

Proposed Rule Change by National Association of Securities Dealers  
Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial <input checked="" type="checkbox"/>	Amendment <input type="checkbox"/>	Withdrawal <input type="checkbox"/>	Section 19(b)(2) <input type="checkbox"/>	Section 19(b)(3)(A) <input checked="" type="checkbox"/>	Section 19(b)(3)(B) <input type="checkbox"/>
Pilot <input type="checkbox"/>			Rule		
Extension of Time Period for Commission Action <input type="checkbox"/>			<input checked="" type="checkbox"/> 19b-4(f)(1)	<input type="checkbox"/> 19b-4(f)(4)	
Date Expires <input type="text"/>			<input type="checkbox"/> 19b-4(f)(2)	<input type="checkbox"/> 19b-4(f)(5)	
			<input type="checkbox"/> 19b-4(f)(3)	<input type="checkbox"/> 19b-4(f)(6)	

Exhibit 2 Sent As Paper Document <input type="checkbox"/>	Exhibit 3 Sent As Paper Document <input type="checkbox"/>
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**Description**  
Provide a brief description of the proposed rule change (limit 250 characters).

**Contact Information**  
Provide the name, telephone number and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the proposed rule change.

First Name  Last Name   
 Title   
 E-mail   
 Telephone  Fax

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

Date   
 By  Senior Vice President and Deputy General Counsel  
 (Name) (Title)

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFS website.

**Form 19b-4 Information**

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The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

**Exhibit 1 - Notice of Proposed Rule Change**

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

**Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications**

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Exhibit Sent As Paper Document

Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

**Exhibit 3 - Form, Report, or Questionnaire**

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Exhibit Sent As Paper Document

Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

**Exhibit 4 - Marked Copies**

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The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

**Exhibit 5 - Proposed Rule Text**

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The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

**Partial Amendment**

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If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

**1. Text of Proposed Rule Change**

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> the National Association of Securities Dealers, Inc. ("NASD") is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to amend NASD Rule 2711 to codify NASD's existing interpretive guidance relating to certain provisions of the rule and to make several non-substantive, technical changes to clarify the rule's intended meaning.

The text of the proposed rule change is attached as Exhibit 5 to this rule filing.

(b) Not applicable.

(c) Not applicable.

**2. Procedures of the Self-Regulatory Organization**

The proposed rule change was approved by the Board of Directors of NASD Regulation, Inc. at its meeting on February 1, 2006, which 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 Board of Governors of NASD had an opportunity to review the proposed rule change at its meeting on February 2, 2006. No other action by 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 Board of Governors of NASD to adopt amendments to NASD Rules without recourse to the membership for approval.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

NASD has filed the proposed rule change for immediate effectiveness. The effective date and the implementation date will be the date of filing, September 27, 2006.

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

(a) Purpose

NASD Rule 2711 (Research Analysts and Research Reports) is intended to improve the objectivity of research and provide investors with important conflicts disclosures and other useful and reliable information with which to make investment decisions. Generally, Rule 2711 restricts the relationship between research and investment banking; requires disclosure of financial interests in covered companies by the analyst and the firm; requires disclosure of existing and potential investment banking relationships with subject companies; imposes quiet periods for issuance of research reports; restricts personal trading by analysts; requires disclosure of information that helps investors track the correlation between an analyst's rating and the stock's price movements; requires that a compensation committee, without investment banking representation, review and approve compensation of research analysts; prohibits research analysts from participating in the solicitation of investment banking business; and prohibits research analysts from participating in road shows related to investment banking transactions.

Since adoption of the rule in 2002,<sup>2</sup> NASD has jointly published with the New

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<sup>2</sup> See Securities Exchange Act Release No. 45908 (May 10, 2002), 67 FR 34968 (May 16, 2002) (order approving SR-NASD-2002-021).

York Stock Exchange ("NYSE") two memoranda that provide interpretive guidance to members on a number of issues relating to the rule. See NASD Notice to Members 02-39 (July 2002) and NASD Notice to Members 04-18 (March 2004). On December 21, 2005, NASD and the NYSE submitted to the Commission a joint report on the operation and effectiveness of the SRO rules relating to research analyst conflicts of interest (the "SRO Report"). In connection with that report, NASD staff performed a detailed review of Rule 2711 and recommended various rule changes, among them, codifying certain existing interpretations.<sup>3</sup>

The proposed rule change would make express in Rule 2711 a number of existing interpretations, most of which have previously been set forth in the two joint interpretive memoranda. Specifically, NASD is proposing to amend Rule 2711 to make express in the rule language the interpretive guidance contained in Notice to Members 02-39 and Notice to Members 04-18 relating to (1) the definition of "equity security," (2) the definition of "investment banking services," (3) the definition of "member of a research analyst's household," (4) the definition of "public appearance," (5) the definition of "research report," (6) certain disclosure requirements, (7) compendium reports and (8) third-party research. In addition, NASD is proposing non-substantive, technical changes to Rule 2711 where necessary to clarify the rule's intended meaning.

