711(a)(5) solely to extend the personal trading restrictions contained in Rule 2711(g) to include persons who have direct influence or control over research analysts or the contents of research reports. Commenters objected to this proposed change on the ground that it would unfairly burden supervisors of research analysts and discourage qualified persons from acting in supervisory capacities.

Accordingly, NASD is revising its proposed changes to the personal trading restrictions in several respects. First, NASD will not revise the definition of “research analyst” to include supervisory personnel. Instead, this term will remain the same as it is currently defined, except that the term “primarily” will replace “principally” to achieve consistency with the definition of “research analyst” in SEC Regulation AC – a non-substantive change. NASD notes that throughout the proposal, as amended here, it sometimes uses the term “research analyst” and sometimes uses the phrase “research analyst primarily responsible for the preparation of the substance of a research report.” The latter is a narrower phrase that refers only to the lead analyst that is required to certify a research report pursuant to Regulation AC; the former is a defined term that encompasses not only the lead analyst, but also those associated persons who report directly or indirectly to such analyst in connection with the preparation of the substance of a research report. Second, rather than applying the same trading restrictions to supervisory personnel that apply to research analysts, Rule 2711(g) will be amended to require a member’s legal or compliance personnel to pre-approve all transactions of persons who supervise research analysts to the extent that the transactions involve securities of subject companies covered by research analysts that they supervise.

In this regard, proposed Rule 2711(a)(5) is amended as follows (new text is underlined; deletions are bracketed):

(5) “Research analyst” means the associated person who is [~~principally~~] 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.” [Solely for purposes of paragraph (g), the term “research analyst” also includes such other persons as the director or research, supervisory analyst, or member of a committee who have direct influence or control with respect to (A) the preparation of research reports, or (B) establishing or changing a rating or price target of a subject company’s equity securities.]

In addition, a new Rule 2711(g)(6) is inserted as follows (new text is underlined):

(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.

3. Commenters also noted that the NYSE rules exempt from the personal trading restrictions managed accounts not controlled by the account owner, while the NASD rules do not exempt these accounts. In practice, NASD and NYSE both have interpreted the provision to exclude from the personal trading restrictions only so-called “blind trusts” of research analysts or their household members where the account owner is unaware of the account’s holdings or transactions. NASD is amending the definition of “research analyst account” (Rule 2711(a)(6)) to exclude expressly these blind trusts, as follows (new text is underlined):

(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 investment transactions.

4. NASD is amending the definition of “research report” in Rule 2711(a)(8) to make it more consistent with the definition of that term as it appears in Regulation AC. NASD also is amending the definition of “subject company” in Rule 2711(a)(9) to make it more consistent with the definition of “public appearance,” which includes not only recommendations, but also opinions concerning an equity security. Accordingly, Rules 2711(a)(8) and (9) are amended as follows (new text is underlined; deletions are bracketed):

(8) “Research report” means a written or electronic communication [which] that includes an analysis of equity securities of individual companies or industries, and [which] 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 [recommendation in] a public appearance.

5. NASD is amending Rule 2711(b)(1) to make clear that, in accordance with Sarbanes-Oxley, a member’s investment banking department not only is prohibited from supervising or controlling any research analyst, but also may not have any influence or control over the compensatory evaluation of a research analyst. Accordingly, Rule 2711(b)(1) is revised as follows (new text is underlined):

(1) No research analyst may be subject to the supervision or control of any employee of the member’s investment banking department, and no person engaged in investment banking activities may have any influence or control over the compensatory evaluation of a research analyst.

NASD also is amending proposed Rule 2711(d)(2) to clarify that the compensation restrictions of that provision apply only to those research analysts who are primarily responsible for the preparation of the substance of research reports – the same standard used with regard to the certification requirements under SEC Regulation AC. NASD also is amending that provision to clarify further that the compensation committee must review and approve such research analysts’ compensation, but is not required to determine initially that compensation. Accordingly, Rule 2711(d)(2) is amended as follows (new text is underlined; deletions are bracketed):

(2) [A research analyst’s] 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 member’s 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 [determining] reviewing and approving [the] such a research analyst’s compensation his or 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.

