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May 20, 2003

Katherine A. England  
Assistant Director  
Division of Market Regulation  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-1001

**Re: File No. SR-NASD-2002-154 – Amendment No. 2**

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed please find the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Philip Shaikun, Office of General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8451; e-mail philip.shaikun@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Barbara Z. Sweeney  
Senior Vice President  
and Corporate Secretary

Enclosures

File No. SR-NASD-2002-154  
Consists of 59 Pages  
May 20, 2003  
Amendment No. 2

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C.

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Form 19b-4

Proposed Rule Change

by

**NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.**

Pursuant to Rule 19b-4 under the  
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”), the National Association of Securities Dealers, Inc. (“NASD”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) Amendment No. 2 (“the Amendment”) to SR-NASD-2002-154,<sup>1</sup> a proposed rule change to strengthen rules that govern analyst conflicts of interest by amending NASD Rules 1120 and 2711 and creating a new NASD Rule 1050. The Amendment to the proposed rule change would implement provisions of the Sarbanes-Oxley Act of 2002<sup>2</sup> (“Sarbanes-Oxley”) related to analyst conflicts of interest, create an exemption from some provisions of Rule 2711 for certain smaller firms, and make certain other changes to the current rule. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

\* \* \* \* \*

**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 responsible for the preparation of research reports.

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<sup>1</sup> SR-NASD-2002-154 was filed with the SEC on Oct. 25, 2002.

<sup>2</sup> Pub. L. No. 107-204, 116 Stat. 745 (2002).

## **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, 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; [and]

(iii) Applicable regulatory requirements[.]; and

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

(3) through (4) No change.

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**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, 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 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.

(6) through (7) No change.

(8) “Research report” means 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].

(9) No change.

**(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.

(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 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 issue 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.

**(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) A research analyst's compensation 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 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 the research analyst's compensation his or her contributions to the member's investment banking

business. The committee must document the basis upon which each research analyst's compensation was established. The annual attestation required by Rule 2711(i) must certify that the committee reviewed and approved each 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 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:

[(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 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] published or otherwise distributed; 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).

(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 regarding that issuer for 25 calendar days following 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 that legal or compliance personnel authorize publication of that research report before it is issued.

(5) If a member intends to discontinue 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 and must include the member's final recommendation or rating.

**(g) Restrictions on Personal Trading by Research Analysts**

(1) No change.

(2) (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) through (C) No change.

(5) No change.

**(h) Disclosure Requirements**

(1) No change.

**(2) Receipt of Compensation**

(A) A member must disclose in research reports if [:(i)] the research analyst principally responsible for preparation of the report received compensation that is based upon (among other factors) the member's investment banking revenues<sub>2</sub>[; and]

(B)[(ii) the member or its affiliates:] 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;

(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.

(C) A member must disclose in research reports if the member or any affiliate received any compensation other than for investment banking services from the subject company in the past 12 months.

(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)(F), 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) 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) to the extent such disclosure would reveal material non-public information regarding specific potential future investment banking services transactions of the subject company.

[(B) A research analyst must 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.]

(3) through (11) No change.

(i) No change.

**(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) Exemption 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 debt and equity 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.

\* \* \* \* \*

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The Board of Directors of NASD Regulation, Inc. approved the proposed rule change at its meeting on September 25, 2002, and authorized the filing of the rule change with the SEC. Counsel for The Nasdaq Stock Market and NASD Dispute Resolution have been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by NASD to its Subsidiaries. The NASD Board of Governors approved the proposed rule change at its meeting on September 26, 2002. No other action by the NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt amendments to NASD Rules without recourse to the membership for approval.

NASD will announce the effective date of the proposed rule change in a Notice to Members to be published following Commission approval. The effective date will be no less than 30 days following publication of the Notice to Members announcing Commission approval, except for the small firm exemption, which shall be effective upon Commission approval.