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<sup>3</sup> The SRO Report also recommended a number of substantive rule changes that extend beyond codifying existing interpretations of the provisions of Rule 2711. Those changes are not included in this proposed rule change, but are the subject of a separate proposed rule change SR-NASD-2006-113, which has been filed contemporaneously herewith.

Definition of "equity security"

Currently, "equity security" is not defined in Rule 2711. The proposed rule change would add "equity security" as a defined term in paragraph (a)(1) and would codify existing interpretive guidance that for purposes of this rule, the term has the meaning ascribed to it in Section 3(a)(11) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(11). See Notice to Members 02-39.

Definition of "investment banking services"

Rule 2711(a)(2) defines "investment banking services" to include, without limitation, acting as an underwriter in an offering for the issuer; acting as a financial adviser in a merger or acquisition; providing venture capital, equity lines of credit, PIPEs or similar investments; or serving as placement agent for the issuer.

The proposed rule change would renumber paragraph (a)(2) as paragraph (a)(3) in light of the rule change discussed above and would codify an existing interpretation that the definition of "investment banking services" also includes acting as a member of a selling group in a securities underwriting. See Notice to Members 02-39. Additionally, the proposed rule change would make a technical change to clarify that the acronym PIPE stands for "private investment, public equity transactions."

Definition of "member of a research analyst's household"

Rule 2711(a)(3) defines a "member of a research analyst's household" as any individual whose principal residence is the same as the research analyst's principal residence.

The proposed rule change would renumber paragraph (a)(3) as paragraph (a)(4) in light of the rule change discussed above and would codify an existing interpretation that

excludes from this definition any unrelated person who shares the same residence as a research analyst provided that the research analyst and unrelated person are financially independent of one another. Thus, for example, an analyst's roommate or apartment-mate, who is financially independent of the analyst, would not be considered a member of the analyst's household for purposes of the restrictions on personal trading and disclosure requirements in Rule 2711. See Notice to Members 02-39.

Definition of "public appearance"

Rule 2711(a)(4) defines "public appearance" as 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.

The proposed rule change would renumber paragraph (a)(4) as paragraph (a)(5) in light of the rule change discussed above and would codify several existing interpretations relating to the definition of "public appearance." First, NASD proposes to include conference calls in the definition. See Notice to Members 02-39.

Second, NASD proposes to amend the definition to expressly provide that only a conference call, seminar, forum (including an interactive electronic forum) or other public speaking activity before 15 or more persons constitutes a "public appearance." This 15-person standard is consistent with SEC Regulation Analyst Certification ("Regulation AC") and the proposed amendment to the definition of "research report" under Rule 2711 (discussed below). See Notice to Members 04-18. As set forth in that Notice, the 15-person standard applies to separate investors. Thus, where a research

analyst can ascertain at a public speaking activity before 15 or more individuals that those individuals represent fewer than 15 separate investors, then such activity would not constitute a "public appearance."

Third, the proposed rule change would amend the definition to provide that any conference call, seminar, forum or other public speaking activity before one or more representatives of the media constitutes a "public appearance" if the research analyst makes a recommendation or offers an opinion concerning an equity security. See Notice to Members 04-18. Thus, even if there are only five persons in attendance at a public speaking activity, if one of those persons is a representative of the media, the event will be a "public appearance." This interpretation is consistent with the current definition, which expressly includes radio, television and print media interviews because the media are a conduit to the public.

Finally, NASD proposes to exclude from the definition password-protected Webcasts, conference calls and similar events with 15 or more existing customers (either individuals or entities), provided that the event participants have previously received the most current research report or other documentation that includes the disclosures required by Rule 2711 and the research analyst appearing at the event corrects or updates during the public appearance any disclosures that are inaccurate, misleading or no longer applicable. See Notice to Members 04-18.

Definition of "research report"

Rule 2711(a)(8) defines "research report" as a written or electronic communication that includes an analysis of equity securities of individual companies or industries, and that provides information reasonably sufficient upon which to base an

investment decision.

