

Notice to Members

JULY 2002

SUGGESTED ROUTING

Executive Representative
Legal & Compliance
Operations
Senior Management

KEY TOPICS

Advertising
Investment Banking
Research Reports

Research Analysts and Research Reports

SEC Approves Rule Governing Research Analysts' Conflicts of Interest

Executive Summary

On May 10, 2002, the SEC approved new NASD Rule 2711, Research Analysts and Research Reports. The rule is intended to improve the objectivity of research and provide investors with more useful and reliable information when making investment decisions. The SEC also approved on that day similar proposed amendments to New York Stock Exchange (NYSE) Rule 472. The rules will be implemented in phases during the period from July 9, 2002, to November 6, 2002.

This *Notice* includes as Attachment A the text of the new rule and the implementation schedule of the rule's effective dates. This *Notice* also includes as Attachment B a Joint Memorandum of NASD and the NYSE that provides interpretive guidance for the NASD and NYSE rules governing research reports and analysts.

Research Reports Must Reflect an Analyst's Actual Opinion

Rule 2711 is intended to restore investor confidence in a process that is critical to the equities markets. The rule reflects a self-policing approach consistent with strong self-regulation. Members and research analysts must take all measures that are necessary to ensure that all research reports reflect an analyst's honest views and that any opinion or recommendation is not influenced by conflicts of interest. If a member issues a report or a research analyst renders an opinion that is inconsistent with the analyst's actual views regarding a subject company, NASD considers such action to constitute a fraudulent act and conduct inconsistent with just and equitable principles of trade.

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Disclosure Required by NASD Rule 2210

The Joint Memorandum discusses interpretive issues that are common to NASD Rule 2711 and NYSE Rule 472 with regard to research reports and research analysts. Members should refer to the Joint Memorandum for a discussion of most of these interpretive issues.

One issue is unique to NASD members, however, and thus covered in this *Notice*. In addition to the disclosures required by Rule 2711, NASD members and research analysts must provide disclosure in research reports that is required by NASD Rule 2210. In two cases, Rule 2711's disclosure requirements operate differently than those under Rule 2210.

First, Rule 2210(d)(2)(B)(i)(a) requires disclosure if the member "*usually makes a market* in the securities being recommended," while Rule 2711(h)(8) requires disclosure if the member "*was making a market* in the subject company's securities *at the time that the research report was published.*" Second, Rule 2210(d)(2)(B)(i)(c) requires disclosure if the member was manager or co-manager of a public offering of any securities of the recommended issuer within the last three years, while Rule 2711(h)(2)(A)(ii)(a) only requires disclosure of this information for the past *12 months*.

In these two situations, a member's compliance with the requirements of Rule 2711(h) will override the disclosure requirements of Rule 2210(d)(2)(B)(i). Members still must comply with all other disclosure requirements of Rule 2210, such as those regarding buying or selling securities on a principal basis and ownership of options, rights, or warrants. Additionally, member communications other than research reports remain subject to all applicable provisions of Rule 2210, including those regarding recommendations.

Questions/Further Information

Questions or comments concerning NASD Rule 2711 or this *Notice* may be directed to the NASD Corporate Financing Department at (240) 386-4623.

ATTACHMENT A: RULE TEXT

Rule 2711. Research Analysts and Research Reports

(a) Definitions

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

- (1) “Investment banking department” means any department or division, whether or not identified as such, that performs any investment banking service on behalf of a member.
- (2) “Investment banking services” 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.
- (3) “Member of a research analyst’s household” means any individual whose principal residence is the same as the research analyst’s principal residence.
- (4) “Public appearance” means any participation in a seminar, forum (including an interactive electronic forum), radio or television interview, or other public speaking activity in which a research analyst makes a recommendation or offers an opinion concerning an equity security.
- (5) “Research analyst” means the associated person who is principally responsible for, and any associated person who reports directly or indirectly to such a research analyst in connection with, preparation of the substance of a research report, whether or not any such person has the job title of “research analyst.”
- (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.
- (7) “Research department” means any department or division, whether or not identified as such, that is principally responsible for preparing the substance of a research report on behalf of a member.

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

(9) “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 Relationship with Research Department

(1) No research analyst may be subject to the supervision or control of any employee of the member’s investment banking department.

(2) Except as provided in paragraph (b)(3), no employee of the investment banking department may review or approve a research report of the member before its publication.

(3) Investment banking 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 any potential conflict of interest, provided that:

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

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

(c) Restrictions on Review of a Research Report by the Subject Company

(1) Except as provided in paragraphs (c)(2) and (c)(3), a member may not submit a research report to the subject company before its publication.

(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) the sections of the research report submitted to the subject company do not contain the research summary, the research rating or the price target;

(B) a complete draft of the research report is provided to the legal or compliance department 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 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) The member may notify a subject company that the member intends to change its rating of the subject company's securities, provided that the notification occurs on the business day before the member announces the rating change, after the close of trading in the principal market of the subject company's securities.

(d) Prohibition of Certain Forms of Research Analyst Compensation

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.

(e) Prohibition of Promise of Favorable Research

No member may directly or indirectly offer favorable research, a specific rating or a specific price target, or threaten to change research, a rating or a price target, to a company as consideration or inducement for the receipt of business or compensation.

