

October 25, 2002

Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: **File No. SR-NASD-2002-154** – Proposed Amendments to Rules Governing Research
Analyst Conflicts of Interest

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed please find the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Philip Shaikun, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8451; e-mail philip.shaikun@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Barbara Z. Sweeney
Senior Vice President
and Corporate Secretary

Enclosures

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C.

Form 19b-4

Proposed Rule Change

by

NASD

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”) and Rule 19b-4 thereunder, NASD is filing with the Securities and Exchange Commission (“SEC” or “Commission”) proposed amendments to NASD Rules 1120 and 2711, and a proposed rule change to create a new NASD Rule 1050, to expand upon recently approved rules that govern research analyst conflicts of interest. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

Rule 1050. Registration of Research Analysts

All persons associated with a member who are to function as research analysts as that term is defined in Rule 2711 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.

* * *

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) – (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, and to the immediate supervisors of such persons, and to any person registered as a research analyst pursuant to Rule 1050 (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, training in ethics, professional responsibility and the requirements of Rule 2711.

(3) – (4) (No change.)

* * *

Rule 2711. Research Analysts and Research Reports

(a) Definitions

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

(1) – (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 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.”

Solely for purposes of paragraph (g), the term “research analyst” also includes such other persons as the director of research, supervisory analyst, or member of a committee who

have direct influence or control with respect to (A) the preparation of research reports, or (B) establishing or changing a rating or price target of a subject company's equity securities.

(6) – (9) (No change.)

(b) (No change.)

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

(1) – (3) (No change.)

(4) No research analyst may issue a research report or make a public appearance concerning a subject company if the research analyst engaged in any communication with the subject company in furtherance of obtaining investment banking business prior to the time the subject company entered into a letter of intent or other written agreement with the member designating the member as an underwriter of an initial public offering by the subject company. This provision shall not apply to any due diligence communication between the research analyst and the subject company, the sole purpose of which was to analyze the financial condition and business operations of the subject company.

(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) A research analyst's compensation 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 a research analyst's compensation:

- (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 determining the research analyst's compensation his or her contributions to the member's investment banking business.

The committee must document the basis upon which each research analyst's compensation was established. The annual attestation required by Rule 2711(i) must certify that the committee reviewed and approved each 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 a research report regarding a subject company or recommend a subject company's securities in a public appearance 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 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)](ii) paragraph (f)[(2)](1)(B) 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).

(3) No member that has acted as a manager or co-manager of a securities offering may publish 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 a research report concerning the effects of significant news or a significant event on the subject company within such period, provided that the legal and compliance department authorized publication of that research report before it is

issued.

(4) If a member intends to discontinue its research coverage of a subject company, notice of this withdrawal must be made in the same manner as when research coverage was first initiated by the member and must include the member's final recommendation or rating.

(g) – (i) (No change.)

* * *

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The Board of Directors of NASD Regulation, Inc. approved the proposed rule change at its meeting on September 25, 2002, and authorized the filing of the rule change with the SEC. Counsel for The Nasdaq Stock Market and NASD Dispute Resolution have been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by NASD to its Subsidiaries. The NASD Board of Governors approved the proposed rule change at its meeting on September 26, 2002. No other action by the NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of

Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt NASD Rules without recourse to the membership for approval.

NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be no less than 30 days following publication of the Notice to Members announcing Commission approval.

(b) Questions regarding this rule filing may be directed to Philip Shaikun, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8451.

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

(a) Purpose

1. *Background*

In May 2002, the SEC approved new NASD Rule 2711 and similar amendments to existing New York Stock Exchange (“NYSE”) rules that increased the regulation of research analysts and research reports.¹ The new rules are intended to improve the objectivity of research and provide investors with more useful and reliable information when making investment decisions. Most of the new rules’ provisions became effective on July 9, 2002, although some provisions took effect on September 9, 2002, and one provision will take effect on November 6,

¹ See SEC Release No. 34-45908 (May 10, 2002), 67 Fed. Reg. 34968 (May 16, 2002). See also SEC Release No. 34-46402 (June 6, 2002), 67 Fed. Reg. 40361 (June 12, 2002) (correcting language contained in Rule 2711(h)).

