

# Notice to Members

FEBRUARY 2007

## SUGGESTED ROUTING

Corporate Financing  
Legal & Compliance  
Registration  
Senior Management  
Branch Office  
Initial Public Offering

## KEY TOPICS

Office of Supervisory Jurisdiction  
Registration  
Rule 2711 (Research Analysts and  
Research Reports)  
Rule 3010 (Supervision)  
Rule Harmonization  
Supervision

## REQUEST FOR COMMENT

### Rule Harmonization

NASD Requests Comment on Proposed Amendments to Rules 3010(g) and 2711 in connection with the Rule Harmonization Project with the NYSE; **Comment Period Expires March 26, 2007**

#### Executive Summary

NASD is issuing this *Notice to Members* to solicit comments from members and other interested parties on a proposal to amend Rule 3010(g) (Supervision - Definition of "Office of Supervisory Jurisdiction") and Rule 2711 (Research Analysts and Research Reports - Definition of "Initial Public Offering").

Early last year, the New York Stock Exchange (NYSE) and NASD announced a plan to work jointly to harmonize their rulebooks in an effort to eliminate duplicative rules and streamline regulation. Further, on November 28, 2006, NASD and the NYSE announced a plan to consolidate their member regulation operations into a new organization that will be the single self-regulatory organization (SRO) for all securities firms doing business with the public in the U.S. The consolidation plan sets forth a more sensible and less complex regulatory system that will make securities regulation more efficient and effective.

The new SRO will work diligently toward the creation of single rulebook; however, the rule harmonization plan discussed in this NTM is a separate endeavor from the rulebook consolidation project. NASD believes that continuation of the rule harmonization project at this time remains a critical step toward ending duplication and reducing regulatory inefficiency.

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Accordingly, NASD is issuing this *Notice to Members* to solicit comments from members and interested persons on the first round of proposed rules changes as part of the harmonization effort. NASD is proposing to amend Rule 3010(g)(2) to eliminate the definition of "Office of Supervisory Jurisdiction" and adopt definitions for a "supervisory branch office," a "limited supervisory branch office," a "non-supervisory branch office" and "non-branch office." NASD is also seeking comment on a proposal to amend Rule 2711 to define the term "initial public offering" consistent with the definition of such term in NYSE Rule 472.

### Action Requested

NASD requests comment on the proposed amendments. Comments must be received by March 26, 2007. Members and interested persons can submit their comments using the following methods:

- Emailing comments to [pubcom@nasd.com](mailto:pubcom@nasd.com)
- Mailing comments in hard copy to:

Barbara Z. Sweeney  
NASD  
Office of the Corporate Secretary  
1735 K Street, NW  
Washington, D.C. 20006-1506

**Important Notes:** The only comments that will be considered are those submitted pursuant to the methods set forth above. All comments received in response to this *Notice* will be made available to the public on the NASD Web site. Generally, comments will be posted on the NASD Web site one week after the end of the comment period.<sup>1</sup>

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the NASD Board, and then must be approved by the SEC, following publication for public comment in the Federal Register.<sup>2</sup>

### Questions/Further Information

As noted, hard copy comments should be submitted to Barbara Z. Sweeney. Questions concerning this *Notice* should be directed to Kosha K. Dalal, Associate General Counsel, Office of General Counsel, at (202) 728-6903.

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## Background

### Rule Harmonization Project

Early last year, NASD and the NYSE announced a plan to work jointly to harmonize their rulebooks in an effort to eliminate duplicative rules and streamline regulation. A series of industry committees was convened to assist in the detailed work required to bring the two rulebooks into line. The industry committees reviewed a wide range of rules, including all rules in the NASD and NYSE manuals covering sales practices, supervision, financial and operational obligations, registration, and qualification and continuing education requirements.

Further, on November 28, 2006, NASD and the NYSE announced a plan to consolidate their member regulation operations into a new organization that will be the single SRO for all securities firms doing business with the public in the U.S. On January 19, 2007, NASD member firms approved By-Law changes necessary for the proposed consolidation. The consolidation plan sets forth a more sensible and less complex regulatory system that will make securities regulation more efficient and effective. The By-Laws amendments will be sent to the Securities and Exchange Commission (SEC) for approval. NASD currently expects to have all the necessary approvals and a final agreement with the NYSE completed in the second quarter of 2007.