The proposed rule change would renumber paragraph (a)(8) as paragraph (a)(9) in light of the rule change discussed above and would codify an existing interpretation that communications that are limited to the following do not meet the definition of "research report": (1) discussions of broad-based indices, such as the Russell 2000 or S&P 500 index; (2) commentaries on economic, political or market conditions; (3) technical analyses concerning the demand and supply for a sector, index or industry based on trading volume and price; (4) statistical summaries of multiple companies' financial data, including listings of current ratings; (5) recommendations regarding increasing or decreasing holdings in particular industries or sectors; and (6) notices of ratings or price target changes, provided that the member simultaneously directs the readers of the notice to the most recent research report on the subject company that includes all current applicable disclosures required by Rule 2711 and that such research report does not contain materially misleading disclosure, including disclosures that are outdated or no longer applicable. See Notice to Members 02-39.<sup>4</sup>

In addition, the proposed rule change would codify three exclusions from the

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<sup>4</sup> These exclusions essentially parallel those contained in SEC Regulation AC and the terms of the so-called "Global Settlement," an agreement among NASD, NYSE, the SEC, the North American Securities Administrators Association and ten of the largest investment banks to resolve allegations regarding biased research.

NASD notes that the proposed rule language to codify these interpretations is not identical to that in the joint memoranda. The changes reflect, in part, the fact that the definition of "research report" was subsequently amended and no longer requires a recommendation. Also, in some instances, NASD has chosen language more appropriate for rule text. In any event, unless otherwise noted, the substance of the existing interpretations are not intended to be different than those set forth in the joint memoranda.

definition of "research report" for certain communications, even if they include an analysis of an individual equity security and information reasonably sufficient upon which to base an investment decision. First, NASD proposes to exclude any communication distributed to fewer than 15 persons. See Notice to Members 04-18.<sup>5</sup> This exclusion supersedes the interpretive guidance provided in Notice to Members 02-39 that an analysis prepared by a registered representative for a specific customer's account would not be considered a research report. Second, NASD proposes to exclude periodic reports or other communications prepared for investment company shareholders or discretionary investment account clients that discuss individual securities in the context of a fund's or an account's past performance or the basis for previously made discretionary investment decisions. Thus, for example, a manager's discussion of fund performance in a mutual fund shareholder report would not constitute a research report. See Notice to Members 04-18.<sup>6</sup> Third, NASD proposes to exclude from the definition internal communications that are not given to current or prospective customers. See Notice to Members 02-39.<sup>7</sup>

Additionally, the proposed rule change would codify an interpretation that communications that constitute statutory prospectuses that are filed as part of the registration statement are not considered "research reports," even if they meet the definitional elements. Prospectuses serve different purposes than research reports and are subject to a separate comprehensive regulatory scheme.

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<sup>5</sup> This exclusion parallels SEC Regulation AC.

<sup>6</sup> This exclusion parallels SEC Regulation AC.

<sup>7</sup> This exclusion parallels SEC Regulation AC.

NASD is also proposing a non-substantive, technical change to the definition of "research report" to clarify that written communications include electronic communications. This change would be consistent with the definition of "research report" in SEC Regulation AC.

#### Disclosure requirements

Rule 2711(h) sets forth a number of disclosure requirements for research reports and public appearances by research analysts. In addition to disclosures relating to conflicts, this provision requires that a member disclose the meanings of ratings used in the member's rating system, the distribution of buy, hold, and sell ratings assigned by the member, and a price chart that plots the assignment or changes of the analyst's ratings and price targets for the subject company against the movement of the subject company's stock price over time.

The proposed rule change would amend Rule 2711(h)(5) to codify the existing interpretation that the ratings distribution should reflect the current distribution of the most recent ratings that the member has issued for all subject companies, unless the most recent rating was issued more than 12 months ago. See Notice to Members 04-18. In addition, the proposed rule change would amend Rule 2711(h)(6) to clarify that a price chart is required if a research report contains either a rating or a price target; however, a member is not required to provide a price chart if the research report does not include a rating or price target. See Notice to Members 04-18.

The proposed rule change would also make certain non-substantive, technical changes to the disclosure requirements of Rule 2711(h) in order to clarify that such disclosures are required only in certain research reports. Specifically, NASD proposes to

amend: (1) Rule 2711(h)(4) to clarify that a research report must disclose the meanings of ratings used in the member's ratings system only if the report contains a rating of the subject company's stock; (2) Rule 2711(h)(5) to clarify that a research report must disclose the member's ratings distribution information only if the report contains a rating; and (3) Rule 2711(h)(7) to clarify that a research report must disclose valuation methods used in determining price targets only if the report contains a price target.

#### Compendium reports

Rule 2711(h)(11) provides that when a member distributes a research report covering six or more companies, for purposes of the Rule's disclosure requirements, such report may direct the reader in a clear manner as to where the reader may obtain the applicable current disclosures in written or electronic format.

The proposed rule change would codify the existing interpretation that an electronic compendium report – a research report covering six or more subject companies – may include a hyperlink to the required disclosures. A paper-based compendium report must provide either a toll-free number to call or a postal address to write for the required disclosures and may also include a web address of the member where the disclosures can be found. See Notice to Members 02-39.