(b) Questions regarding this rule filing may be directed to Philip Shaikun, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight, NASD at (202) 728-8451.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

On October 25, 2002, NASD filed with the SEC SR-NASD-2002-154, a proposed rule change to further improve the quality and objectivity of research and provide investors with better information to make their investment decisions. On December 18, 2002, NASD submitted Amendment No. 1<sup>3</sup> to the proposed rule change. Generally, the proposed rule change would effectuate the following: it would further separate analyst compensation from investment banking influence; prohibit analysts from issuing “booster shot” research reports; extend to public appearances quiet periods on research issued by underwriting managers and co-managers; prohibit analysts from issuing research where they participated in solicitation of the issuer to be an underwriter for the issuer’s initial public offering; require members to publish a final research report when they terminate coverage of a subject company; change the definitions of research analyst and research report; impose registration, qualification and continuing education requirements on research analysts; and certain other changes.

The Amendment implements provisions of Sarbanes-Oxley regarding securities analysts. Sarbanes-Oxley, which amends Section 501 of the Securities Exchange Act of 1934<sup>4</sup> (“the Act”), requires either the SEC or a registered securities association to enact by July 30, 2003 rules reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances. Sarbanes-

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<sup>3</sup> Letter from Philip Shaikun, Assistant General Counsel, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission (December 18, 2002).

<sup>4</sup> 15 U.S.C. § 78a.

Oxley further sets forth certain specific rules that must be promulgated. The Amendment would implement those specific rules that are not already contained in current Rule 2711 or the pending rule change proposal, SR-NASD-2002-154.

The Amendment also would create an exemption from certain provisions of Rule 2711 for smaller firms that engage in limited underwriting activity. Finally, the Amendment would make certain other changes to clarify language in current or proposed rules or conform language to that used in Sarbanes-Oxley. The proposed changes are explained in more detail below.

*Restrictions on Relationships With Research Department*

Section 15D(a)(1)(A)<sup>5</sup> of the Act restricts prepublication clearance or approval of research reports by persons not directly responsible for investment research, other than legal or compliance staff. Rule 2711(b) already bans review and approval by investment banking personnel. The Amendment would extend the prohibition to other non-research personnel and also require that communications about the content of a research report between all non-research personnel and the research department be intermediated by legal or compliance staff.

*Quiet Periods*

Section 15D(a)(2)<sup>6</sup> of the Act requires establishment of periods during which brokers or dealers who have participated or are to participate in a public securities offering as underwriters *or dealers* may not publish or otherwise distribute research reports related to the issuer of the offering. Rule 2711(f) currently imposes such quiet periods – for 40 calendar

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<sup>5</sup> 15 U.S.C. § 78o-6(a)(1)(A).

<sup>6</sup> 15 U.S.C. § 78o-6(a)(2).

days following an initial public offering and 10 calendar days following a secondary offering – on underwriting managers and co-managers, but not on other members of the underwriting syndicate or selling group. To comply with Sarbanes-Oxley, the Amendment would establish a 25-day period after the “date of the offering” during which an underwriter or dealer other than a manager or co-manager would be prohibited from publishing or distributing research on the issuing company’s securities. This 25-day prohibition effectively codifies a *de facto* quiet period that exists because of the prospectus delivery requirements under Rule 174 of the Securities Act of 1933<sup>7</sup> (“Securities Act”). In general, brokers or dealers refrain from issuing research on exchange-listed or National Market System securities for 25 days after a registration statement becomes effective or bona fide public trading begins to avoid the risk that such communications may be deemed prospectuses that do not meet the requirements of Section 10 of the Securities Act.<sup>8</sup>

The Amendment also would define “date of the offering” for all quiet period provisions to mean the later of the effective date of the registration statement or the first date on which the security was bona fide offered to public.

*Prohibition of Retaliation Against Research Analysts*

Section 15D(a)(1)(C)<sup>9</sup> of the Act prohibits a broker or dealer engaged in investment banking activities from directly or indirectly retaliating, or threatening to retaliate, against a research analyst who publishes a research report that may adversely affect a member’s present

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<sup>7</sup> 17 CFR 230.174.

<sup>8</sup> 15 U.S.C. § 77j.

<sup>9</sup> 15 U.S.C. § 78o-6(a)(1)(C).

or prospective investment banking relationship. The Amendment creates new Rule 2711(j) to implement this directive and extends the prohibition to public appearances. The proposed rule incorporates language in Sarbanes-Oxley that clarifies that the prohibition does not limit a member's authority to discipline a research analyst, in accordance with the member's policies and procedures, for any cause other than writing a research report or making a public appearance that is unfavorable to a current or potential investment banking relationship. NASD has further clarified in the proposal that the anti-retaliation provision would not preclude termination, in accordance with firm policies and procedures, for causes unrelated to issuing or distributing such adverse research or for making an unfavorable public appearances regarding a current or potential investment banking relationship.