NASD believes that continuation of the rule harmonization project at this time remains a critical step toward ending duplication and reducing regulatory inefficiency. As part of an initial round of changes, NASD is soliciting comment on proposed amendments to Rules 3010(g)(1) and 2711.

## Discussion

### Rule 3010(g)(1)

Rule 3010(g)(1) defines the term "Office of Supervisory Jurisdiction" to mean any office of a member at which any one or more of the following functions take place: (a) order execution and/or market making; (b) structuring of public offerings or private placements; (c) maintaining custody of customers' funds and/or securities; (d) final acceptance (approval) of new accounts on behalf of the member; (e) review and endorsement of customer orders, pursuant to paragraph (d) above; (f) final approval of advertising or sales literature for use by persons associated with the member, pursuant to Rule 2210(b)(1); or (g) responsibility for supervising the activities of persons associated with the member at one or more other branch offices of the member.

One recommendation of the industry committee was that NASD consider eliminating its definition of OSJ to prevent locations where the only activity being conducted is principal review and approval of research reports from being classified as branch offices under Rule 3010(g).

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In July 2006, amendments to NASD's branch office definition under Rule 3010(g)(2) went into effect (Uniform Branch Office Definition). The Uniform Branch Office Definition was developed collectively by NASD, the NYSE and NASAA to establish a broad national standard. In conjunction with the new Uniform Branch Office Definition, a new Form BR was introduced to provide a more efficient, standardized method for members to register branch office locations.

While the SROs have sought to adopt consistent interpretations of the new Uniform Branch Office Definition, NASD and the NYSE have different classifications of a location where final approval by a principal of research reports occurs. Under NASD's current rules, final review of advertising or sales literature (which includes research reports) makes a location an OSJ, and therefore a branch office. The NYSE, however, does not have an OSJ definition and stated in NYSE *Information Memorandum 06-13* that it deems a location where a member stations a Series 16 qualified supervisory analyst solely to review research reports as a "non-sales location," which is an express exclusion from the Uniform Branch Office Definition.<sup>3</sup> Because of NASD's OSJ definition, NASD could not permit such locations to qualify as "non-sales locations" under the Uniform Branch Office Definition.

This inconsistency led the industry committee to recommend that NASD consider eliminating its OSJ definition to prevent such locations from being treated differently by the two SROs.

As a result, NASD is proposing to eliminate the definition of OSJ from NASD's rulebook. In its place, NASD proposes to adopt express definitions for the terms "supervisory branch office," "limited supervisory branch office," "non-supervisory branch office," and "non-branch locations." NASD believes this proposal will simplify the current structure by clearly delineating, in one rule, four classifications for member offices and the supervisory and inspection obligations that attach to each. In addition, with the proposed elimination of the term "OSJ," locations that conduct only final review of research reports would no longer be classified as OSJs and thereby required to register as branch offices. Such locations would become "non-branch locations."

The functions that currently make a location an OSJ would be captured in a proposed new definition of "supervisory branch office." A "supervisory branch office" would be any location that performs all the functions currently included in the OSJ definition, except for locations at which the only activity being conducted is the final review of research reports. A location that supervises one or more other supervisory branch offices, one or more limited supervisory branch offices, or one or more non-supervisory branch offices would be deemed a "supervisory branch office." A main office of a member may qualify as a supervisory branch office. Like the current system for OSJs, an appropriately registered principal would have to be on-site at a supervisory branch office as provided in Rule 3010(a)(4) and such location would be subject to an annual inspection cycle as provided in Rule 3010(c)(1)(A).

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A “limited supervisory branch office” would be any location of the member that supervises one or more non-branch locations and does not supervise any supervisory branch offices or any other limited supervisory branch offices. A main office of a member may qualify as a limited supervisory branch office. Like the current system, such location would be subject to branch office registration and would be subject to an annual inspection cycle as provided in Rule 3010(c)(1)(A). But, the office would not be required to have an appropriately registered principal on-site as provided in Rule 3010(a)(4).

