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James A. Brigagliano, Esq.  
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Division of Market Regulation  
Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, DC 20549

Re: **SR-NASD-2002-21** (Proposed Rule Change Relating to Research Analyst  
Conflicts of Interest) – Response to Comments

Dear Mr. Brigagliano:

NASD Regulation, Inc. (“NASD Regulation”) hereby submits its response to comments received by the Securities and Exchange Commission (“SEC” or “Commission”) on SR-NASD-2002-21, the Proposed Rule Change Relating to Research Analyst Conflicts of Interest (the “NASD Proposal”), which was published for comment in the Federal Register on March 14, 2002.<sup>1</sup> The NASD Proposal and a parallel set of rule changes proposed by the New York Stock Exchange<sup>2</sup> (the “NYSE Proposal;” collectively with the NASD Proposal, the “Proposals”) would limit contact and supervision between a broker/dealer’s investment banking department and its research department, and limit contact between a firm’s research department and a company that is the subject of a research report (“Subject Company”). The Proposals also would impose disclosure requirements on research reports and research analyst public appearances that include a securities recommendation. Further, the Proposals would require member firms to adopt written supervisory procedures to ensure compliance with these new requirements.

On May 1, 2002 NASD Regulation filed Amendment No. 2 to its rule filing with the Commission. This amendment is intended to further align the NASD Proposal with the NYSE Proposal by making certain conforming changes, and to revise certain provisions of the NASD Proposal in response to the comments received. These changes are addressed throughout this letter.

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<sup>1</sup> SEC Release No. 34-45526 (Mar. 8, 2002), 67 Fed. Reg. 11526 (Mar. 14, 2002).

<sup>2</sup> See SR-NYSE-2002-09.

## **Relationship Between Investment Banking and Research Departments**

The provisions regulating the contact between a member firm's investment banking and research departments are intended to reinforce the integrity of and confidence in the capital markets. These provisions impose new requirements on member firms that are designed to foster an environment where research analysts, and the research reports they write, remain independent of the influences of investment banking departments and Subject Companies. In this regard, proposed Rule 2711(b) would prohibit research analysts from being under the supervision or control of a firm's investment banking department and would require legal and compliance personnel to act as intermediaries between research and investment banking with regard to the contents of research reports. Proposed Rule 2711(c) would limit the extent to which Subject Companies could review research reports prior to distribution, and would require legal or compliance personnel to receive copies of the portions of reports that are submitted to Subject Companies and approve changes to ratings or price targets that occur after Subject Company review.

While industry commenters overwhelmingly support the goals of these provisions, they expressed concern that these provisions would turn legal and compliance personnel into supervisors of research analysts, and that the "gatekeeper" requirements may burden member firms. In particular, some commenters expressed the concern that the "gatekeeper" provisions would impair the ability of small firms to operate both research and investment banking departments.

NASD Regulation believes that the legal or compliance personnel's role is necessary to achieve these goals, and will serve two important purposes. First, the proposal would bolster the monitoring of potential conflicts of interest between a firm's research department and its investment banking department. Second, the proposal would reduce the possibility of any undue influence or pressure by investment banking and/or Subject Companies on the integrity and objectivity of a research analyst's analysis. The former obligation is already codified in both self-regulatory organization ("SRO") and SEC Rules; the latter furthers the purpose of this vital regulatory initiative.

NASD Regulation considered different possible exemptions for small firms, such as an exemption for firms with de minimis investment banking revenues as a percentage of total revenues or a de minimis number of employees. However, we believe that some smaller firms may present similar conflict of interests as large firms. Ultimately, we concluded that we could not resolve this issue without public comment on any standard that we developed. NASD Regulation intends to review this issue again in the future to determine what accommodation may be made consistent with investor protection.

## **Research Analyst and Member Compensation Disclosures**

Proposed Rule 2711(h)(2)(A)(ii) would require a member firm to disclose in a research report if it or its affiliates have received compensation from the Subject Company in the preceding twelve months, or whether it reasonably expects to receive such compensation in the three months following issuance of the research report. Proposed Rule 2711(h)(2)(B) further would require a research analyst to disclose in public appearances if the analyst knows, or has reason to know, that the Subject Company is a client of the member or its affiliates.

