

Barbara Z. Sweeney
Senior Vice President and
Corporate Secretary

November 4, 2002

Ms. 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-2002-161 To Establish Effective Dates For NASD Rule 2711,
Research Analysts and Reports**

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 A. Shaikun, Office of General Counsel, Division of Regulatory Policy and Oversight, NASD, Inc. 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-2002-161
Consists of 23 Pages
November 4, 2002

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C.

Form 19b-4

Proposed Rule Change

by

NASD

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 (“Exchange Act” or “Act”), NASD is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to establish May 5, 2003 as the effective date for Rules 2711(b) and (c) for members that over the previous three years, on average per year, have participated in 10 or fewer investment banking transactions as manager or co-manager and generated \$5 million or less in gross investment banking revenues from those transactions. Rules 2711(b) and (c) prohibit a research analyst from being subject to the supervision or control of any employee of a member’s investment banking department and further require legal or compliance personnel to intermediate certain communications between the research department and the investment banking department or the company that is the subject of a research report or recommendation (“subject company”).

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The Board of Directors of NASD Regulation approved NASD Rule 2711 at its meeting on January 23, 2002, and authorized the filing of the proposed rule change with the SEC. The Board’s approval permits the staff to file such additional changes and amendments to Rule 2711 as are necessary to carry out the Board’s intent, and thus authorized the filing of this proposed rule change. NASD Regulation provided counsel for The Nasdaq Stock Market and NASD Dispute Resolution an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by the NASD to its Subsidiaries.

The NASD Board of Governors approved Rule 2711 at its meeting on January 24, 2002. No other action by NASD is necessary for the filing of the proposed rule change.

(b) Questions regarding this rule filing may be directed to Philip A. Shaikun, Assistant General Counsel, Office of General Counsel, Division of 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

NASD is filing the proposed rule change to establish May 5, 2003 as the effective date for Rules 2711(b) and (c) for members that over the previous three years, on average per year, have participated in 10 or fewer investment banking transactions as manager or co-manager and generated \$5 million or less in gross investment banking revenues from those transactions. Pursuant to the SEC's approval of SR-NASD-2002-87¹, Rules 2711(b) and (c) as applied to this class of members otherwise will go into effect on November 6, 2002. NASD seeks to delay implementation of these provisions for this limited set of members to allow NASD to continue to explore with the SEC the appropriate treatment of small firms under Rule 2711 and the recently-enacted Sarbanes-Oxley law ("Sarbanes-Oxley"). Smaller members often are the sole or primary source of underwriting and research coverage for some smaller companies; therefore, NASD continues to consider ways to preserve this important role served by these firms, to the extent consistent with the requirements and objectives of Sarbanes-Oxley and Rule 2711.

¹ SEC Release No. 34-46165 (July 3, 2002).

On May 10, 2002, the Commission approved new NASD Rule 2711, which governs conflicts of interest when research analysts recommend equity securities in research reports and during public appearances.² The Commission approved a staggered implementation period for the rule. Most provisions of the rule became effective on July 9, 2002, including those that restrict supervision and control of research analysts by the investment banking department. The “gatekeeper” provisions, described below, became effective September 9, 2002. The remaining provisions of the Rule become effective on November 6, 2002, including two provisions that were delayed pursuant to approval of SR-NASD-2002-87: (1) provisions that require disclosure of investment banking compensation received by foreign affiliates and (2) prohibitions against trading against a member’s recommendation for those members that have instituted a ban on ownership of securities covered by an analyst and that have instituted a specific, periodic divestiture schedule.

Rule 2711(b) contains provisions that generally restrict the relationship between the research and investment banking departments, including “gatekeeper” provisions that require a legal or compliance person to intermediate certain communications between the research and investment banking departments. Rule 2711(b)(1) prohibits a research analyst from being under the control or supervision of any employee of the investment banking department. Rule 2711(b)(2) prohibits employees in the investment banking department from reviewing or approving any research reports prior to publication. Rule 2711(b)(3) creates an exception to (b)(2) to allow investment banking personnel to review a research report prior to publication to verify the factual information contained therein and to screen for potential conflicts of interest.

² SEC Release No. 34-45908 (May 10, 2002).

Any permissible written communications must be made through an authorized legal or compliance official or copied to such official. Oral communications must be made through, or in the presence of, an authorized legal or compliance official and must be documented.

Similarly, Rule 2711(c) restricts communications between a member and the subject company of a research report, except that a member may submit sections of the research report to the company to verify factual accuracy and may notify the subject company of a ratings change after the “close of trading” on the business day preceding the announcement of the ratings change. Submissions to the subject company may not include the research summary, the rating or the price target, and a complete draft of the report must be provided beforehand to legal or compliance personnel. Finally, any change to a rating or price target after review by the subject company must first receive written authorization from legal or compliance.

As the Commission noted in its approval order of Rule 2711, several commenters argued that the gatekeeper provisions 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.

