

Notice to Members

AUGUST 2003

SUGGESTED ROUTING

Executive Representative
Legal & Compliance
Senior Management
Operations

KEY TOPICS

Research Reports
Qualification and Registration
Continuing Education Requirements
Advertising
Investment Banking

ACTION REQUIRED

Research Analysts and Research Reports

SEC Approves Amendments to Rules Governing Research Analysts' Conflicts of Interest

Executive Summary

On July 29, 2003, the Securities and Exchange Commission (SEC) approved new NASD Rule 1050 (Registration of Research Analysts) and amendments to Rule 1120 (Continuing Education Requirements) and Rule 2711 (Research Analysts and Research Reports).¹ Generally, the new rule and amendments impose registration, qualification, and continuing education requirements on research analysts; further separate analyst compensation from investment banking influence; prohibit analysts from issuing "booster shot" research reports; prohibit analysts from soliciting investment banking business; and require members to publish a final research report when they terminate coverage of a subject company. The amendments also revise Rule 2711 to augment disclosure requirements and make other changes necessary to comply with the research analyst provisions of the Sarbanes-Oxley Act of 2002.

The SEC also approved on the same day similar amendments to New York Stock Exchange Rules 344, 345A, 351 and 472. NASD generally will implement the new rule and amendments in phases during the period from July 29, 2003, to January 26, 2004. The implementation schedule is set forth below.

This *Notice* includes as Attachment A the text of the new rule and amendments.

Questions/Further Information

Questions concerning this *Notice* may be directed to Nileema Pargaonker in NASD's Corporate Financing Department, Regulatory Policy and Oversight, at (240) 386-4623, or Philip Shaikun, Associate General Counsel, Regulatory Policy and Oversight, at (202) 728-8451.

Implementation Schedule

New Rule 1050 and the amendments to Rules 1120 and 2711 will take effect as follows:

- ◆ Qualification, examination, registration, and continuing education requirements for research analysts (new Rule 1050 and amendments to Rule 1120): January 26, 2004, or such later date as determined by NASD.
- ◆ New compensation and client disclosure provisions (Rule 2711(h)(2)): January 26, 2004, plus up to an additional 90 days as deemed appropriate by NASD on a case-by-case basis.
- ◆ Rule 2711(h)(2)(C) – Exemption from Disclosure Requirements:
 - ◆ As applied to disclosures under Rules 2711(h)(2)(A)(ii)(b) and (c): July 29, 2003.
 - ◆ As applied to disclosures under Rule 2711(h)(2)(A)(iii)(b), (h)(2)(B)(i) and (iii): January 26, 2004.
- ◆ Research analyst compensation review procedures (Rule 2711(d)(2)): October 27, 2003.
- ◆ Prohibition of retaliation against research analysts (Rule 2711(j)): July 29, 2003.
- ◆ Exceptions for small firms (Rule 2711(k)): July 29, 2003.
- ◆ All other rule changes: September 29, 2003.

Endnote

- 1 SEC Release No. 34-48252 (July 29, 2003), 68 Fed. Reg. 45875 (Aug. 4, 2003).

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ATTACHMENT A

This attachment provides the text of new Rule 1050 and the amendments to Rules 1120 and 2711. New text is underlined, and deleted text is bracketed. Paragraphs that have not been revised are designated as "No change."

Rule 1050. Registration of Research Analysts

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

* * * * *

Rule 1120. Continuing Education Requirements

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

(a) Regulatory Element

(1) through (4) No change.

(5) Definition of Registered Person

For purposes of this Rule, the term "registered person" means any person registered with [the Association]NASD as a representative, principal, [or] assistant representative or research analyst pursuant to Rule 1020, 1030, 1040, 1050 and 1110 Series.

(6) No change.

(b) Firm Element

(1) Persons Subject to the Firm Element

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

organization, other than another broker or dealer, executing securities transactions with or through or receiving investment banking services from a member.

(2) Standards for the Firm Element

(A) No change.

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

(i) General investment features and associated risk factors;

(ii) Suitability and sales practice considerations; [and]

(iii) Applicable regulatory requirements[.]; and

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

(C) No change.

(3) through (4) No change.