2002. Additionally, in July 2002, the SEC approved an NASD rule proposal to delay until November 6, 2002 the effectiveness of certain provisions for certain members with foreign affiliates, certain research analysts that are divesting the securities of all subject companies that they cover, and certain defined small firms.²

In June 2002, NASD and the NYSE issued a joint memorandum that provided members with the new rule language, as well as interpretive guidance on a number of Rule 2711's provisions.³ NASD and the NYSE also have been examining members' research practices to determine compliance with the new research analyst rules.

As a result of the examinations and further discussions with the SEC staff, NASD and NYSE agreed that additional rules governing members' research activities are necessary to protect investors. This rule change proposal would effectuate those additional safeguards. Generally, the proposed amendments would further separate analyst compensation from investment banking influence, prohibit analysts from issuing "booster shot" research reports, prohibit analysts from participating in "bake-off" meetings with prospective investment banking clients, require members to publish a final research report when they terminate coverage of a subject company, impose registration, qualification and continuing education requirements on research analysts, and make certain other changes.

These amendments do not implement changes that may be required pursuant to the research analyst provisions of the Sarbanes-Oxley Act of 2002. NASD anticipates filing additional proposed amendments to Rule 2711 in the future to meet the requirements of that Act

² See SEC Release No. 34-46165 (July 3, 2002), 67 Fed. Reg. 46555 (July 15, 2002).

³ See Notice to Members 02-39 (July 2002).

after further discussions with NYSE and SEC staff.

A more detailed discussion of the proposed rule change follows.

2. *Analyst Compensation*

The proposed amendments would require members to further separate analyst compensation from investment banking influence by imposing new restrictions on the manner in which research analysts may be compensated. The rule proposal would require members to employ a compensation committee that reports to the member's board of directors (or if the member does not have a board of directors, a senior executive officer of the member) responsible for reviewing and approving analyst compensation at least annually. The committee could not have representation from the member's investment banking department. In determining an analyst's compensation, the committee would have to consider the research analyst's individual performance, including the analyst's productivity and research quality, the correlation between the analyst's recommendations and stock price performance, and overall ratings of clients, sales force, and peers independent of the member's investment banking department. The committee could not consider the analyst's contributions to the member's investment banking business.

The committee would be required to document the basis for establishing the analyst's compensation. The member also would have to attest annually to NASD that the committee reviewed and approved each analyst's compensation and documented the basis upon which the compensation was established.

3. *Restrictions on Publishing Research Reports and Public Appearances*

The proposed amendments would make several changes to current Rule 2711(f), which imposes "quiet periods" on members during which members may not publish research reports

following an initial or secondary public offering of securities. First, the proposed amendments would extend the quiet period prohibitions to public appearances by research analysts as well as to the issuance of research reports.

Second, the proposed amendments would prohibit “booster shot” research reports or public appearances around the time of the expiration, waiver or termination of a “lock-up” agreement. Members often enter into lock-up agreements with subject companies or their shareholders that restrict or prohibit the sale of a subject company’s or its shareholder’s securities for a defined period after the completion of a securities offering. This provision would prohibit members from publishing a research report or making a public appearance concerning a subject company for 15 days prior to or after the expiration, waiver or termination of a lock-up agreement, thus helping prevent members from publishing favorable research that is intended to benefit the shareholders whose lock-up agreement is no longer in effect by driving up the price of the issuer’s shares. However, the rule proposal includes an exception that would allow members to publish research reports during this quiet period to comment on the effect of significant news or a significant event on the subject company, provided that the legal and compliance department authorizes the publication of the report before it is issued. A similar exception exists with respect to quiet periods in the current rule.

Third, the proposed amendments would require a member that decides to terminate coverage of a subject company to publish a notice of this termination, and to publish a final rating or recommendation of the subject company’s securities (assuming the member had issued a prior rating or recommendation). This provision is intended to eliminate the practice of dropping coverage of a subject company rather than lowering a rating or recommendation.