#### Third-party research

The proposed rule change would add new paragraph (h)(13) to Rule 2711 to codify the existing interpretive guidance relating to members' disclosure obligations in the context of distributing third-party research. Proposed new paragraph (h)(13)(A) would make express the existing interpretation that when a member distributes research produced by another member, a non-member affiliate (e.g., a foreign broker-dealer or an

investment adviser) or an independent third party, the member must disclose (1) the member's and its affiliate's ownership of the subject company's securities, pursuant to Rule 2711(h)(1)(B); (2) the member's and its affiliate's investment banking relationships with the subject company, pursuant to Rule 2711(h)(2)(A)(ii); (3) the member's market making activities in the subject company's securities, pursuant to Rule 2711(h)(8); and (4) any other actual, material conflict of interest of the analyst or member, pursuant to Rule 2711(h)(1)(C) (the "third-party disclosures"). Thus, when a member distributes another member's research report, the distributing member must include the third-party disclosures as pertains to the distributing member's relationship to the subject company, while the member whose report is being distributed must comply with all of the disclosure requirements under Rule 2711. See Notice to Members 02-39 and Notice to Members 04-18.<sup>8</sup>

The joint interpretive memoranda indicate that distribution of independent third-party research through a soft-dollar arrangement is not encompassed by the disclosure requirements. The proposed rule change would supersede this interpretation. Thus, when a member distributes independent third-party research through a soft-dollar arrangement, the third-party disclosure requirements would apply, unless another exception is available (e.g., where such research is provided upon customer request).

The proposed rule change would codify the existing interpretation that a member is not required to make the third-party disclosures when the member makes independent third-party research reports available to its customers upon request or through a member-

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<sup>8</sup> New paragraph (h)(13) and existing paragraphs (h)(1)(C), (h)(2)(A)(ii) and (h)(8) of Rule 2711 will be renumbered pursuant to related rule filing SR-NASD-2006-113, discussed herein at note 3.

maintained web site. See Notice to Members 02-39 and Notice to Members 04-18.

However, a member that makes a non-member affiliate's research report available to its customers upon request or through its web site must include the third-party disclosures.

See Notice to Members 04-18.

Finally, consistent with the requirements of Rule 2210(b)(1), the proposed rule change would clarify that a registered principal must approve by signature or initial any third-party research distributed by a member. This requirement may be met by the signature or initial of a supervisory analyst approved pursuant to Rule 344 of the New York Stock Exchange (*i.e.*, a Series 16 Supervisory Analyst). All third-party research distributed by a member must be reviewed by the designated principal (or Series 16 Supervisory Analyst, as the case may be) to determine that the applicable disclosures required by Rule 2711 are complete and accurate, and the content of the research report is consistent with all applicable standards regarding communications with the public.

With respect to research reports prepared by a member, NASD reminds members that the content of the research report must be approved by an individual who has passed either (1) the Series 24 and the Series 87 or (2) the Series 16. If the member elects to have a Series 16 approve the content of research, then a Series 24 principal who has also passed either the Series 87 or the Series 16 must supervise the conduct of both the Series 16 Supervisory Analyst and the research analyst. See Rule 1022(a)(5) and NASD Notice to Members 04-81 (November 2004). Similar to the approach set forth above regarding the approval of third-party research, NASD will permit any registered principal or a Series 16 Supervisory Analyst to supervise for compliance with the disclosure provisions (only) of Rule 2711. All other content of the research report must continue to be

approved by an individual who has passed either the Series 24 and the Series 87, or the Series 16. NASD reminds members that in accordance with Rule 3010 (Supervision), all personnel reviewing both member and third-party research must be qualified by virtue of experience and training to carry out such review.

As noted in Item 2 of this filing, NASD has filed the proposed rule change for immediate effectiveness. The effective date and the implementation date will be the date of filing, September 27, 2006.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>9</sup> which requires, among other things, that NASD 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 the proposed rule change will enhance the clarity and consistency of the research analyst rules, thereby facilitating the goals of reducing conflicts of interest and fraudulent and manipulative practices, and providing investors with more objective, reliable information upon which to base 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.

**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.

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<sup>9</sup> 15 U.S.C. 78o-3(b)(6).

6. **Extension of Time Period for Commission Action**

Not applicable.

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

The proposed rule change is effective upon filing pursuant to Section 19(b)(3)(A)(i) of the Act and paragraph (f)(1) of Rule 19b-4 thereunder,<sup>10</sup> in that the proposed rule change constitutes a stated policy, practice or interpretation with respect to the meaning, administration or enforcement of the existing rule.

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

The NYSE is expected to file with the Commission a substantially similar proposed rule change to codify in NYSE rules the interpretations set forth in the two joint interpretive memoranda. Additionally, certain amendments that are proposed in this proposed rule change are consistent with the SEC's Regulation Analyst Certification, 17 CFR 242.500 through 242.505.