The comment letters raised three primary concerns about the compensation disclosure provisions. First, they contended that the requirement to disclose anticipated compensation could tip analysts and the market about non-public transactions. Second, they asserted that the requirement to disclose all forms of compensation from both the member and its affiliates is too broad and would provide little useful information to investors. Finally, the letters expressed concern that the cost to track all compensation received from Subject Companies would be overly burdensome, particularly for large, diversified members with many affiliates.

We agree with the commenters who believe that disclosure of all forms of compensation is too broad and should therefore be limited to compensation that the member or its affiliates received, or expected to receive, for investment banking services provided to the Subject Company. While we recognize the risk that disclosure of non-public transactions may tip the market, based on discussions with the Commission staff, we believe that the definition of “investment banking services” is sufficiently broad not to tip the market as to specific transactions. Limiting reporting of compensation to investment banking services should also significantly reduce the costs associated with tracking the relevant information.

Therefore, in response to these comments, we have amended proposed Rule 2711(h)(2)(A)(ii) to require disclosure if the member or its affiliates (1) managed or co-managed a public offering of securities for the Subject Company in the past 12 months; (2) received compensation for investment banking services from the Subject Company in the past 12 months; or (3) expects to receive or intends to seek compensation for investment banking services from the Subject Company in the next 3 months.

We also received comments on proposed Rule 2711(d), which would prohibit payment of compensation to a research analyst based upon a specific investment banking services transaction. Some commenters felt that the prohibition was inappropriate since analysts often are key to obtaining business for the firm on a specific investment banking transaction and therefore should be able to share directly in the revenue derived from that transaction. Other commenters found the prohibition too narrow and suggested that it be expanded to proscribe the receipt of any compensation by research analysts derived from investment banking activities.

NASD Regulation believes that the proposed restrictions on analyst compensation are appropriate. By prohibiting compensation from specific investment banking transactions, the NASD Proposal would significantly curtail a potentially major influence on a research analyst's objectivity. At the same time, this provision would not deprive a research analyst from sharing generally in the overall success of the firm, some of which may result from investment banking transactions for Subject Companies. Importantly, the NASD Proposal would require disclosure in research reports if the research analyst has been compensated based in part upon the member's investment banking revenues, so the investor could consider that fact in evaluating the objectivity of a research report.

### **Quiet Periods**

Commenters suggested three reasons why proposed Rule 2711(f), which imposes quiet periods of 40 days for initial public offerings ("IPOs") and 10 days for secondary offerings, should not be adopted. First, commenters noted that the proposed quiet periods exceed those provided for under the federal securities laws. Second, commenters argued that they would hurt market efficiency by limiting information to investors. Third, commenters stated that the quiet periods create a competitive disadvantage between managers and co-managers who are subject to the rules and other offering participants who are not subject to the same requirements.

While the proposed rules are not intended to prevent a member firm from issuing a positive research report on the company for which it acted as a manager of its offering, lengthening the quiet periods for an IPO would permit market forces to determine the price of the security in the after-market unaffected by a research report from entities with direct vested interests. The quiet period would assist in the public perception of an unbiased, objective marketplace. In addition, an extended quiet period would reduce a managing underwriter's incentive to reward a Subject Company for its securities underwriting business by publishing favorable research right after the completion of the distribution. While the rules would prohibit the managers and co-managers from publishing research reports during this period, other broker/dealers would be able to initiate and maintain research coverage on the Subject Company, which we believe would better serve the investing public because of its potentially greater objectivity.

Further, the NASD Proposal would permit exceptions to these prohibitions for significant news or events concerning the issuer. In addition, the NASD Proposal does not completely prohibit communications during the quiet period. For example, a research analyst is not prohibited from speaking to investors about the Subject Companies or from making public appearances, provided that the research analyst makes the disclosures required by the NASD Proposal.

Moreover, in response to the comments noted above, NASD Regulation is amending proposed Rule 2711(f)(2) to provide for an exception to the secondary offering quiet period. This exception permits the issuance of research reports in accordance with Rule 139 under the Securities Act of 1933 as to those issuers whose securities are

actively traded, as defined in Securities Exchange Act Rule 101(c)(1) of Regulation M. The proposed amendment would support market efficiency by permitting the dissemination of research reports for certain actively traded securities.