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Rule 2711. Research Analysts and Research Reports

(a) Definitions

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

(1) through (3) No change.

(4) “Public appearance” means any participation in a seminar, forum (including an interactive electronic forum), radio, [or] television or print media interview, or other public speaking activity, or the writing of a print media article, in which a research analyst makes a recommendation or offers an opinion concerning an equity security.

(5) "Research analyst" means the associated person who is [principally] primarily responsible for, and any associated person who reports directly or indirectly to such a research analyst in connection with, preparation of the substance of a research report, whether or not any such person has the job title of "research analyst."

(6) "Research analyst account" means any account in which a research analyst or member of the research analyst's household has a financial interest, or over which such analyst has discretion or control, other than an investment company registered under the Investment Company Act of 1940. This term does not include a "blind trust" account that is controlled by a person other than the research analyst or member of the research analyst's household where neither the research analyst nor a member of the research analyst's household knows of the account's investments or investment transactions.

(7) No change.

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

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

(b) Restrictions on [Investment Banking Department]Relationships with Research Department

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

(2) Except as provided in paragraph (b)(3), no employee of the investment banking department or any other employee of the member who is not directly responsible for investment research ("non-research personnel"), other than legal or compliance personnel, may review or approve a research report of the member before its publication.

(3) [Investment banking]Non-research personnel may review a research report before its publication as necessary only to verify the factual accuracy of information in the research report or [to review the research report for]identify any potential conflict of interest, provided that:

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

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

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

(1) No change.

(2) A member may submit sections of such a research report to the subject company before its publication for review as necessary only to verify the factual accuracy of information in those sections, provided that:

(A) No change.

(B) a complete draft of the research report is provided to [the] legal or compliance [department]personnel before sections of the report are submitted to the subject company; and

(C) if after submitting the sections of the research report to the subject company the research department intends to change the proposed rating or price target, it must first provide written justification to, and receive written authorization from, [the] legal or compliance [department]personnel for the change. The member must retain copies of any draft and the final version of such a research report for three years following its publication.

(3) No change.

(4) No research analyst may participate in efforts to solicit investment banking business. Accordingly, no research analyst may, among other things, participate in any "pitches" for investment banking business to prospective investment banking clients, or have other communications with companies for the purpose of soliciting investment banking business.

(d) [Prohibition of Certain Forms of]Restrictions on Research Analyst Compensation

(1) No member may pay any bonus, salary or other form of compensation to a research analyst that is based upon a specific investment banking services transaction.

(2) The compensation of a research analyst who is primarily responsible for the preparation of the substance of a research report must be reviewed and approved at least annually by a committee that reports to the member's board of directors, or when the member has no board of directors, to a senior executive officer of the member. This committee may not have representation from the member's investment banking department. The committee must consider the following factors when reviewing such a research analyst's compensation, if applicable:

(A) the research analyst's individual performance, including the analyst's productivity and the quality of the analyst's research;

(B) the correlation between the research analyst's recommendations and the stock price performance; and

(C) the overall ratings received from clients, sales force, and peers independent of the member's investment banking department, and other independent ratings services.

The committee may not consider as a factor in reviewing and approving such a research analyst's compensation his or her contributions to the member's investment banking business. The committee must document the basis upon which each such research analyst's compensation was established. The annual attestation required by Rule 2711(i) must certify that the committee reviewed and approved each such research analyst's compensation and documented the basis upon which this compensation was established.

(e) No change.

(f) [Imposition of Quiet Periods]Restrictions on Publishing Research Reports and Public Appearances; Termination of Coverage

(1) No member may publish or otherwise distribute a research report and no research analyst may make a public appearance regarding a subject company for which the member acted as manager or co-manager of:

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

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

[(A)](i) paragraphs (f)(1)(A) and (f)(2)(1)(B) will not prevent a member from publishing or otherwise distributing a research report, or prevent a research analyst from making a public appearance, concerning the effects of significant news or a significant event on the subject company within such 40- and 10-day periods, and provided further that [the] legal [and]or compliance [department]personnel authorize[s] publication of that research report before it is issued or authorize the public appearance before it is made; and

[(B)](ii) paragraph (f)(2)(1)(B) will not prevent a member from publishing or otherwise distributing a research report pursuant to SEC Rule 139 regarding a subject company with “actively-traded securities,” as defined in Regulation M, 17 CFR 242.101(c)(1), and will not prevent a research analyst from making a public appearance concerning such a company.