(f) Imposition of Quiet Periods

No member may publish a research report regarding a subject company for which the member acted as manager or co-manager of:

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

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

(A) paragraphs (f)(1) and (f)(2) will not prevent a member from publishing a research report concerning the effects of significant news or a significant event on the subject company within such 40- and 10-day periods, and provided further that the legal and compliance department authorizes publication of that research report before it is issued; and

(B) paragraph (f)(2) will not prevent a member from publishing 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).

(g) Restrictions on Personal Trading by Research Analysts

(1) No research analyst account may purchase or receive any securities before the issuer's initial public offering if the issuer is principally engaged in the same types of business as companies that the research analyst follows.

(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) a member may permit a research analyst account to sell securities held by the account that are issued by a company that the research analyst follows, within 30 calendar days after the research analyst began following the company for the member;

(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 pre-approves the research report and any change in the rating or price target.

(3) No research analyst account may purchase or sell any security or any option on or derivative of such security in a manner inconsistent with the research analyst's

recommendation as reflected in the most recent research report published by the member.

(4) A member's legal or compliance department 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 authorizes 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 and the personal trading activities of a research analyst; and

(C) the member maintains written records concerning each transaction and the justification for permitting the transaction for three years following the date on which the transaction is approved.

(5) The prohibitions in paragraphs (g)(1) through (g)(3) do not apply to a purchase or sale of the securities of:

(A) any registered diversified investment company as defined under Section (5)(b)(1) of the Investment Company Act of 1940; or

(B) any other investment fund over which neither the research analyst nor a member of the research analyst's household has any investment discretion or control, provided that:

(i) the research analyst accounts collectively own interests representing no more than 1% of the assets of the fund;

(ii) the fund invests no more than 20% of its assets in securities of issuers principally engaged in the same types of business as companies that the research analyst follows; and

(iii) if the investment fund distributes securities in kind to the research analyst or household member before the issuer's initial public offering, the research analyst or household member must either divest

those securities immediately or the research analyst must refrain from participating in the preparation of research reports concerning that issuer.

(h) Disclosure Requirements

(1) *Ownership and Material Conflicts of Interest*

A member must disclose in research reports and a research analyst must disclose in public appearances:

- (A) if the research analyst or a member of the research analyst's household has a financial interest in the securities of the subject company, and the nature of the financial interest (including, without limitation, whether it consists of any option, right, warrant, future, long or short position);
- (B) if, as of the end of the month immediately preceding the date of publication of the research report or the public appearance (or the end of the second most recent month if the publication date is less than 10 calendar days after the end of the most recent month), the member or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company. Computation of beneficial ownership of securities must be based upon the same standards used to compute ownership for purposes of the reporting requirements under Section 13(d) of the Securities Exchange Act of 1934; and
- (C) any other actual, material conflict of interest of the research analyst or member of which the research analyst knows or has reason to know at the time of publication of the research report or at the time of the public appearance.

(2) *Receipt of Compensation*

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

(B) A research analyst must disclose in public appearances if the analyst knows or has reason to know that the subject company is a client of the member or its affiliates.

(3) *Position as Officer or Director*

A member must disclose in research reports and a research analyst must disclose in public appearances if the research analyst or a member of the research analyst's household serves as an officer, director or advisory board member of the subject company.

(4) *Meaning of Ratings*

A member must define in its research reports 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) Regardless of the rating system that a member employs, a member must disclose in each research report the percentage of all securities rated by the member to which the member would assign a "buy," "hold/neutral," or "sell" rating.

(B) In each research report, the member must disclose the percentage of subject companies within each of these three categories for whom the member has provided investment banking services within the previous twelve months.

(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).

(6) Price Chart

A member must present in any research report concerning an equity security on which the member has assigned any rating for at least one year, a line graph of the security's daily closing prices for the period that the member has assigned any rating or for a three-year period, whichever is shorter. The line graph must:

- (A) indicate the dates on which the member assigned or changed each rating or price target;
- (B) depict each rating and price target assigned or changed on those dates; and
- (C) 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).

(7) Price Targets

A member must disclose in research reports the valuation methods used to determine a 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) Market Making

A member must disclose in research reports if it was making a market in the subject company's securities at the time that the research report was published.

(9) Disclosure Required by Other Provisions

In addition to the disclosure required by this rule, members and research analysts must provide disclosure in research reports and public appearances that is required by applicable law or regulation, including NASD Rule 2210 and the antifraud provisions of the federal securities laws.

(10) Prominence of Disclosure

The disclosures required by this paragraph (h) must be presented on the front page of research reports or the front page must refer to the page on which disclosures are found. Disclosures and references to disclosures must be clear, comprehensive and prominent.

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

When a member distributes a research report covering six or more subject companies, for purposes of the disclosures required in paragraph (h), such research report may direct the reader in a clear manner as to where they may obtain applicable current disclosures in written or electronic format.

(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, and a senior officer of such a member must attest annually to the Association that it has adopted and implemented those procedures.