6. Proposed Rule 2711(c)(4) would prohibit a research analyst issuing such reports or making public appearances with respect to a subject company if the analyst participated in "pitch" meetings or other communications to obtain investment banking business prior to the time the company had entered into a letter of intent or other written agreement that designated the analyst's firm as an underwriter for an initial public offering. The proposal would create an exception for "due diligence" communications, where the sole purpose is to analyze the financial condition and business operations of the subject company.

Since Rule 2711(c) contains this new subject matter, its current heading – "Restrictions on Review of a Research Report by the Subject Company" – is no longer appropriate. Accordingly, the heading for paragraph (c) is revised as follows (new text is underlined; deletions are bracketed):

(c) Restrictions on [Review of a Research Report by] Communications with the Subject Company

With regard to new proposed Rule 2711(c)(4), several commenters found the language "in furtherance of" to be vague and similarly sought clarification of the scope of "due diligence" communications. NASD is therefore amending its proposal to prohibit outright an analyst from "participating in efforts to solicit investment banking business." The amendment tracks similar language contained in the terms of the Global Settlement. NASD believes this amendment is more straightforward and not only will promote regulatory consistency, but also will further the overriding goals of research objectivity and investor confidence by eliminating all participation by research analysts in solicitation efforts that could suggest a promise of favorable research in exchange for underwriting business. Since the same potential conflict exists with respect to solicitation of all investment banking business, the amendment is not limited to initial public offerings.

Accordingly, NASD is amending Rule 2711(c)(4) as follows (new text is underlined; deletions are bracketed):

(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 [publish or otherwise distribute a research report or make a public appearance concerning a subject company if the research analyst engaged in any communication with the subject company in furtherance of obtaining investment banking business prior to the time the subject company entered into a letter of intent or other written agreement with the member designating the member as an underwriter of an initial public offering by the subject company. This provision shall not apply to any due diligence communication between the research analyst and the subject company, the sole

purpose of which was to analyze the financial condition and business operations of the subject company].

7. Amendment No. 2 would revise proposed Rule 2711(f)(1) to extend the “quiet period” restrictions following a public offering of securities to public appearances as well as the publication or issuance of research reports. Commenters recommended that the exceptions to the quiet period provisions for significant news or events and for certain secondary offerings also apply to public appearances. NASD agrees with these comments and will revise the rule proposal in this regard. In addition, NASD is rewording the language extending these restrictions to public appearances to make it consistent with the definition of that term. NASD also is clarifying that the 25-day quiet period with respect to a member that has agreed to participate or is participating as an underwriter or dealer (other than as manager or co-manager) extends to public appearances.

Accordingly, NASD Rule 2711(f)(1) and (2) are revised as follows (new text is underlined; deletions are bracketed):

(1) No member may publish or otherwise distribute a research report and no research analyst may make a public appearance regarding a subject company [or recommend a subject company’s securities in a public appearance] 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 published or otherwise distributed 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.

8. Proposed Rule 2711(f)(4) would prohibit a member that has acted as a manager or co-manager of a securities offering from distributing a research report or making a public appearance concerning a subject company 15 days prior to and after the expiration, waiver or termination of a lock-up agreement that restricts the sale of securities held by the subject company or its shareholders after the completion of a securities offering.

Commenters requested that this blackout period not apply to the publication of research reports pursuant to SEC Rule 139 regarding a subject company with actively traded securities as defined in SEC Regulation M, or to public appearances regarding such companies. These commenters noted that, since the quiet period following secondary offerings does not apply to these types of companies, the quiet period surrounding waivers or expirations of a lock-up agreement also should not apply. NASD agrees with this comment and will revise proposed Rule 2711(f)(4) as follows (new text is underlined):

(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 that the legal and compliance department authorized 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.

9. Proposed Rule 2711(f)(5) would require members to provide notice and make available a final research report on a subject company before discontinuing research coverage of the company. The proposed rule also would specify that “notice of this withdrawal must be made in the same manner as when research coverage was first initiated by the member.”

In response to comments received on this provision, NASD is making several changes to proposed Rule 2711(f)(5). First, the rule provision will use only “terminate” rather than “discontinue” or “withdrawal” to describe a member’s termination of coverage. Second, the rule will be revised to require that the final report be made available using means of dissemination equivalent to those the member ordinarily uses to provide the customer with its research reports on the subject company. This standard is similar to the standard used in the Global Settlement provisions regarding termination of coverage. Third, the rule will be revised to make clear that the final report must be comparable in scope and detail to prior research reports, and must

include a final recommendation or rating, unless impractical. If it is impracticable to produce a final rating or recommendation, the report must disclose the rationale for terminating coverage.