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<sup>10</sup> 17 CFR 240.19b-4.

**9. Exhibits**

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

Exhibit 5. Text of the proposed rule change marked to show additions to and deletions from current rule language.

**EXHIBIT 1**

**SECURITIES AND EXCHANGE COMMISSION**

(Release No. 34- ; File No. SR-NASD-2006-112)

Self-Regulatory Organizations: National Association of Securities Dealers, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Amend NASD Rule 2711 to Codify Existing Interpretive Guidance Relating to Research Analyst Rules

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") 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" under Section 19(b)(3)(A)(i) of the Act<sup>3</sup> and Rule 19b-4(f)(1) thereunder,<sup>4</sup> 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**

NASD is proposing to amend NASD Rule 2711 to codify NASD's existing interpretive guidance relating to certain provisions of the rule and to make several non-substantive, technical changes to clarify the rule's intended meaning. The text of the

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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> 15 U.S.C. 78s(b)(3)(A)(i).

<sup>4</sup> 17 CFR 240.19b-4(f)(1).

proposed rule change is attached as Exhibit 5 to this rule filing.

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**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**

1. Purpose

NASD Rule 2711 (Research Analysts and Research Reports) is intended to improve the objectivity of research and provide investors with important conflicts disclosures and other useful and reliable information with which to make investment decisions. Generally, Rule 2711 restricts the relationship between research and investment banking; requires disclosure of financial interests in covered companies by the analyst and the firm; requires disclosure of existing and potential investment banking relationships with subject companies; imposes quiet periods for issuance of research reports; restricts personal trading by analysts; requires disclosure of information that helps investors track the correlation between an analyst's rating and the stock's price movements; requires that a compensation committee, without investment banking representation, review and approve compensation of research analysts; prohibits research analysts from participating in the solicitation of investment banking business; and prohibits research analysts from participating in road shows related to investment

banking transactions.

Since adoption of the rule in 2002,<sup>5</sup> NASD has jointly published with the New York Stock Exchange ("NYSE") two memoranda that provide interpretive guidance to members on a number of issues relating to the rule. See NASD Notice to Members 02-39 (July 2002) and NASD Notice to Members 04-18 (March 2004). On December 21, 2005, NASD and the NYSE submitted to the Commission a joint report on the operation and effectiveness of the SRO rules relating to research analyst conflicts of interest (the "SRO Report"). In connection with that report, NASD staff performed a detailed review of Rule 2711 and recommended various rule changes, among them, codifying certain existing interpretations.<sup>6</sup>

The proposed rule change would make express in Rule 2711 a number of existing interpretations, most of which have previously been set forth in the two joint interpretive memoranda. Specifically, NASD is proposing to amend Rule 2711 to make express in the rule language the interpretive guidance contained in Notice to Members 02-39 and Notice to Members 04-18 relating to (1) the definition of "equity security," (2) the definition of "investment banking services," (3) the definition of "member of a research analyst's household," (4) the definition of "public appearance," (5) the definition of "research report," (6) certain disclosure requirements, (7) compendium reports and (8) third-party research. In addition, NASD is proposing non-substantive, technical changes

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<sup>5</sup> See Securities Exchange Act Release No. 45908 (May 10, 2002), 67 FR 34968 (May 16, 2002) (order approving SR-NASD-2002-021).

<sup>6</sup> The SRO Report also recommended a number of substantive rule changes that extend beyond codifying existing interpretations of the provisions of Rule 2711. Those changes are not included in this proposed rule change, but are the subject of a separate proposed rule change SR-NASD-2006-113, which has been filed contemporaneously herewith.

to Rule 2711 where necessary to clarify the rule's intended meaning.

Definition of "equity security"

Currently, "equity security" is not defined in Rule 2711. The proposed rule change would add "equity security" as a defined term in paragraph (a)(1) and would codify existing interpretive guidance that for purposes of this rule, the term has the meaning ascribed to it in Section 3(a)(11) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(11). See Notice to Members 02-39.

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Rule 2711(a)(2) defines "investment banking services" to include, without limitation, acting as an underwriter in an offering for the issuer; acting as a financial adviser in a merger or acquisition; providing venture capital, equity lines of credit, PIPEs or similar investments; or serving as placement agent for the issuer.

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Definition of "member of a research analyst's household"

Rule 2711(a)(3) defines a "member of a research analyst's household" as any individual whose principal residence is the same as the research analyst's principal residence.

The proposed rule change would renumber paragraph (a)(3) as paragraph (a)(4) in light of the rule change discussed above and would codify an existing interpretation that

excludes from this definition any unrelated person who shares the same residence as a research analyst provided that the research analyst and unrelated person are financially independent of one another. Thus, for example, an analyst's roommate or apartment-mate, who is financially independent of the analyst, would not be considered a member of the analyst's household for purposes of the restrictions on personal trading and disclosure requirements in Rule 2711. See Notice to Members 02-39.