IMPLEMENTATION SCHEDULE

Pursuant to the SEC's order approving NASD Rule 2711 (Research Analysts and Research Reports) dated May 10, 2002, NASD members must implement the provisions of the rule in accordance with the following schedule:

No later than Wednesday, November 6, 2002:

- + Rule 2711(h)(1)(B) (Disclosure of 1% Firm Ownership) and related written procedures under Rule 2711(i)

No later than Monday, September 9, 2002:

- + Rule 2711(b)(2) and (3) and Rule 2711(c)(1) and (2) (Gatekeeper Functions) and related written procedures under Rule 2711(i)
- + Rule 2711(h)(5) (Disclosure of Distribution of Ratings) and related written procedures under Rule 2711(i)
- + Rule 2711(h)(6) (Disclosure of Price Chart) and related written procedures under Rule 2711(i)

No later than Tuesday, July 9, 2002:

- + All other provisions of Rule 2711



ATTACHMENT B

JOINT MEMORANDUM OF NASD AND THE NEW YORK STOCK EXCHANGE

Discussion and Interpretation of Rules Governing Research Analysts and Research Reports (NASD Rule 2711 and NYSE Rules 351 and 472)

Background

On May 10, 2002, the Securities and Exchange Commission ("SEC") approved new NASD Rule 2711 ("Research Analysts and Research Reports") and amendments to New York Stock Exchange ("NYSE") Rules 351 ("Reporting Requirements") and 472 ("Communications with the Public") with respect to research analysts and research reports (collectively, NASD Rule 2711 and the amendments to NYSE Rules 351 and 472 are referred to as the "SRO Rules").

The SRO Rules implement reforms designed to increase analyst independence and to provide more extensive disclosure of conflicts of interest in research reports and public appearances. Generally, the SRO Rules restrict the relationship between research and investment banking departments; require disclosure of financial interests in covered companies by the analyst and the firm; require disclosure of existing and potential investment banking relationships with subject companies; impose quiet periods for the issuance of research reports; restrict personal trading by analysts; and require disclosure of information that helps investors track the correlation between an analyst's rating and the stock's price movements.

The SRO Rules are being phased in to give members time to adopt compliant systems and procedures. Most provisions of the Rules will go into effect on July 9, 2002, with the following exceptions. The provisions requiring disclosure of firm ownership of 1% or more of any class of common equity securities of the subject company¹ and related written procedures² become effective November 6, 2002. The following rules and their accompanying written procedures become effective on September 9, 2002: the gatekeeper functions;³ the required disclosure of ratings distribution;⁴ and the price charts.⁵ The NYSE had previously issued an information memo outlining the implementation schedule (see NYSE Information Memo No. 02-24, dated May 20, 2002).

1 NASD Rule 2711(h)(1)(B) and NYSE Rule 472(k)(1)(i)a.

2 NASD Rule 2711(i) and NYSE Rule 472(c).

3 NASD Rule 2711(b)(2) and (3), NASD Rule 2711(c)(1) and (2) and NYSE Rule 472(b)(2) and (3).

4 NASD Rule 2711(h)(5) and NYSE Rule 472(k)(2)(iv).

5 NASD Rule 2711(h)(6) and NYSE Rule 472(k)(2)(v).

In its approval order, the SEC noted that NASD and the NYSE (collectively, the “SROs”) would provide interpretive guidance on certain provisions of the SRO Rules. This Joint Memorandum provides that guidance, and addresses certain other issues that NASD and NYSE members have raised since the SEC approved the SRO Rules. This Joint Memorandum does not attempt to address every possible interpretive question or factual scenario that might arise under the Rules. As with other SRO Rules, the NASD and NYSE staffs will consider additional requests for interpretive guidance on a case-by-case basis.

For purposes of the NYSE Rules, the term “research analyst” as used in the Joint Memorandum refers to any “associated person” as that term is defined in NYSE Rule 472.40. In addition, for purposes of the NYSE Rules, the term “member” refers to both members and member organizations of the NYSE.

Definitions

The SRO Rules include a number of definitions that are important to their application. Certain of these definitions are discussed in more detail below.

Investment Banking Services

The SRO Rules⁶ define “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 (private investment, public equity transactions) or similar investments; or serving as placement agent for the issuer. The term also includes acting as a member of a selling group in a securities underwriting.

Household Members

NASD Rule 2711(a)(3) defines the term “member of a research analyst’s household,” and NYSE Rule 472.40 defines the term “household member,” to mean any individual whose principal residence is the same as the research analyst’s principal residence. These terms do not include, however, a roommate, apartment mate or other unrelated person who shares the same residence as a research analyst if that person is not financially dependent on the research analyst, or the research analyst is not financially dependent on that person.

6 NASD Rule 2711(a)(2) and NYSE Rule 472.20.

Public Appearance

“Public appearance” is defined in the SRO Rules⁷ to mean any participation in a seminar, forum (including an interactive electronic forum), radio or television interview, or other public speaking activity in which a research analyst makes a recommendation or offers an opinion concerning an equity security. This term includes a research analyst’s participation in a conference call or Web cast that is open to the public in which the analyst makes a recommendation or offers an opinion concerning an equity security.

Research Analyst and Associated Person

NASD Rule 2711(a)(5) defines “research analyst” to mean “the associated person who is principally responsible for, and any associated person who reports directly or indirectly to such a research analyst in connection with, preparation of the substance of a research report, whether or not any such person has the job title of ‘research analyst.’” NYSE Rule 472.40 defines “associated person” for purposes of its rule to include “a member, allied member, or employee of a member or member organization responsible for, and any person who reports directly or indirectly to such associated person in connection with the making of the recommendation to purchase, sell or hold an equity security in research reports, or public appearances or establish a rating or price target of a subject company’s equity securities.”