A “non-supervisory branch office” would be any location of the member that satisfies the definition of branch office, but does not qualify as a supervisory branch office or limited supervisory branch office. A main office of a member may qualify as a non-supervisory branch office. Like the current system for non-OSJ branch offices, a non-supervisory branch office would be subject to branch office registration, but would not be required to have an appropriately registered principal on-site, but must have one or more appropriately registered representatives or principals on-site with authority to carry out the supervisory responsibilities assigned to that office by the member (“person-in-charge”) as provided in Rule 3010(a)(4), and such location would be subject to inspection at least every three years as provided in Rule 3010(c)(1)(B).

A “non-branch location” would be any location of the member, including but not limited to a main office, that does not qualify as a supervisory branch office, a limited supervisory branch office, or a non-supervisory branch office. In addition, a “non-branch location” would include any of the following locations, provided such locations do not engage in any other activities that would require branch office registration: (A) a location that qualifies for an exclusion from the definition of “branch office” pursuant to Rule 3010(g)(2); (B) a location that engages solely in final approval of research reports by a person registered in a principal capacity (or equivalent NYSE registration category, e.g., Series 16) for use by persons associated with the member pursuant to Rule 2210(b)(1) provided no other sales functions are conducted and the location is not held out to the public as a branch office; (C) a location that engages solely in soliciting a member’s “investment banking services” as defined in NASD Rule 2711 (and NYSE Rule 472.20) provided no other sales functions are conducted and the location is not held out to the public as a branch office; or (D) a location that engages solely in proprietary trading or securities lending provided no other sales functions are conducted and the location is not held out to the public as a branch office.<sup>4</sup> A non-branch location would not be required to register as a branch office. Further, a non-branch location would be permitted to engage in a combination of the activities described above provided the location does not engage in any activities that would otherwise require branch office registration. Non-branch locations would not be required to have an appropriately registered principal on-site and would be subject to a regular inspection cycle established by the member as provided in Rule 3010(c)(1)(C).

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### **Rule 2711**

Rule 2711 (Research Analysts and Research Reports), among other things, imposes quiet periods after an initial public offering during which a member is prohibited from publishing or otherwise distributing research and also restricts research analysts from purchasing or owning certain securities issued before a company's initial public offering. NASD Rule 2711 does not, however, define the term "initial public offering."

The industry committee recommended that NASD add an express definition of the term "initial public offering" for purposes of its research analyst rule to make it consistent with the NYSE research analyst rule. NYSE Rule 472 defines the term "initial public offering" for purposes of NYSE's research analyst rule as "the initial registered equity security offering by an issuer, regardless of whether such issuer is subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, prior to the time of the filing of such issuer's registration statement."

Specifically, Rule 2711(f)(1) provides that a member may not publish or otherwise distribute a research report and that a research analyst may not make a public appearance regarding a subject company for which the member has acted as manager or co-manager of, among other things, an initial public offering for 40 calendar days following the date of the offering. Rule 2711(f)(2) imposes a 25-day quiet period after an initial public offering on any other member that has agreed to participate or is participating as an underwriter or dealer in such offering.<sup>5</sup> Further, Rule 2711(g)(1) restricts a research analyst from purchasing or receiving any securities before an issuer's initial public offering if the issuer is principally engaged in the same types of businesses as the companies that the research analyst follows.

While Rule 2711 does not expressly define the term "initial public offering," NASD has interpreted the term as used in Rule 2711 to have the same meaning as in NYSE Rule 472. As a result, NASD is proposing to amend Rule 2711 to codify this interpretation.

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## Endnotes

- 1 See *Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments). Personal identifying information, such as names or email addresses, will not be edited from submissions. Submit only information that you wish to make publicly available.
- 2 Section 19 of the Securities Exchange Act (Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has authority to summarily abrogate these types of rule changes within 60 days of filing. See Exchange Act Section 19 and the rules thereunder.
- 3 See *NYSE Information Memorandum 06-13* (March 22, 2006) Joint Interpretive Guidance from NYSE and NASD Relating to the Uniform Branch Office Definition, Question and Answer #5.
- 4 Proposed subparagraphs (C) and (D) are currently excluded from the Uniform Branch Office Definition in *Notice to Members 06-12* and *NYSE Information Memorandum 06-13* as qualifying for the “non-sales location” exclusion. The proposal would amend the rule text to reflect these exclusions.
- 5 A proposed rule change pending with the Commission would amend the rule to establish a unified 25-day quiet period for all underwriters and dealers, irrespective of whether a member acts as a lead or co-manager.

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