### **Personal Trading Restrictions**

Proposed Rule 2711(g), among other things, would prohibit research analysts and members of their households from purchasing or receiving pre-IPO shares of companies in the industries that the research analysts cover, and trading in recommended securities 30 days prior and 5 days after issuance of research report or a change in a rating or price target. Commenters had a number of questions and recommendations concerning these personal trading restrictions. Some commenters argued that research analysts should not be subject to any personal trading restrictions as long as they disclose their investments.

We believe that disclosure alone is not sufficient to mitigate the conflicts of interest that can arise when a research analyst invests in securities of companies that the analyst covers, particularly with respect to purchases or receipt of pre-IPO shares. Accordingly, it is appropriate to retain the personal trading restrictions in addition to requiring research analysts to disclose any financial interest they or a household member may have in a Subject Company.

A number of commenters questioned whether the term “household member” would include roommates and other unrelated persons who occupy the same residence as a research analyst. These commenters argued that the term “household member” should be limited to family members and others who are financially dependent on the research analyst. NASD Regulation agrees that further interpretation is necessary and will address the questions regarding the scope of the term “household member” through interpretation of this definition.

### **Disclosure of Member Firm Ownership of Securities**

Proposed Rule 2711(h)(1)(B) would require disclosure if, as of 5 business days before the publication of a research report or a public appearance, the member or its affiliates beneficially own 1% or more of any class of common equity securities of the Subject Company. The purpose of this disclosure is to provide investors with information to better evaluate the nature and extent of the member’s financial interest in the Subject Company.

Commenters suggest that a 5-day rolling period is impractical and burdensome given the amount of information that member firms would have to gather from their different departments and affiliates. Some commenters believe that their concerns would be mitigated if they were permitted to track the 1% disclosure requirement threshold on a quarterly basis, similar to the timing requirements used for disclosure of proprietary positions under the Securities Exchange Act of 1934.

NASD Regulation agrees that a less burdensome approach can be adopted without compromising the intent of these provisions. Accordingly, proposed Rule 2711(h)(1)(B) is being amended to require disclosure on a month-end rather than a 5-day rolling basis. The revised rule provision would allow member firms an additional 10 calendar days after the month-end to make this calculation.

### **Definition of Research Report**

In response to comments concerning the scope of what constitutes a “research report” in the original rule filing, proposed Rule 2711(a)(8) is being amended to provide a uniform definition of “research report” under both Proposals. “Research report” would now be defined as “a written or electronic communication which includes an analysis of equity securities of individual companies or industries, and which provides information reasonably sufficient upon which to base an investment decision and includes a recommendation.”

### **Compendium Issue**

The Proposals would require members to disclose in research reports, among other things, the percentage of all recommended securities in “buy, “sell”, or “hold” categories, the percentage of Subject Companies in each category that are investment banking services clients of the firm, and a chart of the Subject Company’s stock price performance plotted with references to assignment and/or change in ratings and price targets.

Commenters have suggested that it would be technically unfeasible and practically burdensome to provide the required disclosures where a research report discusses multiple subject companies. Specifically, commenters noted that including a price chart for each security discussed in a research report, where multiple securities are discussed, could add considerable length to such communications. Commenters noted that technological limitations would make it impossible to transmit the required disclosures for each Subject Company for certain devices.

In response to these comments, proposed Rule 2711(h) is being amended to provide an exception to the required disclosures for research reports covering 6 or more Subject Companies, provided such research reports clearly and prominently refer the reader to where the required disclosures can be obtained.

Further, NASD Regulation would, through interpretations, address practical issues raised by commenters in a manner consistent with the purposes of the Rule. In this regard, we would, among other things, examine various communications such as abstracts, updates, weekly and monthly summaries, industry/market sector reports, portfolio strategy pieces, quantitative research and technical analysis, and general market

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commentary and trading strategies, to determine whether they are “research reports” for purposes of the proposed rule requirements.

### **Non-Member Research Reports**

Many commenters inquired as to whether the Proposals’ disclosure requirements would apply to research reports that are distributed by members to their customers, but have been prepared by both non-members affiliated with and not affiliated with a member, such as investment advisers or foreign broker/dealers. We recognize that the use of third-party non-member research reports raises unique and complex regulatory issues which will vary depending on the type of report used and the entity that created the report. We intend to address these issues more thoroughly at a later date.

Please feel free to contact Thomas M. Selman, at (240) 386-4533, Joseph P. Savage, at (240) 386-4534, or Philip A. Shaikun, at (202) 728-8451, should you have any questions concerning the above.

Sincerely,

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