Definition of "public appearance"

Rule 2711(a)(4) defines "public appearance" as 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.

The proposed rule change would renumber paragraph (a)(4) as paragraph (a)(5) in light of the rule change discussed above and would codify several existing interpretations relating to the definition of "public appearance." First, NASD proposes to include conference calls in the definition. See Notice to Members 02-39.

Second, NASD proposes to amend the definition to expressly provide that only a conference call, seminar, forum (including an interactive electronic forum) or other public speaking activity before 15 or more persons constitutes a "public appearance." This 15-person standard is consistent with SEC Regulation Analyst Certification ("Regulation AC") and the proposed amendment to the definition of "research report" under Rule 2711 (discussed below). See Notice to Members 04-18. As set forth in that Notice, the 15-person standard applies to separate investors. Thus, where a research analyst can ascertain at a public speaking activity before 15 or more individuals that those

individuals represent fewer than 15 separate investors, then such activity would not constitute a "public appearance."

Third, the proposed rule change would amend the definition to provide that any conference call, seminar, forum or other public speaking activity before one or more representatives of the media constitutes a "public appearance" if the research analyst makes a recommendation or offers an opinion concerning an equity security. See Notice to Members 04-18. Thus, even if there are only five persons in attendance at a public speaking activity, if one of those persons is a representative of the media, the event will be a "public appearance." This interpretation is consistent with the current definition, which expressly includes radio, television and print media interviews because the media are a conduit to the public.

Finally, NASD proposes to exclude from the definition password-protected Webcasts, conference calls and similar events with 15 or more existing customers (either individuals or entities), provided that the event participants have previously received the most current research report or other documentation that includes the disclosures required by Rule 2711 and the research analyst appearing at the event corrects or updates during the public appearance any disclosures that are inaccurate, misleading or no longer applicable. See Notice to Members 04-18.

Definition of "research report"

Rule 2711(a)(8) defines "research report" as a written or electronic communication that includes an analysis of equity securities of individual companies or industries, and that provides information reasonably sufficient upon which to base an investment decision.

The proposed rule change would renumber paragraph (a)(8) as paragraph (a)(9) in

light of the rule change discussed above and would codify an existing interpretation that communications that are limited to the following do not meet the definition of "research report": (1) discussions of broad-based indices, such as the Russell 2000 or S&P 500 index; (2) commentaries on economic, political or market conditions; (3) technical analyses concerning the demand and supply for a sector, index or industry based on trading volume and price; (4) statistical summaries of multiple companies' financial data, including listings of current ratings; (5) recommendations regarding increasing or decreasing holdings in particular industries or sectors; and (6) notices of ratings or price target changes, provided that the member simultaneously directs the readers of the notice to the most recent research report on the subject company that includes all current applicable disclosures required by Rule 2711 and that such research report does not contain materially misleading disclosure, including disclosures that are outdated or no longer applicable. See Notice to Members 02-39.<sup>7</sup>

In addition, the proposed rule change would codify three exclusions from the definition of "research report" for certain communications, even if they include an analysis of an individual equity security and information reasonably sufficient upon which to base an investment decision. First, NASD proposes to exclude any

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<sup>7</sup> These exclusions essentially parallel those contained in SEC Regulation AC and the terms of the so-called "Global Settlement," an agreement among NASD, NYSE, the SEC, the North American Securities Administrators Association and ten of the largest investment banks to resolve allegations regarding biased research.

NASD notes that the proposed rule language to codify these interpretations is not identical to that in the joint memoranda. The changes reflect, in part, the fact that the definition of "research report" was subsequently amended and no longer requires a recommendation. Also, in some instances, NASD has chosen language more appropriate for rule text. In any event, unless otherwise noted, the substance of the existing interpretations are not intended to be different than those set forth in the joint memoranda.

communication distributed to fewer than 15 persons. See Notice to Members 04-18.<sup>8</sup>

This exclusion supersedes the interpretive guidance provided in Notice to Members 02-39 that an analysis prepared by a registered representative for a specific customer's account would not be considered a research report. Second, NASD proposes to exclude periodic reports or other communications prepared for investment company shareholders or discretionary investment account clients that discuss individual securities in the context of a fund's or an account's past performance or the basis for previously made discretionary investment decisions. Thus, for example, a manager's discussion of fund performance in a mutual fund shareholder report would not constitute a research report. See Notice to Members 04-18.<sup>9</sup> Third, NASD proposes to exclude from the definition internal communications that are not given to current or prospective customers. See Notice to Members 02-39.<sup>10</sup>

Additionally, the proposed rule change would codify an interpretation that communications that constitute statutory prospectuses that are filed as part of the registration statement are not considered "research reports," even if they meet the definitional elements. Prospectuses serve different purposes than research reports and are subject to a separate comprehensive regulatory scheme.