NASD shares the concern raised by these commenters. To that end, NASD has been exploring with the SEC possible exemptions or accommodations that can be made while preserving the purposes of the rule. In SR-NASD-2002-87, NASD sought comment on whether

the parameters set forth above to be eligible for delayed implementation of Rules 2711(b) and (c) should be made permanent or whether another approach should be considered. Moreover, in July 2002, NASD issued *Notice to Members* 02-44, which similarly sought comment on whether a certain members should be exempted from certain provisions of the Rule and what criteria should be employed to fashion such an exemption. NASD received 10 comments in response to the *Notice to Members*.³ Generally, the comments emphasized the financial and administrative burdens imposed by Rule 2711 to implement the gatekeeper provisions and to structure firms so that research personnel are not subject to supervision by investment banking personnel. Commenters argued that the conflicts addressed by Rule 2711 are less pronounced with respect to smaller firms and that the burdens of compliance could force firms to discontinue their research business.

The enactment of Sarbanes-Oxley has further complicated the picture with respect to small firms. While the provisions of Sarbanes-Oxley related to analyst conflicts closely parallel Rule 2711 in many respects, they also require the SEC or self-regulatory organizations, such as NASD and NYSE, to promulgate additional – and sometimes more burdensome – rules on firms to further limit the influence of investment banking on research and increase analyst accountability. Notably, Sarbanes-Oxley makes no explicit exception for small firms. NASD is

³ Letter from David Amster, CRT Capital Group, dated August 19, 2002; Letter from Peter V.B. Unger, Fulbright & Jaworski, LLP, dated August 30, 2002; Letter from First Analysis Securities Corp., dated August 30, 2002; Letter from Scott Cleland and John Eade, Investorside Research Association, dated August 29, 2002; Letter from W. Gray Medlin, The Carson Medlin Co., dated August 29, 2002; Letter from Cathryn Streeter, BioScience Securities, Inc., dated August 28, 2002; E-mail from James Nelson, Minnesota Valley Investments, dated July 31, 2002; E-mail from Joe B. Kercheville, Kercheville & Company, dated August 28, 2002; E-mail from Ray Chin, DBS Vickers Securities (USA) Inc., dated July 29, 2002; Letter from Stuart J. Kaswell, Securities Industry Association, dated August 30, 2002.

currently assessing, with the SEC and NYSE, the implications of Sarbanes-Oxley generally and its impact on small firms, specifically.

Meanwhile, compliance with Rules 2711(b) and (c) continues to pose financial and administrative challenges for certain smaller firms. As such, NASD believes it appropriate to extend the effective date of those provisions for the limited class of members cited above, so that NASD may fully explore with the SEC the treatment of small firms that is consistent with the mandates of Sarbanes-Oxley, the purposes of Rule 2711 and the best interests of the markets and the investing public. Therefore, NASD proposes to delay the effective date of Rules 2711(b) and (c) until May 5, 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.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that NASD's rules must 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 would 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.

6. Extension of Time Period for Commission Action

NASD does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

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

The proposed rule change is effective upon filing pursuant to Section 19(b)(3)(A) of the Act and paragraph (f)(1) of Rule 19b-4 thereunder, in that the proposed rule change constitutes a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule, NASD Rule 2711, previously approved by the SEC. The sole purpose of the rule change is to establish certain effective dates for rules previously approved.

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

The New York Stock Exchange ("NYSE") is expected to file with the Commission, on or around the filing date of this proposed rule change, a similar rule change proposal to establish the same effective dates for its parallel rule related to research reports and research analysts.

Although the existing NYSE rule differs in the language used from NASD Rule 2711, it is intended to be substantially similar to the NASD rule.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.
2. NASD Notice to Members 02-44 (July 26, 2002).

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

BY: _____
Barbara Z. Sweeney
Senior Vice President and Corporate Secretary

Date: November 4, 2002

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-

; File No. SR-NASD-2002-161)

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Establishing Effective Date of Rules Requiring Debt Securities Reporting and Dissemination (TRACE Rules)

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act” or “Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on _____, NASD filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. NASD has designated the proposed rule change as constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule series under paragraph (f)(1) of Rule 19b-4 under the Act,³ which renders the proposal effective upon receipt of this filing by the Commission. 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

Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act” or “Act”), NASD is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to establish May 5, 2003 as the effective date

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 17 CFR § 240.19b-4(f)(1).

for Rules 2711(b) and (c) for members that over the previous three years, on average, have participated in 10 or fewer investment banking transactions as manager or co-manager and generated \$5 million or less in gross investment banking revenues from those transactions.

Rules 2711(b) and (c), when effective, will prohibit a research analyst from being subject to the supervision or control of any employee of a member's investment banking department, and will further require legal or compliance personnel to intermediate certain communications between the research department and either the investment banking department or the company that is the subject of a research report or recommendation ("subject company").

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

In its original rule 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

NASD is filing the proposed rule change to establish May 5, 2003 as the effective date for Rules 2711(b) and (c) for members that over the previous three years, on average per year, have participated in 10 or fewer investment banking transactions as manager or co-manager and generated \$5 million or less in gross investment banking revenues from those transactions.