Accordingly, proposed Rule 2711(f)(5) will be revised as follows (new text is underlined; deletions are bracketed):

(5) If a member intends to [discontinue] terminate its research coverage of a subject company, notice of this withdrawal must be made, [in the same manner as when research coverage was first initiated by the member] 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.

10. Current Rule 2711(g)(4) creates an exception to the personal trading restrictions of Rules 2711(g)(2) and (3) for certain transactions based upon unanticipated significant changes in the personal financial circumstances of the beneficial owner of a research analyst account. While we are not changing the substance of this provision, we are making certain technical changes to this provision to make it clearer. Accordingly, Rule 2711(g)(4) is revised as follows (new text is underlined):

(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) No change.

(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) No change.

11. Proposed Rule 2711(h)(2) would substantially revise the current disclosure requirements regarding the receipt of compensation by the member and its affiliates from the subject company. A number of commenters expressed serious reservations with proposed provisions that would require disclosure of *any* compensation received by a member and its affiliates from the subject

company. These commenters argued that this disclosure requirement would be extremely burdensome, complex and not in the public interest, inconsistent with Sarbanes-Oxley's requirements that the mandated rules be "reasonably designed to address conflicts of interest," and provide little useful information to investors.

NASD is sensitive to these concerns and does not wish to adopt new rules whose burdens outweigh their benefits. On the other hand, NASD must be true to the statutory language and purposes of Sarbanes-Oxley. In relevant part, Section 15D of the Securities Exchange Act of 1934 (as adopted pursuant to Sarbanes-Oxley) requires "rules reasonably designed to require [disclosure of] ... conflicts of interest that are known or should have been known by the securities analyst or broker or dealer ..." Section 15D(b)(2) includes among the those conflicts of interest "whether any compensation has been received by the registered broker or dealer, or any affiliate thereof, including the securities analyst . . . as is appropriate in the public interest and consistent with the protection of investors."

NASD believes the cited Sarbanes-Oxley language requires disclosure of certain compensation received by a member or its affiliates, in addition to investment banking services compensation, that could influence the content of a research report or public appearance. However, NASD does not believe such concerns arise where the receipt of compensation by an affiliate is not known or should not be known by the research analyst or employees of the member who are in a position to influence the content of research reports or public appearances.

Based on these comments, NASD is significantly revising proposed Rule 2711(h)(2) to incorporate these concepts in a way that it believes satisfies the mandates of Sarbanes-Oxley and minimizes the burden on members. Accordingly, NASD is revising its proposed Rule 2711(h)(2) as follows (new text is underlined; deletions are bracketed):

(2) Receipt of Compensation

(A) A member must disclose in research reports:

(i) if the research analyst [principally responsible for the preparation of the research report] received any compensation:

a. [that is] based upon (among other factors) the member's investment banking revenues[.]; or

b. from the subject company in the past 12 months.

(ii) [(B) A member must disclose in research reports] if the member or any affiliate:

[(i)a.] managed or co-managed a public offering of securities for the subject company in the past 12 months; [or]

[(ii)]b. received compensation for investment banking services from the subject company in the past 12 months; or

[(iii)]c. expects to receive or intends to seek compensation for investment banking services from the subject company in the next 3 months.

(iii) [(C) A member must disclose in research reports] 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 report knows:

a. the member [or any affiliate] 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 must also 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 research analysts and employees of the member with the ability to influence and 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 must disclose the types of services provided to the subject company, if known by the research analyst.

[(D) A member must disclose in research reports and a research analyst must disclose in public appearances if the research analyst received any compensation from the subject company in the past 12 months.]

[(E) A research analyst must disclose in public appearances (if the analyst knows or has reason to know) if the member or any affiliate received any compensation from the subject company in the past 12 months.]