*Receipt of Compensation and Disclosure of Client Relationships*

Section 15D(b)(2)<sup>10</sup> of the Act requires disclosure by a broker or dealer in research reports, and by a research analyst in public appearances, if any compensation has been received by the broker or dealer, or any affiliate thereof (including the analyst), from the issuer that is the subject of the report or public appearance. Section 15D(b)(3)<sup>11</sup> of the Act further requires disclosure if the subject issuer is, or has been during the previous year, a client of the broker dealer, and if so, the types of services provided to the issuer. Section 15D(b)(2)<sup>12</sup> is subject to exemptions as the Commission may determine appropriate and necessary to prevent

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<sup>10</sup> 15 U.S.C. § 78o-6(b)(2).

<sup>11</sup> 15 U.S.C. § 78o-6(b)(3).

<sup>12</sup> 15 U.S.C. § 78o-6(b)(2).

disclosure of material non-public information regarding specific potential future investment banking transactions of the issuer.<sup>13</sup>

These mandates necessitate several changes to current Rule 2711. First, Rule 2711 currently requires disclosure only of investment banking compensation received from a subject company or its affiliates in the past 12 months. Accordingly, the Amendment would expand the required disclosure to cover any compensation received by a member or its affiliates from the subject company. While the Act does not specify a look-back period, NASD has established a 12-month retrospective period to be consistent with the existing rule and Section 15D(b)(3)<sup>14</sup> of the Act, which imposes the same timeframe for disclosure of a client relationship with the subject company.

The Amendment would require separate disclosure of investment banking compensation and other, non-investment banking compensation received from the subject company or its affiliates. NASD believes this approach will result in more meaningful disclosure by separating out investment banking compensation, which generally is the primary influence on research objectivity. Absent the separate disclosure, investors might not learn whether disclosure of compensation received by the member from the subject company came from lucrative investment banking services or less remunerative and influential business lines. NASD specifically requests comment on whether a de minimis exemption would be appropriate for this provision, and if so, at what dollar level such exemption should be set.

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<sup>13</sup> The exemptive language of Sarbanes-Oxley appears only in Section 15D(b)(2) of the Act (15 U.S.C. § 78o-6(b)(2)). However, NASD and the staff of the New York Stock Exchange (“NYSE”) believe that the exemption must be interpreted to apply to certain other disclosure requirements that could tip material non-public information regarding a specific potential future investment banking transaction or else the purpose of the exemption would be frustrated.

<sup>14</sup> 15 U.S.C. § 78o-6(b)(3).

Second, Rule 2711 currently does not expressly require disclosure of compensation received by a research analyst from a subject company. To the extent that receipt of such compensation constitutes an actual, material conflict of interest, disclosure would be required under Rule 2711(h)(1)(C). Nonetheless, NASD is amending Rule 2711 to require disclosure of any compensation received by an analyst from the subject company in the past 12 months.

Third, NASD is amending Rule 2711 to add a provision that requires a research analyst to disclose in public appearances if the member or any of its affiliates received any compensation from the subject company within the past 12 months. A research analyst must only disclose this fact if the analyst knows or has reason to know it to be the case.

Fourth, NASD is amending Rule 2711 to require disclosure in research reports and public appearances if the subject company is, or has been over the preceding 12 months, a client of the member. If this disclosure is applicable, the member (in research reports) or the research analyst (in public appearances, if the research analyst knows or has reason to know) must also disclose the types of client services provided to the subject company. These services may be described as falling into one of the following three categories: (1) investment banking services, (2) non-investment banking securities-related services or (3) non-securities services.

#### *Small Firm Exemption*

The Amendment also would create new Rule 2711(k), an exemption from Rule 2711(b) for certain firms that engage in limited underwriting activity. Rule 2711(b) prohibits a research analyst from being subject to the supervision or control of any employee of a member's investment banking department and further requires legal or compliance personnel

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to intermedate certain communications between the research department and the investment banking department.