NASD is also proposing a non-substantive, technical change to the definition of "research report" to clarify that written communications include electronic communications. This change would be consistent with the definition of "research report" in SEC Regulation AC.

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<sup>8</sup> This exclusion parallels SEC Regulation AC.

<sup>9</sup> This exclusion parallels SEC Regulation AC.

<sup>10</sup> This exclusion parallels SEC Regulation AC.

Disclosure requirements

Rule 2711(h) sets forth a number of disclosure requirements for research reports and public appearances by research analysts. In addition to disclosures relating to conflicts, this provision requires that a member disclose the meanings of ratings used in the member's rating system, the distribution of buy, hold, and sell ratings assigned by the member, and a price chart that plots the assignment or changes of the analyst's ratings and price targets for the subject company against the movement of the subject company's stock price over time.

The proposed rule change would amend Rule 2711(h)(5) to codify the existing interpretation that the ratings distribution should reflect the current distribution of the most recent ratings that the member has issued for all subject companies, unless the most recent rating was issued more than 12 months ago. See Notice to Members 04-18. In addition, the proposed rule change would amend Rule 2711(h)(6) to clarify that a price chart is required if a research report contains either a rating or a price target; however, a member is not required to provide a price chart if the research report does not include a rating or price target. See Notice to Members 04-18.

The proposed rule change would also make certain non-substantive, technical changes to the disclosure requirements of Rule 2711(h) in order to clarify that such disclosures are required only in certain research reports. Specifically, NASD proposes to amend: (1) Rule 2711(h)(4) to clarify that a research report must disclose the meanings of ratings used in the member's ratings system only if the report contains a rating of the subject company's stock; (2) Rule 2711(h)(5) to clarify that a research report must disclose the member's ratings distribution information only if the report contains a rating;

and (3) Rule 2711(h)(7) to clarify that a research report must disclose valuation methods used in determining price targets only if the report contains a price target.

#### Compendium reports

Rule 2711(h)(11) provides that when a member distributes a research report covering six or more companies, for purposes of the Rule's disclosure requirements, such report may direct the reader in a clear manner as to where the reader may obtain the applicable current disclosures in written or electronic format.

The proposed rule change would codify the existing interpretation that an electronic compendium report – a research report covering six or more subject companies – may include a hyperlink to the required disclosures. A paper-based compendium report must provide either a toll-free number to call or a postal address to write for the required disclosures and may also include a web address of the member where the disclosures can be found. See Notice to Members 02-39.

#### Third-party research

The proposed rule change would add new paragraph (h)(13) to Rule 2711 to codify the existing interpretive guidance relating to members' disclosure obligations in the context of distributing third-party research. Proposed new paragraph (h)(13)(A) would make express the existing interpretation that when a member distributes research produced by another member, a non-member affiliate (e.g., a foreign broker-dealer or an investment adviser) or an independent third party, the member must disclose (1) the member's and its affiliate's ownership of the subject company's securities, pursuant to Rule 2711(h)(1)(B); (2) the member's and its affiliate's investment banking relationships with the subject company, pursuant to Rule 2711(h)(2)(A)(ii); (3) the member's market

making activities in the subject company's securities, pursuant to Rule 2711(h)(8); and (4) any other actual, material conflict of interest of the analyst or member, pursuant to Rule 2711(h)(1)(C) (the "third-party disclosures"). Thus, when a member distributes another member's research report, the distributing member must include the third-party disclosures as pertains to the distributing member's relationship to the subject company, while the member whose report is being distributed must comply with all of the disclosure requirements under Rule 2711. See Notice to Members 02-39 and Notice to Members 04-18.<sup>11</sup>

The joint interpretive memoranda indicate that distribution of independent third-party research through a soft-dollar arrangement is not encompassed by the disclosure requirements. The proposed rule change would supersede this interpretation. Thus, when a member distributes independent third-party research through a soft-dollar arrangement, the third-party disclosure requirements would apply, unless another exception is available (e.g., where such research is provided upon customer request).

The proposed rule change would codify the existing interpretation that a member is not required to make the third-party disclosures when the member makes independent third-party research reports available to its customers upon request or through a member-maintained web site. See Notice to Members 02-39 and Notice to Members 04-18. However, a member that makes a non-member affiliate's research report available to its customers upon request or through its web site must include the third-party disclosures. See Notice to Members 04-18.