These terms do not include every registered person who may express an opinion on an equity security. Thus, for example, the terms exclude registered representatives who recommend securities to their customers, so long as they do not prepare the substance of research reports and do not report to persons who do prepare research reports. The terms also exclude investment advisers, such as mutual fund portfolio managers, who are not principally responsible for preparing the substance of a research report, even if they are registered persons of members.

Research Analyst Account

NASD Rule 2711(a)(6) defines “research analyst account” to mean any account in which a research analyst or member of the research analyst’s household has a financial interest or over which the analyst has discretion or control. NYSE Rule 472 does not include a comparably

7 NASD Rule 2711(a)(4) and NYSE Rule 472.50.

defined term. However, NYSE Rule 472.40 generally applies the rule's personal trading restrictions and disclosure requirements to any account over which an associated person has a financial interest, or over which the associated person exercises discretion or control. Under both NASD Rule 2711(a)(6) and NYSE Rule 472.40, if a research analyst manages the portfolio investments of a registered investment company, the investment company is not a "research analyst account" for purposes of NASD Rule 2711, and is not subject to the personal trading restrictions or disclosure requirements of NYSE Rule 472.

Research Report

Under the SRO Rules,⁸ the term "research report" has four components. A "research report" is (1) a written or electronic communication, (2) that includes an analysis of equity securities of individual companies or industries, (3) that provides information reasonably sufficient upon which to base an investment decision, and (4) that includes a recommendation. Members should consider each communication in this context in determining whether it is or is not a "research report." The term "research report" includes any public communication of a member that falls within the definition, regardless of the means of distribution or whether the report of the member is distributed within or outside the United States.

Member communications that mention or discuss particular equity securities come in a variety of forms, and it is not possible to provide a complete list of all types of communications that fall or do not fall within this definition. The issue of whether a particular communication constitutes a "research report" for purposes of the SRO Rules will turn on the individual facts and circumstances surrounding that communication. The SROs generally would not consider the following communications to be "research reports":

- Reports discussing broad-based indices, such as the Russell 2000 or S&P 500 index, that do not recommend or rate individual securities.
- Reports commenting on economic, political or market conditions that do not recommend or rate individual securities.
- Technical analysis concerning the demand and supply for a sector, index or industry based on trading volume and price.
- Statistical summaries of multiple companies' financial data (including listings of current ratings) that do not include any narrative discussion or analysis of individual companies' data.

⁸ NASD Rule 2711(a)(8) and NYSE Rule 472.10(2).

- Reports that recommend increasing or decreasing holdings in particular industries or sectors but that do not contain recommendations or ratings for individual securities.
- Notices of ratings or price target changes that do not contain any narrative discussion or analysis of the company, provided that the member simultaneously directs the readers of the notice as to where they may obtain the most recent research report on the subject company that includes the disclosures required by the SRO Rules. In no event should such a notice refer to a research report that contains materially misleading disclosure, i.e., where disclosures are no longer applicable or new disclosures would pertain.
- An analysis prepared by a registered representative for a specific customer's account.
- Internal communications that are not given to customers.

For purposes of this definition, the term "equity security" has the same meaning as defined in Section 3(a)(11) of the Securities Exchange Act of 1934 (the "Exchange Act").⁹

Application of the SRO Rules to Third Party Research

The SROs have received a number of questions regarding whether the SRO Rules apply to research distributed by a member that is produced by a third party. In general, the SRO Rules are intended to address conflicts of interest that can arise when a member produces its own research. When a member distributes research produced by an independent third party generated in accordance with a soft-dollar arrangement, the member's disclosure requirements do not apply. If the independent third-party source of the research is also an NASD or NYSE member, the third-party member firm must comply with the applicable SRO Rules' provisions described below.

In some cases, a member may distribute research produced by a non-member affiliate, such as a foreign broker/dealer or an investment adviser, or an independent third party other than through a soft-dollar arrangement. The member must, however, accompany this research with the following disclosures, to the extent applicable:

- the member's and its affiliates' ownership of the subject company's securities;¹⁰
- that the member or its affiliates managed or co-managed a public offering of the subject company's securities in the past 12 months, received compensation for

⁹ See 15 U.S.C. 78c(a)(11).

¹⁰ NASD Rule 2711(h)(1)(B) and NYSE Rule 472(k)(1)(i)a.

investment banking services from the subject company in the past 12 months, or expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months;¹¹

- that the member was making a market in the subject company's securities at the time the research report was published;¹² and
- any other actual, material conflict of interest of the member known at the time of distribution of the research report.¹³

Generally, a member will not be considered to have distributed independent third-party research to a customer when the customer independently requests or accesses such research from the member or the member makes such research available to its customers through the member's or a third party's Web site and customers select their own research.

Prohibition of Certain Forms of Analyst Compensation

The SRO Rules¹⁴ expressly prohibit the payment of a "bonus, salary or other form of compensation to a research analyst that is based upon a specific investment banking services transaction." The SROs have received questions as to the continuing validity of existing contractual arrangements that contain compensation agreements contrary to these SRO Rule provisions.