As the Commission noted in its approval order of Rule 2711, several commenters argued that the gatekeeper provisions of Rules 2711(b) and (c) would impose significant costs, especially for smaller firms that would have to hire additional personnel. Commenters also noted that personnel often wear multiple hats in smaller firms, thereby causing a greater burden to comply with the restriction on supervision and control by investment banking personnel over research analysts. These comments raised the prospect that the rules might force some firms out of business or reduce important sources of capital and research coverage for smaller companies and companies of regional or local interest.

To temporarily address those concerns while it considered an appropriate exemption, NASD delayed effectiveness of Rules 2711(b) and (c) until July 30, 2003 for those members that over the previous three years, on average per year, have participated in 10 or fewer investment banking transactions or underwritings as manager or co-manager and generated \$5 million or less in gross investment banking revenues from those transactions.<sup>15</sup> The Amendment would create a permanent exemption from Rule 2711(b) for those members that meet the same eligibility requirements. NASD is not proposing to exempt these members from Rule 2711(c), which restricts communications between the research department and the issuer, because those communications are essentially voluntary and therefore NASD believes they do not result in the same burdens as Rule 2711(b).

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<sup>15</sup> SEC Release No. 34-47876 (May 15, 2003).

The Amendment also would require members that qualify for this exemption to maintain records for three years of any communication that otherwise would be subject to the review and monitoring provisions of Rule 2711(b)(3).

*Other Changes*

The Amendment also would conform certain existing rule language with that used in Sarbanes-Oxley. For example, the term “publish or otherwise distribute” has been substituted in place of references to research reports that are “issued” or “published.” The amendment also would make a few other non-substantive language changes.

*Effective Dates*

NASD suggests the following effective dates for the new provisions contained in SR-NASD-2002-154 and this Amendment thereto:

- Rule 1050 – Registration of Research Analysts: such time as announced in a *Notice to Members* after SEC approval of the rule change, but not less than 180 days from such approval
- Rule 1120(a)(5) and (b)(1) – Regulatory and Firm Elements: Not less than 180 days after SEC approval of the rule change
- Rule 2711(h)(2)(C) – Disclosure of Non-Investment Banking Compensation: 120 days after SEC approval of the rule change
- Rule 2711(h)(2)(E) – Disclosure in Public Appearances of Compensation Received from Issuer and Affiliates: 120 days after SEC approval of the rule change

- Rule 2711(h)(2)(F) – Disclosure of Client Relationship and Types of Services:  
120 days after SEC approval of the rule change
  - Rule 2711(h)(2)(G) – Exemption from Disclosure Requirements:
    - As applied to disclosures under Rules 2711(h)(2)(B)(ii) and (iii):  
Immediate upon SEC approval of the rule change
    - As applied to disclosures under Rule 2711(h)(2)(F): 120 days after  
SEC approval of the rule change
  - Rule 2711(j) – Prohibition of Retaliation Against Research Analysts:  
Immediate upon SEC approval of the rule change
  - Rule 2711(k) – Small Firm Exemption: Immediate upon SEC approval of the  
rule change
  - All other provisions: 60 days after SEC approval of the rule change
- (b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which require, among other things, that NASD's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that this proposed rule change will reduce or expose conflicts of interest and thereby significantly curtail the potential for fraudulent and manipulative acts. NASD further believes that the proposed rule change will provide investors with better and more reliable information with which to make investment decisions.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received for the Amendment.

Comments received by the SEC in response to the initial publication of SR-NASD-2002-154 will be addressed together with comments received after publication of the Amendment.

6. Extension of Time Period for Commission Action

NASD has consented to an extension of the statutory time period for Commission action specified in Securities Exchange Act Section 19(b)(2) of the Act until such time as the Commission takes action on the above-referenced rule filing.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

NASD expects the NYSE to file with the Commission a substantially similar proposed rule change to implement the provisions of Sarbanes-Oxley on or around the filing date of this proposed rule change. Although the NYSE proposed rule change may differ in the language used from this proposed rule change, it is intended to be substantially similar to this proposed rule change.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.

4. Text of the originally filed proposed rule change with the original language changes shown as if adopted and the new language marked to show additions and deletions.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD, INC.