[(F) A member must disclose in research reports and a research analyst must disclose in public appearances (if the analyst knows or has reason to know) if the subject company currently is a client of the member or was a client of the member during the 12-month period preceding the date of distribution of the research report or date of the public appearance. In such cases, the member or research analyst (if the analyst knows or has reason to know) also must disclose the types of services provided to the subject company. For purposes of this paragraph (h)(2)(E), the types of services provided to the subject company may be described as investment banking services, non-investment banking securities-related services, and non-securities services.]

~~[(G)](C)~~ A member or research analyst will not be required to make a disclosure required by paragraphs ~~[(h)(2)(B)(ii), (h)(2)(B)(iii), or (h)(2)(F)]~~ (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.

12. NASD is amending its proposal to create new Rule 2711(h)(12), which would require members to maintain records of any public appearances sufficient to demonstrate compliance with the public appearance provisions of the Rule. This amendment essentially codifies the guidance set forth in the Joint Memorandum and provides as follows (new text is underlined):

(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.

13. NASD Rule 2711(i) requires a senior officer of each member to attest annually that the member has adopted and implemented procedures reasonably designed to ensure compliance with the analyst conflict rules. Proposed Rule 2711(d)(2) requires that the attestation include a certification that the compensation of certain research analysts was reviewed and approved by a committee as described in that proposed provision.

NASD is amending Rule 2711(i) to reference specifically that requirement in Rule 2711(d)(2). NASD also is amending the rule to change the date by which its attestation must be filed to April 1 – the same deadline currently employed by NYSE. In so doing, the amendment achieves the uniformity requested by commenters without invoking a member’s designated examining authority; rather, a firm sends an attestation to the SRO of which it is a member. Dual members need only send a copy of the attestation to each SRO at the same time. Members will be required to submit their next attestation no later than April 1, 2004.

The amendment is as follows (new text is underlined; deletions are bracketed):

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 [the Association] NASD by April 1 of each year that it has adopted and implemented those procedures.

14. NASD is clarifying that for the purposes of this provision, underwritings involving municipal securities are not included in the definition of “investment banking services transactions.” Accordingly, NASD is amending proposed Rule 2711(k) as follows (new text is underlined):

(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 revenues from those transactions. For purposes of 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.

15. Effective Dates

NASD has changed its recommended implementation dates to provide additional time to meet the amended compensation disclosure provisions. Accordingly, NASD believes that the proposed changes to Rule 2711 should take effect the below number of days following the SEC’s approval of the proposed rule change:

- ?? Qualification, examination, registration and continuing education requirements for research analysts (proposed new Rule 1050 and proposed amendments to Rule 1120): 180 days or such longer period as determined by NASD.
- ?? New compensation and client disclosure provisions (proposed Rule 2711(h)(2)): 180 days, plus up to an additional 90 days as deemed appropriate on a case-by-case basis.
- ?? Rule 2711(h)(2)(C) – Exemption from Disclosure Requirements:
 - As applied to disclosures under Rules 2711(h)(2)(A)(ii)(a) and (b): Immediate upon SEC approval of the rule change
 - As applied to disclosures under Rule 2711(h)(2)(A)(iii)(b), (h)(2)(B)(i) and (iii): 180 days
- ?? Research analyst compensation review procedures (proposed Rule 2711(d)(2)): 90 days.
- ?? Prohibition against retaliation against research analysts (proposed Rule 2711(j)): immediately.
- ?? Exceptions for small firms (proposed Rule 2711(k)): immediately.
- ?? All other proposed rule changes: 60 days.

If you have any questions, please contact Thomas M. Selman, at (240) 386-4533, Joseph P. Savage, at (240) 386-4534, or me at (202) 728-8451. The fax number of the Office of General Counsel is (202) 728-8264.

Sincerely,

Philip A. Shaikun
Associate General Counsel

cc: Marc Menchel
Patrice M. Gliniecki
Thomas M. Selman
Joseph P. Savage

EXHIBIT A

**Changes From Current NASD Rules Resulting From
SR-NASD-2002-154 and Amendment Nos. 1-3 Thereto**

Rule 1050. Registration of Research Analysts

All persons associated with a member who are to function as research analysts shall be registered with NASD. Before their registrations can become effective, they shall pass a Qualification Examination for Research Analysts as specified by the Board of Governors. 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.

* * * * *

Rule 1120. Continuing Education Requirements

This Rule prescribes requirements regarding the continuing education of certain registered persons subsequent to their initial qualification and registration with the Association. The requirements shall consist of a Regulatory Element and a Firm Element as set forth below.