The SROs are of the view that as of the effective date for that provision of the SRO Rules (July 9, 2002), any contractual provision that provides for compensation based upon specific banking transactions that have not yet closed is inconsistent with the SRO Rules. A member may not pay compensation based on specific investment banking transactions that may have been entered into before the effective date but that will not close until after the effective date. However, research analysts may be compensated, pursuant to contractual agreements executed prior to July 9, 2002, for any investment banking transactions that have closed before that date.

11 NASD Rule 2711(h)(2)(A)(ii) and NYSE Rule 472(k)(1)(ii).

12 NASD Rule 2711(h)(8) and NYSE Rule 472(k)(2)(i).

13 NASD Rule 2711(h)(1)(C) and NYSE Rule 472(k)(1)(i)c as they pertain solely to the member.

14 NASD Rule 2711(d) and NYSE Rule 472(h).

Prohibition of Promises of Favorable Research

The SRO Rules¹⁵ prohibit members from directly or indirectly offering a company favorable research, a specific rating or a specific price target, or threatening to change research, a rating or price target, as consideration or inducement for the receipt of business or compensation. These provisions extend to the research, ratings and price targets issued by an affiliate, since the rule prohibits indirect as well as direct actions.

Nevertheless, these provisions are not intended to prevent a member's investment banking department from obtaining a research analyst's view of a prospective client before committing to undertake an investment banking transaction. They also do not prevent a member from agreeing to provide research as part of its investment banking agreement with a subject company, so long as there is no promise of *favorable* research.

Quiet Periods

The SRO Rules¹⁶ generally prohibit a member from publishing a research report on a company for which the member has acted as manager or co-manager for 40 calendar days after an initial public offering and 10 calendar days after a secondary offering. The SRO Rules provide an exception for publication of research concerning the effects of significant news or a significant event relating to the subject company during those quiet periods. For purposes of these Rules "significant news or a significant event" refers to any news or event that is expected to have a material impact on, or that is expected to cause a material change to, the subject company's operations, earnings or financial condition. The SRO Rules also exempt research reports issued pursuant to SEC Rule 139 for certain secondary offerings of "actively-traded" securities as defined in Rule 101(c)(1) of Regulation M of the Exchange Act.

The SRO Rules impose the 40-day or 10-day quiet periods, as applicable, following the date of the offering. Members have requested clarification of the definition of date of the offering. For NASD Rule 2711(f)(1) and NYSE Rule 472(f)(1) (regarding IPOs), members should use the effective date of the registration statement as the date of the offering. For some secondary offerings, particularly shelf-offerings, the effective date of registration may not be meaningful for the purposes of the Rules. Accordingly, for NASD Rule 2711(f)(2) and NYSE Rule 472(f)(2), the date of offering is the date on which the secondary shares are first offered to the public.

15 NASD Rule 2711(e) and NYSE Rule 472(g).

16 NASD Rule 2711(f) and NYSE Rule 472(f)(1) and (2).

As noted above, the SRO Rules apply only to “equity security” offerings, as that term is defined in Section 3(a)(11) of the Exchange Act. This definition includes convertible debt offerings. The provisions do not apply with respect to straight debt offerings.

The quiet period requirements only apply to IPOs and secondary offerings that occur on or after July 9, 2002. Offerings that occur before July 9, 2002 are not subject to these provisions.

Personal Trading

The SRO Rules¹⁷ impose a number of restrictions on the personal trading of securities in accounts in which a research analyst or a member of his or her household has a financial interest or over which the analyst has discretion or control. For purposes of both SROs’ rules, these accounts are referred to herein as “research analyst accounts.”

Prohibition of Purchasing or Receiving Pre-IPO Securities

The SRO Rules¹⁸ prohibit a research analyst account from purchasing or receiving any securities before the issuer’s initial public offering if the issuer is principally engaged in the same types of business as companies that the research analyst follows. This prohibition applies to shares of any private company that engages in the same types of business that the analyst follows, regardless of whether the company ever goes public.

The SRO Rules do not require a research analyst to divest pre-IPO shares of a company that the research analyst already owned before the SRO Rules’ effective date. However, research analysts in these situations may not provide research on the company unless the analyst has divested all pre-IPO shares in the company.

The SROs have received questions on the meaning of the term “same types of business as companies that the research analyst covers.” As a general matter, a member should assume that an issuer falls within this category if the issuer would be assigned to the analyst if the member began covering the issuer. To the extent that there are still questions, an acceptable approach would be to include all companies that are classified as being in the same industry as the companies that the analyst covers by a nationally recognized system of industry classification.

17 NASD Rule 2711(g) and NYSE Rule 472(e).

18 NASD Rule 2711(g)(1) and NYSE Rule 472(e)(1).

Blackout Periods

The SRO Rules¹⁹ generally prohibit a research analyst account from purchasing or selling 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 5 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. For purposes of this provision, the publication date of a research report is the date that a member first disseminates the report.

Under the SRO Rules,²⁰ a member may permit a research analyst to issue a research report or change a rating or price target for a subject company fewer than 30 days after a research analyst account has traded the subject company's securities if the report or change is due to significant news or a significant event concerning the subject company. The member's legal or compliance department must pre-approve the research report or any change in the subject company's rating or price target.