BY: \_\_\_\_\_  
Barbara Z. Sweeney , Senior Vice President and  
Corporate Secretary

Date: May 20, 2003

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34- ; File No. SR-NASD - 2002-154 )

Self-Regulatory Organizations; Notice of Filing of Amendment No. 2 to Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to NASD Rule 2711, Research Analysts and Research Reports

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on , the National Association of Securities Dealers, Inc. (“NASD”), filed with the Securities and Exchange Commission (“SEC” or “Commission”) Amendment No. 2 (“the Amendment”) to the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD is submitting an amendment to SR-NASD-2002-154<sup>3</sup>, a proposed rule change to strengthen rules that govern analyst conflicts of interest by amending NASD Rules 1120 and 2711 and creating a new NASD Rule 1050. The Amendment to the proposed rule change would implement provisions of the Sarbanes-Oxley Act of 2002<sup>4</sup> (“Sarbanes-Oxley”) related to analyst conflicts of interest, create an exemption from some provisions of Rule 2711 for

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<sup>1</sup> 15 U.S.C. § 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> SR-NASD-2002-154 was filed with the SEC on Oct.25, 2002.

<sup>4</sup> Pub. L. No. 107-204, 116 Stat. 745 (2002).

certain smaller firms, and make certain other changes to the current rule. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

\* \* \* \* \*

### **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 responsible for the preparation of research reports.

\* \* \* \* \*

### **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, 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; [and]
- (iii) Applicable regulatory requirements[.]; and

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

(3) through (4) No change.

\* \* \* \* \*

## **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, 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 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.

(6) through (7) No change.

(8) “Research report” means 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].

(9) No change.

**(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.

(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 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 issue 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.

**(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) A research analyst's compensation 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 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 the research analyst's compensation his or her contributions to the member's investment banking business. The committee must document the basis upon which each research analyst's compensation was established. The annual attestation required by Rule 2711(i) must certify that the committee reviewed and approved each 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 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:

[(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 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] published or otherwise distributed; 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).

(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 regarding that issuer for 25 calendar days following 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 that legal or compliance personnel authorize publication of that research report before it is issued.

(5) If a member intends to discontinue 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 and must include the member's final recommendation or rating.

**(g) Restrictions on Personal Trading by Research Analysts**

(1) No change.

(2) (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) through (C) No change.

(5) No change.

**(h) Disclosure Requirements**

(1) No change.

**(2) Receipt of Compensation**

(A) A member must disclose in research reports if [:(i)] the research analyst principally responsible for preparation of the report received compensation that is based upon (among other factors) the member's investment banking revenues.[:; and]

(B)[(ii) the member or its affiliates:] 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;

(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.

(C) A member must disclose in research reports if the member or any affiliate received any compensation other than for investment banking services from the subject company in the past 12 months.

(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)(F), 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) 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) to the extent such disclosure would reveal material non-public information regarding specific potential future investment banking services transactions of the subject company.

[ (B) A research analyst must 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.]

(3) through (11) No change.

(i) No change.

**(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) Exemption 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 debt and equity 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.

\* \* \* \* \*

II. **SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE**

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

On October 25, 2002, NASD filed with the SEC SR-NASD-2002-154, a proposed rule change to further improve the quality and objectivity of research and provide investors with better information to make their investment decisions. On December 18, 2002, NASD submitted Amendment No. 1<sup>5</sup> to the proposed rule change. Generally, the proposed rule change would effectuate the following: it would further separate analyst compensation from investment banking influence; prohibit analysts from issuing “booster shot” research reports; extend to public appearances quiet periods on research issued by underwriting managers and co-managers; prohibit analysts from issuing research where they participated in solicitation of the issuer to be an underwriter for the issuer’s initial public offering; require members to publish a final research report when they terminate coverage of a subject company; change the definitions of research analyst and research report; impose registration, qualification and continuing education requirements on research analysts; and certain other changes.

The Amendment implements provisions of Sarbanes-Oxley regarding securities analysts. Sarbanes-Oxley, which amends Section 501 of the Securities Exchange Act of 1934<sup>6</sup> (“the Act”), requires either the SEC or a registered securities association to enact by July 30, 2003 rules reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances. Sarbanes-

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<sup>5</sup> Letter from Philip Shaikun, Assistant General Counsel, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission (December 18, 2002).

<sup>6</sup> 15 U.S.C. § 78a.