(a) Regulatory Element

(1) through (4) No change.

(5) Definition of Registered Person

For purposes of this Rule, the term “registered person” means any person registered with [the Association]NASD as a representative, principal, [or]

assistant representative or research analyst pursuant to Rule 1020, 1030, 1040, 1050 and 1110 Series.

(6) No change.

(b) Firm Element

(1) Persons Subject to the Firm Element

The requirements of this subparagraph shall apply to any person registered with the member who has direct contact with customers in the conduct of the member's securities sales, trading and investment banking activities, any person registered as a research analyst pursuant to Rule 1050, and to the immediate supervisors of such persons, (collectively, "covered registered persons").

"Customer" shall mean any natural person and any organization, other than another broker or dealer, executing securities transactions with or through or receiving investment banking services from a member.

(2) Standards for the Firm Element

(A) No change.

(B) Minimum Standards for Training Programs – Programs used to implement a member's training plan must be appropriate for the business of the member and, at a minimum must cover the following matters concerning securities products, services, and strategies offered by the member:

- (i) General investment features and associated risk factors;
- (ii) Suitability and sales practice considerations; [and]
- (iii) Applicable regulatory requirements[.]; and

(iv) With respect to registered research analysts and their immediate supervisors, training in ethics, professional responsibility and the requirements of Rule 2711.

(C) No change.

(3) through (4) No change.

* * * * *

Rule 2711. Research Analysts and Research Reports

(a) Definitions

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

(1) through (3) No change.

(4) “Public appearance” means any participation in a seminar, forum (including an interactive electronic forum), radio, [or] 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 [principally]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 investment transactions.

(7) No change.

(8) “Research report” means a written or electronic communication [which]that includes an analysis of equity securities or individual companies or industries, and [which]that provides information reasonably sufficient upon which to base an investment decision [and includes a recommendation].

(9) “Subject company” means the company whose equity securities are the subject of a research report or [recommendation in] a public appearance.

(b) Restrictions on [Investment Banking Department]Relationships 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) [Investment banking]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 [to review the research report for]identify any potential conflict of interest, provided that:

(A) any written communication between [investment banking]non-research personnel and research department personnel concerning [such]the content of a research report must be made either through [an] authorized legal or compliance [official]personnel of the member or in a transmission copied to such [an official]personnel; and

(B) any oral communication between [investment banking]non-research personnel and research department personnel concerning [such]the content of a research report must be documented and made either through [an] authorized legal or compliance [official]personnel acting as intermediary or in a conversation conducted in the presence of such [an official]personnel.

(c) Restrictions on [Review of a Research Report by]Communications with the Subject Company

(1) No change.

(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) No change.

(B) a complete draft of the research report is provided to [the] legal or compliance [department]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, [the] legal or compliance [department] 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) No change.

(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) [Prohibition of Certain Forms of] 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 member’s 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 or 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) No change.

(f) [Imposition of Quiet Periods]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:

[(1)](A) an initial public offering, for 40 calendar days following the date of the offering; or

[(2)](B) a secondary offering, for 10 calendar days following the date of the offering; provided that:

[(A)](i) paragraphs (f)(1)(A) and (f)[(2)](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 [the] legal [and]or compliance [department]personnel authorize[s] publication of that research report before it is issued or authorize the public appearance before it is made; and

[(B)](ii) paragraph (f)(2)(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 change.

(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) No change.

(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 member's] legal or compliance [department]personnel pre-approve[s] the research report and any change in the rating or price target.

(3) No change.

(4) [A member's]Legal or compliance [department]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) [the] legal or compliance [department]personnel authorize[s] 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) No change.

(5) No change.

(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) No change.

(2) Receipt of Compensation

(A) A member must disclose in research reports [if]:

(i) if the research analyst [principally responsible for the preparation of the report] received any compensation:

a. [that is]based upon (among other factors) the member's investment banking services revenues; [and]or

b. from the subject company in the past 12 months.

(ii) if the member or any [its]affiliate[s]:

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, [that] 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 [or its affiliates]. 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) through (11) No change.

(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 [the Association]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 unfavorable 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 unfavorable research report or the making of such an unfavorable 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.