(2) No member that has agreed to participate or is participating as an underwriter or dealer (other than as manager or co-manager) of an issuer’s initial public offering may publish or otherwise distribute a research report or make a public appearance regarding that issuer for 25 calendar days after the date of the offering.

(3) For purposes of paragraphs (f)(1) and (f)(2), the term “date of the offering” refers to the later of the effective date of the registration statement or the first date on which the security was bona fide offered to the public.

(4) No member that has acted as a manager or co-manager of a securities offering may publish or otherwise distribute a research report or make a public appearance concerning a subject company 15 days prior to and after the expiration, waiver or termination of a lock-up agreement or any other agreement that the member has entered into with a subject company or its shareholders that restricts or prohibits the sale of securities held by the subject company or its shareholders after the completion of a securities offering. This paragraph will not prevent a member from publishing or otherwise distributing a research report concerning the effects of significant news or a significant event on the subject company within such period, provided legal or compliance personnel authorize publication of that research report before it is issued. In addition, this paragraph shall not apply to the publication or distribution of a research report pursuant to SEC Rule 139 regarding a subject company with “actively traded securities,” as defined in Regulation M, 17 CFR 242.101(c)(1), or to a public appearance concerning such a subject company.

(5) If a member intends to terminate its research coverage of a subject company, notice of this termination must be made. The member must make available a final research report on the subject company using the means of dissemination equivalent to those it ordinarily uses to provide the customer with its research reports on the subject company. The report must be comparable in scope and detail to prior research reports and must include a final recommendation or rating, unless it is

impracticable for the member to produce a comparable report (e.g., if the research analyst covering the subject company or sector has left the member or if the member terminates coverage of the industry or sector). If it is impracticable to produce a final recommendation or rating, the final research report must disclose the member's rationale for the decision to terminate coverage.

(g) Restrictions on Personal Trading by Research Analysts

(1) No change.

(2) No research analyst account may purchase or sell any security issued by a company that the research analyst follows, or any option on or derivative of such security, for a period beginning 30 calendar days before and ending five calendar days after the publication of a research report concerning the company or a change in a rating or price target of the company's securities; provided that:

(A) No change.

(B) a member may permit a research analyst account to purchase or sell any security issued by a subject company within 30 calendar days before the publication of a research report or change in the rating or price target of the subject company's securities due to significant news or a significant event concerning the subject company, provided that [the member's] legal or compliance [department] personnel pre-approve[s] the research report and any change in the rating or price target.

(3) No change.

(4) [A member's] Legal or compliance [department] personnel may authorize a transaction otherwise prohibited by paragraphs (g)(2) and (g)(3) based upon an unanticipated significant change in the personal financial circumstances of the beneficial owner of the research analyst account, provided that:

(A) [the] legal or compliance [department] personnel authorize[s] the transaction before it is entered;

(B) each exception is granted in compliance with policies and procedures adopted by the member that are reasonably designed to ensure that these transactions do not create a conflict of interest between the professional responsibilities of the research analyst and the personal trading activities of a research analyst account; and

(C) No change.

(5) No change.

(6) Legal or compliance personnel of the member shall pre-approve all transactions of persons who oversee research analysts to the extent such transactions involve equity securities of subject companies covered by the research analysts that they oversee. This pre-approval requirement shall apply to all persons, such as the director of research, supervisory analyst, or member of a committee, who have direct influence or control with respect to the preparation of the substance of research reports or establishing or changing a rating or price target of a subject company's equity securities.

(h) Disclosure Requirements

(1) No change.

(2) Receipt of Compensation

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

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

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

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

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

a. managed or co-managed a public offering of securities for the subject company in the past 12 months;

b. received compensation for investment banking services from the subject company in the past 12 months; or

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

(iii) if (1) as of the end of the month immediately preceding the date of publication of the research report (or the end of the second most recent month if the publication date is less than 30 calendar days after the end of the most recent month) or (2) to the extent the research analyst or an employee of the member with the ability to influence the substance of the research knows:

a. the member received any compensation for products or services other than investment banking services from the subject company in the past 12 months; or

b. the subject company currently is, or during the 12-month period preceding the date of distribution of the research report was, a client of the member. In such cases, the member also must disclose the types of services provided to the subject company. For purposes of this Rule 2711(h)(2), the types of services provided to the subject company shall be described as investment banking services, non-investment banking securities-related services, and non-securities services.