Oxley further sets forth certain specific rules that must be promulgated. The Amendment would implement those specific rules that are not already contained in current Rule 2711 or the pending rule change proposal, SR-NASD-2002-154.

The Amendment also would create an exemption from certain provisions of Rule 2711 for smaller firms that engage in limited underwriting activity. Finally, the Amendment would make certain other changes to clarify language in current or proposed rules or conform language to that used in Sarbanes-Oxley. The proposed changes are explained in more detail below.

*Restrictions on Relationships With Research Department*

Section 15D(a)(1)(A)<sup>7</sup> of the Act restricts prepublication clearance or approval of research reports by persons not directly responsible for investment research, other than legal or compliance staff. Rule 2711(b) already bans review and approval by investment banking personnel. The Amendment would extend the prohibition to other non-research personnel and also require that communications about the content of a research report between all non-research personnel and the research department be intermediated by legal or compliance staff.

*Quiet Periods*

Section 15D(a)(2)<sup>8</sup> of the Act requires establishment of periods during which brokers or dealers who have participated or are to participate in a public securities offering as underwriters *or dealers* may not publish or otherwise distribute research reports related to the issuer of the offering. Rule 2711(f) currently imposes such quiet periods – for 40 calendar

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<sup>7</sup> 15 U.S.C. § 78o-6(a)(1)(A).

<sup>8</sup> 15 U.S.C. § 78o-6(a)(2).

days following an initial public offering and 10 calendar days following a secondary offering – on underwriting managers and co-managers, but not on other members of the underwriting syndicate or selling group. To comply with Sarbanes-Oxley, the Amendment would establish a 25-day period after the “date of the offering” during which an underwriter or dealer other than a manager or co-manager would be prohibited from publishing or distributing research on the issuing company’s securities. This 25-day prohibition effectively codifies a *de facto* quiet period that exists because of the prospectus delivery requirements under Rule 174 of the Securities Act of 1933<sup>9</sup> (“Securities Act”). In general, brokers or dealers refrain from issuing research on exchange-listed or National Market System securities for 25 days after a registration statement becomes effective or bona fide public trading begins to avoid the risk that such communications may be deemed prospectuses that do not meet the requirements of Section 10 of the Securities Act.<sup>10</sup>

The Amendment also would define “date of the offering” for all quiet period provisions to mean the later of the effective date of the registration statement or the first date on which the security was bona fide offered to public.

*Prohibition of Retaliation Against Research Analysts*

Section 15D(a)(1)(C)<sup>11</sup> of the Act prohibits a broker or dealer engaged in investment banking activities from directly or indirectly retaliating, or threatening to retaliate, against a research analyst who publishes a research report that may adversely affect a member’s present

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<sup>9</sup> 17 CFR 230.174.

<sup>10</sup> 15 U.S.C. § 77j.

<sup>11</sup> 15 U.S.C. § 78o-6(a)(1)(C).

or prospective investment banking relationship. The Amendment creates new Rule 2711(j) to implement this directive and extends the prohibition to public appearances. The proposed rule incorporates language in Sarbanes-Oxley that clarifies that the prohibition does not limit a member's authority to discipline a research analyst, in accordance with the member's policies and procedures, for any cause other than writing a research report or making a public appearance that is unfavorable to a current or potential investment banking relationship. NASD has further clarified in the proposal that the anti-retaliation provision would not preclude termination, in accordance with firm policies and procedures, for causes unrelated to issuing or distributing such adverse research or for making an unfavorable public appearances regarding a current or potential investment banking relationship.

*Receipt of Compensation and Disclosure of Client Relationships*

Section 15D(b)(2)<sup>12</sup> of the Act requires disclosure by a broker or dealer in research reports, and by a research analyst in public appearances, if any compensation has been received by the broker or dealer, or any affiliate thereof (including the analyst), from the issuer that is the subject of the report or public appearance. Section 15D(b)(3)<sup>13</sup> of the Act further requires disclosure if the subject issuer is, or has been during the previous year, a client of the broker dealer, and if so, the types of services provided to the issuer. Section 15D(b)(2)<sup>14</sup> is subject to exemptions as the Commission may determine appropriate and necessary to prevent

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<sup>12</sup> 15 U.S.C. § 78o-6(b)(2).

<sup>13</sup> 15 U.S.C. § 78o-6(b)(3).