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<sup>11</sup> New paragraph (h)(13) and existing paragraphs (h)(1)(C), (h)(2)(A)(ii) and (h)(8) of Rule 2711 will be renumbered pursuant to related rule filing SR-NASD-2006-113, discussed herein at note 6.

Finally, consistent with the requirements of Rule 2210(b)(1), the proposed rule change would clarify that a registered principal must approve by signature or initial any third-party research distributed by a member. This requirement may be met by the signature or initial of a supervisory analyst approved pursuant to Rule 344 of the New York Stock Exchange (i.e., a Series 16 Supervisory Analyst). All third-party research distributed by a member must be reviewed by the designated principal (or Series 16 Supervisory Analyst, as the case may be) to determine that the applicable disclosures required by Rule 2711 are complete and accurate, and the content of the research report is consistent with all applicable standards regarding communications with the public.

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

NASD has filed the proposed rule change for immediate effectiveness. The effective date and the implementation date will be the date of filing, September 27, 2006.

2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>12</sup> which requires, among other things, that NASD 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 the proposed rule change will enhance the clarity and consistency of the research analyst rules, thereby facilitating the goals of reducing conflicts of interest and fraudulent and manipulative practices, and providing investors with more objective, reliable information upon which to base 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.

**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.

**III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action**

The foregoing rule change is effective pursuant to Section 19(b)(3)(A)(i) of the Act and paragraph (f)(1) of Rule 19b-4 thereunder,<sup>13</sup> in that the proposed rule change constitutes a stated policy, practice or interpretation with respect to the meaning,

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<sup>12</sup> 15 U.S.C. 78o-3(b)(6).

<sup>13</sup> 17 CFR 240.19b-4.

administration or enforcement of the existing rule. At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change 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, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

##### Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASD-2006-112 on the subject line.

##### Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASD-2006-112. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). 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 also will be available for inspection and copying at the principal office of NASD.

All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NASD-2006-112 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>14</sup>

Nancy M. Morris

Secretary

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<sup>14</sup> 17 CFR 200.30-3(a)(12).

**Exhibit 5**

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

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

(2) No Change.

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

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

[(4)] (5) "Public appearance" means any participation in a conference call, seminar, forum (including an interactive electronic forum) or other public speaking activity before 15 or more persons or before one or more representatives

of the media, radio, television or print media interview, [or other public speaking activity, ]or the writing of a print media article, in which a research analyst makes a recommendation or offers an opinion concerning an equity security. This term does not include a password protected Webcast, conference call or similar event with 15 or more existing customers, provided that all of the event participants previously received the most current research report or other documentation that contains the required applicable disclosures, and that the research analyst appearing at the event corrects and updates during the public appearance any disclosures in the research report that are inaccurate, misleading or no longer applicable.

[(5)] (6) No Change.

[(6)] (7) No Change.

[(7)] (8) No Change.

[(8)] (9) "Research Report" means [a] any written [or] (including electronic) communication that includes an analysis of equity securities of individual companies or industries, and that provides information reasonably sufficient upon which to base an investment decision. This term does not include:

(A) communications that are limited to the following:

(i) discussions of broad-based indices;

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

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

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

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

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

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

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

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

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

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

[(9)] (10) No Change.

(b) through (g) No Change.

**(h) Disclosure Requirements**

(1) through (3) No Change.

**(4) Meaning of Ratings**

If a research report contains a rating, [A] the member must define in [its] the research report[s] the meaning of each rating used by the member in its rating system. The definition of each rating must be consistent with its plain meaning.

**(5) Distribution of Ratings**

(A) through (B) No Change.

(C) The information that is disclosed under paragraphs (h)(5)(A) and (h)(5)(B) must be current as of the end of the most recent calendar quarter (or the second most recent calendar quarter if the publication date is less than 15 calendar days after the most recent calendar quarter) and must reflect the distribution of the most recent ratings issued by the member for all subject companies, unless the most recent rating was issued more than 12 months ago.

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

**(6) Price Chart**

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

(A) through (C) No Change.

**(7) Price Targets**

If a research report contains a price target, the [A] member must disclose in the research report[s] the valuation methods used to determine [a] the price target. Price targets must have a reasonable basis and must be accompanied by a disclosure concerning the risks that may impede achievement of the price target.

(8) through (10) No Change.

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

**Companies**

When a member distributes a research report covering six or more subject companies (a "compendium report"), for purposes of the disclosures required in paragraph (h), [such research]the compendium report may direct the reader in a clear manner as to where they may obtain applicable current disclosures [in written or electronic format]. Electronic compendium reports may include a hyperlink to the required disclosures. Paper-based compendium reports must

provide either a toll-free number to call or a postal address to write for the required disclosures and may also include a web address of the member where the disclosures can be found.

(12) No Change.

**(13) Third-Party Research Reports**

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

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

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

the public.

(i) through (k) No Change.

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