(iv) if, to the extent the research analyst or an employee of the member with the ability to influence the substance of the research report knows an affiliate of the member received any compensation for products or services other than investment banking services from the subject company in the past 12 months.

(v) if, to the extent the research analyst or member has reason to know, an affiliate of the member received any compensation for products or services other than investment banking services from the subject company in the past 12 months.

a. This requirement will be deemed satisfied if such compensation is disclosed in research reports within 30 days after completion of the last calendar quarter, provided that the member has taken steps reasonably designed to identify any such compensation during that calendar quarter. This requirement shall not apply to any subject company as to which the member initiated coverage since the beginning of the current calendar quarter.

b. The research analyst and the member will be presumed not to have reason to know whether an affiliate received any compensation for products or services other than investment banking services from the subject company in the past 12 months if the member maintains and enforces policies and procedures reasonably designed to prevent the research analysts and employees of the member with the ability to influence the substance of research reports from, directly or indirectly, receiving information from the affiliate concerning whether the affiliate received such compensation.

(vi) For the purposes of this Rule 2711(h)(2), an employee of the member with the ability to influence the substance of the research report is an employee who, in the ordinary course of that person's duties, has the authority to review the particular research report and to change that research report prior to publication.

(B) A research analyst must disclose in public appearances:

(i) if, to the extent the research analyst knows or has reason to know, the member or any affiliate received any compensation from the subject company in the past 12 months;

(ii) if the research analyst received any compensation from the subject company in the past 12 months; or

(iii) if, to the extent the research analyst knows or has reason to know, [that]the subject company currently is, or during the 12-month period preceding the date of distribution of the research report, was, a client of the member [or its affiliates]. In such cases, the research analyst also must disclose the types of services provided to the subject company, if known by the research analyst.

(C) A member or research analyst will not be required to make a disclosure required by paragraphs (h)(2)(A)(ii)(b) and (c), (h)(2)(A)(iii)(b), or (h)(2)(B)(i) and (iii) to the extent such disclosure would reveal material non-public information regarding specific potential future investment banking transactions of the subject company.

(3) through (11) No change.

(12) Records of Public Appearances

Members must maintain records of public appearances by research analysts sufficient to demonstrate compliance by those research analysts with the applicable disclosure requirements under paragraph (h) of this Rule. Such records must be maintained for three years from the date of the public appearance.

(i) Supervisory Procedures

Each member subject to this rule must adopt and implement written supervisory procedures reasonably designed to ensure that the member and its employees comply with the provisions of this rule (including the attestation requirements of Rule 2711(d)(2)), and a senior officer of such a member must attest annually to [the Association]NASD by April 1 of each year that it has adopted and implemented those procedures.

(j) Prohibition of Retaliation Against Research Analysts

No member and no employee of a member who is involved with the member's investment banking activities may, directly or indirectly, retaliate against or threaten to retaliate against any research analyst employed by the member or its affiliates as a result of an adverse, negative, or otherwise unfavorable research report or public appearance written or made by the research analyst that may adversely affect the member's present or prospective investment banking relationship with the subject company of a research report. This prohibition shall not limit a member's authority to discipline or terminate a research analyst, in accordance with the member's policies and procedures, for any cause other than the writing of such an unfavorable research report or the making of such an unfavorable public appearance.

(k) Exceptions for Small Firms

The provisions of paragraph (b) shall not apply to members that over the previous three years, on average per year, have participated in 10 or fewer investment banking services transactions as manager or co-manager and generated \$5 million or less in gross investment banking services revenues from those transactions. For purposes of this paragraph (k), the term "investment banking services transactions" includes the underwriting of both corporate debt and equity securities but not municipal securities. Members that qualify for this exemption must maintain records for three years of any communication that, but for this exemption, would be subject to paragraph (b) of this Rule.