<sup>14</sup> 15 U.S.C. § 78o-6(b)(2).

disclosure of material non-public information regarding specific potential future investment banking transactions of the issuer.<sup>15</sup>

These mandates necessitate several changes to current Rule 2711. First, Rule 2711 currently requires disclosure only of investment banking compensation received from a subject company or its affiliates in the past 12 months. Accordingly, the Amendment would expand the required disclosure to cover any compensation received by a member or its affiliates from the subject company. While the Act does not specify a look-back period, NASD has established a 12-month retrospective period to be consistent with the existing rule and Section 15D(b)(3)<sup>16</sup> of the Act, which imposes the same timeframe for disclosure of a client relationship with the subject company.

The Amendment would require separate disclosure of investment banking compensation and other, non-investment banking compensation received from the subject company or its affiliates. NASD believes this approach will result in more meaningful disclosure by separating out investment banking compensation, which generally is the primary influence on research objectivity. Absent the separate disclosure, investors might not learn whether disclosure of compensation received by the member from the subject company came from lucrative investment banking services or less remunerative and influential business lines. NASD specifically requests comment on whether a de minimis exemption would be appropriate for this provision, and if so, at what dollar level such exemption should be set.

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<sup>15</sup> The exemptive language of Sarbanes-Oxley appears only in Section 15D(b)(2) of the Act (15 U.S.C. § 78o-6(b)(2)). However, NASD and the staff of the New York Stock Exchange (“NYSE”) believe that the exemption must be interpreted to apply to certain other disclosure requirements that could tip material non-public information regarding a specific potential future investment banking transaction or else the purpose of the exemption would be frustrated.

<sup>16</sup> 15 U.S.C. § 78o-6(b)(3).

Second, Rule 2711 currently does not expressly require disclosure of compensation received by a research analyst from a subject company. To the extent that receipt of such compensation constitutes an actual, material conflict of interest, disclosure would be required under Rule 2711(h)(1)(C). Nonetheless, NASD is amending Rule 2711 to require disclosure of any compensation received by an analyst from the subject company in the past 12 months.

Third, NASD is amending Rule 2711 to add a provision that requires a research analyst to disclose in public appearances if the member or any of its affiliates received any compensation from the subject company within the past 12 months. A research analyst must only disclose this fact if the analyst knows or has reason to know it to be the case.

Fourth, NASD is amending Rule 2711 to require disclosure in research reports and public appearances if the subject company is, or has been over the preceding 12 months, a client of the member. If this disclosure is applicable, the member (in research reports) or the research analyst (in public appearances, if the research analyst knows or has reason to know) must also disclose the types of client services provided to the subject company. These services may be described as falling into one of the following three categories: (1) investment banking services, (2) non-investment banking securities-related services or (3) non-securities services.

#### *Small Firm Exemption*

The Amendment also would create new Rule 2711(k), an exemption from Rule 2711(b) for certain firms that engage in limited underwriting activity. Rule 2711(b) prohibits a research analyst from being subject to the supervision or control of any employee of a member's investment banking department and further requires legal or compliance personnel

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to intermediate certain communications between the research department and the investment banking department.

As the Commission noted in its approval order of Rule 2711, several commenters argued that the gatekeeper provisions of Rules 2711(b) and (c) would impose significant costs, especially for smaller firms that would have to hire additional personnel. Commenters also noted that personnel often wear multiple hats in smaller firms, thereby causing a greater burden to comply with the restriction on supervision and control by investment banking personnel over research analysts. These comments raised the prospect that the rules might force some firms out of business or reduce important sources of capital and research coverage for smaller companies and companies of regional or local interest.

To temporarily address those concerns while it considered an appropriate exemption, NASD delayed effectiveness of Rules 2711(b) and (c) until July 30, 2003 for those members that over the previous three years, on average per year, have participated in 10 or fewer investment banking transactions or underwritings as manager or co-manager and generated \$5 million or less in gross investment banking revenues from those transactions.<sup>17</sup> The Amendment would create a permanent exemption from Rule 2711(b) for those members that meet the same eligibility requirements. NASD is not proposing to exempt these members from Rule 2711(c), which restricts communications between the research department and the issuer, because those communications are essentially voluntary and therefore NASD believes they do not result in the same burdens as Rule 2711(b).