Exceptions for Investment Funds

The SRO Rules²¹ exclude investments in certain investment funds from the personal trading restrictions in NASD Rule 2711(g)(1) through (g)(3) and NYSE Rule 472(e)(1) through (e)(3). The SRO Rules²² provide that the personal trading restrictions do not apply to investments in registered diversified investment companies as defined in Section 5(b)(1) of the Investment Company Act of 1940.²³ If a research analyst invests in a registered investment company that is not diversified, the investment company must meet the requirements of NASD Rule 2711(g)(5)(B) and NYSE Rule 472(e)(4)(v) in order to be excluded from the personal trading restrictions.

The SRO Rules²⁴ also exclude any other investment fund over which neither the research analyst nor household member has any investment discretion or control from the personal trading restrictions, provided that the fund meets three criteria. First, the research analyst account(s) collectively owns interests representing no more than 1% of the assets of the fund. Second, the fund invests no more than 20% of its assets in the same types of business as companies that

19 NASD Rule 2711(g)(2) and NYSE Rule 472(e)(2).

20 NASD Rule 2711(g)(2)(B) and NYSE Rule 472(e)(4)(ii).

21 NASD Rule 2711(g)(5) and NYSE Rules 472(e)(4)(v) and (vi).

22 NASD Rule 2711(g)(5)(A) and NYSE Rule 472(e)(4)(vi).

23 15 U.S.C. 80a-5(b)(1).

24 NASD Rule 2711(g)(5)(B) and NYSE Rule 472(e)(4)(v).

the research analyst follows.²⁵ Third, if the investment fund distributes securities in kind to the research analyst or household member before the issuer's IPO, the research analyst or household member must either divest those securities immediately or the research analyst must refrain from participating in the preparation of research reports concerning that issuer.

Members have inquired whether holdings of investment funds that were purchased or received prior to July 9, 2002 are excluded from the trading restrictions in the SRO Rules.²⁶ In general, the SROs will not apply the trading restrictions to these investments. However, if a research analyst or household member makes or receives additional investments in those funds after July 9, 2002, all fund holdings would be subject to the trading restrictions to the extent those funds do not meet the requirements of the SRO Rules.²⁷

Members also have inquired as to when the 1% and 20% tests must be measured. In order to qualify for the trading exceptions of the SRO Rules²⁸ an investment fund must meet the 1% and 20% tests each time a research analyst makes or receives additional investments in the fund.

Disclosure Requirements

The SRO Rules impose a number of disclosure requirements on members and research analysts with respect both to research reports and public appearances. Members are reminded that there may be additional disclosures required by SEC Rule 10b-5 or other securities laws and rules. Certain of the SRO Rules' disclosure requirements are discussed below.

Member Ownership of Subject Company Securities

The SRO Rules²⁹ require a member or research analyst to disclose in a research report and a public appearance if, as of the end of the month preceding publication of a research report or a public appearance, the "member or its affiliates" beneficially owned 1% or more of any class of common equity securities of the subject company. Several members have requested guidance as to the scope of "affiliate" ownership in this provision, including whether it encompasses mutual funds managed by an affiliated investment adviser, ownership by member

25 The phrase "same types of business as companies that the research analyst follows" has the same meaning as under the restrictions on purchasing and receiving pre-IPO securities. See discussion of NASD Rule 2711(g)(1) and NYSE Rule 472(e)(1).

26 NASD Rule 2711(g)(1), (2) and (3) and NYSE Rule 472(e)(1), (2) and (3).

27 NASD Rule 2711(g)(5)(B) and NYSE Rule 472(e)(4)(v).

28 NASD Rule 2711(g)(5)(B) and NYSE Rule 472(e)(4)(v).

29 NASD Rule 2711(h)(1)(B) and NYSE Rule 472(k)(1)(i)a.

employees, and trust accounts managed by an affiliated bank. Members have further inquired whether they may, or must, aggregate their affiliate positions for the purposes of the disclosure requirement.

The SRO Rules refer to Section 13(d) of the Exchange Act for the standards to determine what constitutes beneficial ownership. Thus, members must include the holdings of an affiliate or accounts managed by an affiliate to the same extent those holdings are subject to the Section 13(d) reporting requirements. Members should look to the SEC rules promulgated pursuant to Section 13(d) and relevant interpretations by the SEC to determine which affiliate holdings must be included in calculating whether firm ownership meets the 1% disclosure threshold. While firms must aggregate those affiliate positions that fall under the Section 13(d) reporting requirements, firms may additionally show those positions disaggregated from the member's own holdings.

The SRO Rules³⁰ further require disclosure of "any other actual, material conflict of interest" of which the analyst "knows or has reason to know" at the time of the research report or public appearance. Some members have asked whether this requirement creates a duty of inquiry by the analyst to learn of confidential, non-public information. The "knows or has reason to know" language is intended to require disclosure of those material conflicts of interest of which the analyst has actual knowledge, as well as those conflicts that should be reasonably discovered in the ordinary course of business. The provision does not impose a duty on an analyst to inquire concerning confidential, non-public material information that is properly segregated by a firm's informational barriers.

Member Receipt of Compensation from Subject Company

The SRO Rules³¹ require a member to disclose in research reports if the member or its affiliates: (a) managed or co-managed a public offering of the subject company's securities 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. The Rules do not define the term "affiliate" for purposes of this provision.