Pursuant to the SEC's approval of SR-NASD-2002-87⁴, Rules 2711(b) and (c) as applied to this class of members otherwise will go into effect on November 6, 2002. NASD seeks to delay implementation of these provisions for this limited set of members to allow NASD to continue to explore with the SEC the appropriate treatment of small firms under Rule 2711 and the recently-enacted Sarbanes-Oxley law ("Sarbanes-Oxley"). Smaller members often are the sole or primary source of underwriting and research coverage for some smaller companies; therefore, NASD continues to consider ways to preserve this important role served by these firms, to the extent consistent with the requirements and objectives of Sarbanes-Oxley and Rule 2711.

On May 10, 2002, the Commission approved new NASD Rule 2711, which governs conflicts of interest when research analysts recommend equity securities in research reports and during public appearances.⁵ The Commission approved a staggered implementation period for the rule. Most provisions of the rule became effective on July 9, 2002, including those that restrict supervision and control of research analysts by the investment banking department. The "gatekeeper" provisions, described below, became effective September 9, 2002. The remaining provisions of the Rule become effective on November 6, 2002, including two provisions that were delayed pursuant to approval of SR-NASD-2002-87: (1) provisions that require disclosure of investment banking compensation received by foreign affiliates and (2) prohibitions against trading against a member's recommendation for those members that have instituted a ban on ownership of securities covered by an analyst and that have instituted a specific, periodic divestiture schedule.

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Similarly, Rule 2711(c) restricts communications between a member and the subject company of a research report, except that a member may submit sections of the research report to the company to verify factual accuracy and may notify the subject company of a ratings change after the “close of trading” on the business day preceding the announcement of the ratings change. Submissions to the subject company may not include the research summary, the rating or the price target, and a complete draft of the report must be provided beforehand to legal or compliance personnel. Finally, any change to a rating or price target after review by the subject company must first receive written authorization from legal or compliance.

As the Commission noted in its approval order of Rule 2711, several commenters argued that the gatekeeper provisions 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.

NASD shares the concern raised by these commenters. To that end, NASD has been exploring with the SEC possible exemptions or accommodations that can be made while preserving the purposes of the rule. In SR-NASD-2002-87, NASD sought comment on whether the parameters set forth above to be eligible for delayed implementation of Rules 2711(b) and (c) should be made permanent or whether another approach should be considered. Moreover, in July 2002, NASD issued *Notice to Members* 02-44, which similarly sought comment on whether a certain members should be exempted from certain provisions of the Rule and what criteria should be employed to fashion such an exemption. NASD received 10 comments in response to the *Notice to Members*.⁶ Generally, the comments emphasized the financial and administrative burdens imposed by Rule 2711 to implement the gatekeeper provisions and to structure firms so that research personnel are not subject to supervision by investment banking personnel. Commenters argued that the conflicts addressed by Rule 2711 are less pronounced with respect

⁶ Letter from David Amster, CRT Capital Group, dated August 19, 2002; Letter from Peter V.B. Unger, Fulbright & Jaworski, LLP, dated August 30, 2002; Letter from First Analysis Securities Corp., dated August 30, 2002; Letter from Scott Cleland and John Eade, Investorside Research Association, dated August 29, 2002; Letter from W. Gray Medlin, The Carson Medlin Co., dated August 29, 2002; Letter from Cathryn Streeter, BioScience Securities, Inc., dated August 28, 2002; E-mail from James Nelson, Minnesota Valley Investments, dated July 31, 2002; E-mail from Joe B. Kercheville, Kercheville & Company, dated

to smaller firms and that the burdens of compliance could force firms to discontinue their research business.

The enactment of Sarbanes-Oxley has further complicated the picture with respect to small firms. While the provisions of Sarbanes-Oxley related to analyst conflicts closely parallel Rule 2711 in many respects, they also require the SEC or self-regulatory organizations, such as NASD and NYSE, to promulgate additional – and sometimes more burdensome – rules on firms to further limit the influence of investment banking on research and increase analyst accountability. Notably, Sarbanes-Oxley makes no explicit exception for small firms. NASD is currently assessing, with the SEC and NYSE, the implications of Sarbanes-Oxley generally and its impact on small firms, specifically.

Meanwhile, compliance with Rules 2711(b) and (c) continues to pose financial and administrative challenges for certain smaller firms. As such, NASD believes it appropriate to extend the effective date of those provisions for the limited class of members cited above, so that NASD may fully explore with the SEC the treatment of small firms that is consistent with the mandates of Sarbanes-Oxley, the purposes of Rule 2711 and the best interests of the markets and the investing public. Therefore, NASD proposes to delay the effective date of Rules 2711(b) and (c) until May 5, 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.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that NASD's rules must 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 would 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

Written comments were neither solicited nor received.

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

The proposed rule change has been filed by NASD as a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule series under Rule 19b-4(f)(1) under the Act.⁷ Consequently, it has become effective pursuant to Section 19(b)(3)(A) of the Act and Rule 19b-4(f)(1) thereunder.

⁷ 17 CFR § 240.19b-4(f)(1).

At any time within 60 days of this filing, the Commission may summarily abrogate this proposal if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. 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 the 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).

Jonathan G. Katz
Secretary