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<sup>17</sup> SEC Release No. 34-47876 (May 15, 2003).

The Amendment also would require members that qualify for this exemption to maintain records for three years of any communication that otherwise would be subject to the review and monitoring provisions of Rule 2711(b)(3).

*Other Changes*

The Amendment also would conform certain existing rule language with that used in Sarbanes-Oxley. For example, the term “publish or otherwise distribute” has been substituted in place of references to research reports that are “issued” or “published.” The amendment also would make a few other non-substantive language changes.

*Effective Dates*

NASD suggests the following effective dates for the new provisions contained in SR-NASD-2002-154 and this Amendment thereto:

- Rule 1050 – Registration of Research Analysts: such time as announced in a *Notice to Members* after SEC approval of the rule change, but not less than 180 days from such approval
- Rule 1120(a)(5) and (b)(1) – Regulatory and Firm Elements: Not less than 180 days after SEC approval of the rule change
- Rule 2711(h)(2)(C) – Disclosure of Non-Investment Banking Compensation: 120 days after SEC approval of the rule change
- Rule 2711(h)(2)(E) – Disclosure in Public Appearances of Compensation Received from Issuer and Affiliates: 120 days after SEC approval of the rule change

- Rule 2711(h)(2)(F) – Disclosure of Client Relationship and Types of Services:  
120 days after SEC approval of the rule change
  - Rule 2711(h)(2)(G) – Exemption from Disclosure Requirements:
    - As applied to disclosures under Rules 2711(h)(2)(B)(ii) and (iii):  
Immediate upon SEC approval of the rule change
    - As applied to disclosures under Rule 2711(h)(2)(F): 120 days after  
SEC approval of the rule change
  - Rule 2711(j) – Prohibition of Retaliation Against Research Analysts:  
Immediate upon SEC approval of the rule change
  - Rule 2711(k) – Small Firm Exemption: Immediate upon SEC approval of the  
rule change
  - All other provisions: 60 days after SEC approval of the rule change
- (b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which require, among other things, that NASD's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that this proposed rule change will reduce or expose conflicts of interest and thereby significantly curtail the potential for fraudulent and manipulative acts. NASD further believes that the proposed rule change will provide investors with better and more reliable information with which to make investment decisions.

(B) Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received for the Amendment.

Comments received by the SEC in response to the initial publication of SR-NASD-2002-154 will be addressed together with comments received after publication of the Amendment.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. by order approve such proposed rule change, or

B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change as amended is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room.

Copies of such filing will also be available for inspection and copying at the principal office of NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Margaret H. McFarland  
Deputy Secretary

**Exhibit 4: Changes to Proposed Rule Language from Amendment No. 1**

This exhibit shows the changes to the proposed rule language resulting from Amendment No. 2 to SR-NASD-2002-154 as compared to the version of the rule language that was filed in Amendment No. 1 to this rule proposal. New language is underlined and deletions are bracketed.

**2711. Research Analysts and Research Reports**

(a) No change.

(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.

(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 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) through (4) No change.

(d) through (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 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 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] published or otherwise distributed; 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).

(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 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.

~~[(3)]~~(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]or compliance [department]personnel authorize[d] publication of that research report before it is issued.

~~[(4)]~~(5)If a member intends to discontinue 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 and must include the member’s final recommendation or rating.

**(g) Restrictions on Personal Trading by Research Analysts**

(1) No change.

(2) (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) through (C) No change.

(5) No change.

**(h) Disclosure Requirements**

(1) No change.

(2) Receipt of Compensation

(A) A member must disclose in research reports if [:(i)] the research analyst principally responsible for preparation of the report received compensation that is based upon (among other factors) the member's investment banking revenues.[:; and]

(B)[(ii) the member or its affiliates:] 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;

(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.

(C) A member must disclose in research reports if the member or any affiliate received any compensation for products or services other than for investment banking services from the subject company in the past 12 months.

(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)(F), 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) 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) to the extent such disclosure would reveal material non-public information regarding specific potential future investment services banking transactions of the subject company.

[(B) A research analyst must 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.]

(3) through (11) No change.

(i) No change.

**(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 the paragraph (k), the term "investment banking services transactions" includes the underwriting of both debt and equity 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.