The SROs deem that the term "affiliate" includes any company that controls, is controlled by, or is under common control with, the member. "Affiliate" does not include individuals employed by the member or an affiliate. "Control" means the power to direct, or cause the

30 NASD Rule 2711(h)(1)(C) and NYSE Rule 472(k)(1)(i)c.

31 NASD Rule 2711(h)(2)(A)(ii) and NYSE Rule 472(k)(1)(ii).

direction of, the management or policies of a company, whether through ownership of securities, by contract or otherwise.³²

Meaning of Ratings

The SRO Rules³³ require a member to define in its research reports the meaning of each rating used by the member in its ratings system. For example, a member might disclose that a “strong buy” rating means that the rated security’s price is expected to appreciate at least 10% faster than other securities in its sector over the next 12-month period.³⁴ The definition of each rating must be consistent with its plain meaning. Thus, for example, a “hold” rating should not mean or imply that an investor should sell a security.

In some cases, a member may employ multiple ratings systems based upon the investor’s time horizon. For example, the member may present ratings for “long,” “intermediate” and “short” term investors. In such cases, the member is required to disclose the meanings of the ratings used in each of the ratings systems.

Distribution of Ratings

The SRO Rules³⁵ require a member to disclose in each research report the percentage of all securities rated by the member to which the member has assigned a “buy,” “hold/neutral” or “sell” rating. For example, a research report might disclose that the member has assigned a “buy” rating to 58% of the securities that it follows, a “hold/neutral” rating to 15%, and a “sell” rating to 27%. The SRO Rules³⁶ require this information to be current as of the end of the most recent calendar quarter. If the publication date of the research report is fewer than 15 calendar days after the end of the most recent calendar quarter, the information must be current as of the second most recent calendar quarter end. If a firm does not employ a rating system that uses the terms “buy,” “hold/neutral” and “sell,” a member must determine, based on its own ratings system, into which of the three categories its ratings fall.

When a member employs multiple ratings systems based on the investor’s time horizon, the member is required to disclose the distributions of the ratings used in each of the ratings systems. As discussed above, the distribution need only reflect ratings of equity securities as defined by Section 3(a)(11) of the Exchange Act.

32 See also NASD Rule 2720(b)(1) and NYSE Rule 2.

33 NASD Rule 2711(h)(4) and NYSE Rule 472(k)(2)(iii).

34 When a rating is defined in terms of a security’s performance relative to the market or sector, there is no requirement also to disclose a member’s market or sector forecast.

35 NASD Rule 2711(h)(5)(A) and NYSE Rule 472(k)(2)(iv).

36 NASD Rule 2711(h)(5)(C) and NYSE Rule 472.70.

The SRO Rules³⁷ require a member to disclose in each research report the percentage of subject companies within each of the three categories (buy, hold/neutral, sell) for which the member has provided investment banking services within the last 12 months. For example, if 20 of the 25 companies to which the member has assigned a “buy” rating are investment banking clients of the member, the member would have to disclose that 80% of the companies that received a “buy” rating are its investment banking clients.

Price Chart

The SRO Rules³⁸ require members to include with any research report in which the member has assigned a rating for at least one year a graph that indicates the correlation between the price movement of the subject security and the ratings and price targets assigned by the member. The line graph must cover the period for which a member has assigned a rating or three years, whichever is shorter. This requirement has raised several questions.

First, members have inquired whether a table may be substituted for the chart when the research report is delivered through a technology that will not allow transmission of graphic illustrations. A member may use a table in such circumstances, provided that the table provides all the required data and is presented in an easily readable format. If a table is used rather than a chart, the table is only required to provide the stock closing prices for the days on which the member assigned or changed a rating or price target. However, members may not opt to use a table format if technology is reasonably available to transmit the information as a chart.

Second, members have asked for guidance to comply with the price chart provision when the member employs multiple ratings systems depending on the investor’s time horizon (e.g., short, intermediate and long-term). In such cases, the price chart must show the ratings and price targets assigned to the subject company’s stock for each ratings system.

Third, members have asked whether the SRO Rules permit inclusion of a benchmark performance, such as the S&P 500 Index, in the price chart. Members may include such benchmarks at their discretion, so long as the information required by the rule is prominent and clearly depicted on the chart. If a member uses a benchmark in a research report’s price chart, the member should use the same benchmark in the price charts for all research reports of subject companies within the same industry or peer group.

37 NASD Rule 2711(h)(5)(B) and NYSE Rules 472(k)(2)(iv) and 472.70.

38 NASD Rule 2711(h)(6) and NYSE Rule 472(k)(2)(v).

Fourth, members have inquired whether they must include information about ratings and price targets assigned before the SRO Rules become effective. Members must include that information on price charts for any security that has been assigned a rating for at least a year before a research report is issued. Members have also asked whether the SROs might exempt firms that do not have the historical information readily available in electronic databases that go back as many as three years from the effective date. The price chart provision does not take effect until September 9, 2002. This date provides adequate time to compile the necessary information, particularly given the fact that existing NASD Rule 2210(b)(2) and NYSE Rule 472(d) (formerly Rule 472(c)) already require firms to maintain a file of all sales literature, including research reports, for three years.

Fifth, members have sought guidance on their obligations when coverage of a security is transferred from one analyst to another, i.e., whether the chart should reflect only the recommendations and price targets of the analyst to whom the security is currently assigned, or whether it should reflect data from all analysts during the period covered by the chart. The price chart is intended to depict the recommendations of the member, not the individual analyst. Consequently, the price chart must reflect all ratings and price targets during the specified period, irrespective of the analyst. The SROs would not object, however, if members chose to include additional information on the price chart that indicates when coverage shifted to a new analyst.

Sixth, some members have asked how “breaks” in coverage affect the obligation to include historical data for securities that have been assigned a rating for at least one year. Breaks in coverage would not restart the clock to determine the one-year coverage period. Moreover, the SROs expect members to indicate the breaks in coverage on the price charts.

Price Targets

The SRO Rules³⁹ require a member to disclose in research reports the valuation methods used to determine a price target. Price targets must have a reasonable basis and must be accompanied by disclosure concerning the risks that may impede achievement of a price target. This provision however does not require a member to include a price target in a research report.

39 NASD Rule 2711(h)(7) and NYSE Rule 472(k)(2)(ii).

Prominence of Disclosure

The disclosures required by the SRO Rules must appear on the front page of the research report or the front page must refer to the page on which disclosures are found. Disclosures and references to disclosures must be clear, comprehensive and prominent.

Electronic research reports may utilize hyperlinks to this disclosure, provided that the first screen that the investor sees clearly and prominently labels the hyperlinks to the required disclosures. When hyperlinks are not possible (such as a report in PDF format), members should follow the requirements for paper reports. Thus, for example, the first printed page of a PDF document must either have the disclosures or refer the reader to the pages where the disclosures appear.

Compendium Reports

If a member distributes a research report covering six or more subject companies, the member is not obligated to include the disclosures required by the SRO Rules, provided that the report directs readers in a clear manner as to where they may obtain applicable current disclosures for all covered companies in written or electronic format. In this regard, a compendium report must provide a toll-free number to call or a postal address to write for the required disclosures. Electronic compendium research reports may instead include a hyperlink to the required disclosures. Paper research reports may also include a web address of the member where the disclosures are located.

While members are not obligated to include these disclosures in a compendium report so long as the report directs readers to where they may obtain the applicable current disclosures, members are encouraged to disclose in the compendium report the distribution of the member's ratings as required by NASD Rule 2711(h)(5) and NYSE Rule 472(k)(2)(iv). Because this disclosure is not unique to a particular subject company, this disclosure will be the same regardless of the number of subject companies covered in a compendium report.

Public Appearances

The SRO Rules require an analyst to disclose the following when making a recommendation during a public appearance: any financial interest held by the analyst or his or her household members; whether the firm and its affiliates, as of the end of the preceding month, held at least a 1% ownership interest in any class of common equity shares of the subject company; any other material conflict of interest of the analyst or firm of which the analyst knows or has reason to know; and whether the subject company is a client of the member or its affiliates. The term "public appearance" is defined and discussed above.

The SROs have received a number of questions regarding these provisions. First, some members asked whether the rule applies to analysts who make public appearances outside of the United States. The SRO Rules apply to any public appearance by a person who meets the definition of research analyst. They do not apply to employees of non-members unless they also are employees of the member.

Second, the SRO Rules⁴⁰ require a research analyst to disclose in public appearances if the analyst knows or has reason to know that the subject company is an investment banking client of the firm. As used herein, the term “client” is intended to include those clients from whom the member received revenues from investment banking services within the last 12 months, or for whom the member expects to provide investment banking services in the next three months, as disclosed in the most recent research report.

Third, several members have inquired whether the public appearance disclosures must be made during an extemporaneous radio or television interview when the research analyst does not possess the required disclosure information. If an analyst cannot make all of the required disclosures during a public appearance then the analyst must decline to make a recommendation or offer an opinion.

A related question is whether a research analyst has complied with the Rules if he or she makes all of the required disclosures during an interview, but the media outlet edits out the disclosures when all or part of the appearance is broadcast. The SROs cannot control the editorial decisions of the media. An analyst will not violate the Rules if he or she makes all of the mandated disclosures with a good faith belief, based on discussions with the media outlet, that those disclosures will be included whenever the appearance is broadcast or rebroadcast. However, when an analyst or a member is aware that a particular media outlet has previously edited out the required disclosures, the SROs expect that an analyst will decline subsequent appearances, absent assurances that the disclosures will not be edited out.

Fourth, members have asked whether the required disclosures may appear in a graphics box or a “scroll” across the screen in lieu of oral disclosures during a television or other video appearance. Such disclosure would satisfy the Rules, provided the graphic includes all of the required information presented in a prominent and readable format during the time of the appearance.

⁴⁰ See NASD Rule 2711(h)(2)(B) (which requires disclosure if the research analyst knows or has reason to know that the subject company is a “client” of the member or its affiliates) and NYSE Rule 472(k)(1)(ii) (which requires disclosure if the associated person knows or has reason to know that the subject company is an “investment banking services client” of the member, member organization or one of its affiliates).

Finally, members have asked for guidance about the types of records that they should maintain to demonstrate compliance with the public appearance provisions of the Rules. Members must maintain records of appearances on television, radio or the Internet that are sufficient to record the statements made by a research analyst. These records may include a transcript or an audio or video tape of such an appearance.