4. *Bake-offs*

The proposed amendments would prohibit a research analyst from issuing a research report or making a public appearance concerning a subject company if the research analyst communicated with the subject company in furtherance of obtaining investment banking business before the subject company had entered into a letter of intent or other written agreement designating the member as an underwriter of an initial public offering of the subject company. This provision would not apply to due diligence communications between an analyst and a subject company where the sole purpose is to analyze the financial condition and business operations of the subject company. The purpose of this provision is to prevent research analysts from attending “bake-off” meetings or otherwise communicating with a subject company where the intention is to pitch the member’s investment banking services.

5. *Registration, Qualification and Continuing Education of Research Analysts*

The proposed amendments would create new NASD Rule 1050, which would require all persons associated with a member that function as research analysts, as that term is defined in Rule 2711, to register with NASD. Before these persons’ registrations could become effective, they would be required to pass a qualification examination for research analysts specified by NASD. The proposed amendments also would amend Rule 1120 to require research analysts to participate in the regulatory element and firm element of a member’s continuing education program. The firm element program would have to include research analysts’ training and education in ethics, professional responsibility and the requirements of Rule 2711.

6. *Definitions*

The proposed amendments would revise the definition of “research analyst” to include

supervisors of research analysts, including directors of research and members of supervisory committees. The proposed expanded definition would apply only with respect to the personal trading restrictions of Rule 2711(g). NASD believes the amendment is necessary because these supervisory personnel review and often greatly influence the content of and recommendation contained in research reports and therefore should be subject to the same trading restrictions, such as the prohibition on trading against the member's recommendation. The other provisions of Rule 2711 that govern research analyst conduct and disclosures would not apply to supervisors of research analysts.

Additionally, the definition of "public appearance" would be revised to include interviews with print media and the writing of a print media article. NASD believes that opinions and recommendations made in the print media carry the same need for transparency as those made in radio and television interviews, which are covered by the current definition. As discussed in NASD's *Notice to Members* 02-39, an analyst would not violate the rule if, after making all the required disclosures in a public appearance, the media outlet edits out the disclosures before final publication. However, when an analyst or a member is aware that a particular medial outlet has previously edited out the required disclosures, the analyst would be expected to decline further interviews with that media outlet, absent assurances that the disclosures would not be edited out.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which require, among other things, that NASD's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles

of trade, and, in general, to protect investors and the public interest. NASD believes that this proposed rule change will reduce or expose conflicts of interest and thereby significantly curtail the potential for fraudulent and manipulative acts. NASD further believes that the proposed rule change will provide investors with better and more reliable information with which to make investment decisions.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received for this proposed rule change.

6. Extension of Time Period for Commission Action

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

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

Not applicable.

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

The NYSE filed with the Commission on October 9, 2002 a substantially similar proposed rule expanding upon its rules governing conflicts of interest related to research reports and research analysts of its members on or around the filing date of this proposed rule change. Although the NYSE proposed rule change differs in the language used from this proposed rule

change, it is intended to be substantially similar to this proposed rule change.

9. Exhibits

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

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

NASD, INC.

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

Date: October 25, 2002

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-NASD-2002-154)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by NASD Relating to
Research Analysts Conflicts of Interest

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on October 25, 2002, NASD filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF
SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD is proposing to amend its rules to establish new NASD Rule 2711 to address research analyst conflicts of interest. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

Rule 1050. Registration of Research Analysts

All persons associated with a member who are to function as research analysts as that term is defined in Rule 2711 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.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

* * *

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) – (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

(3) 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, and to the immediate supervisors of such persons, and to any person registered as a research analyst pursuant to Rule 1050 (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.

(4) 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:

(iv) General investment features and associated risk factors;

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

(vi) Applicable regulatory requirements[.]; and

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

(3) – (4) (No change.)

* * *

Rule 2711. Research Analysts and Research Reports

(a) Definitions

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

(1) – (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 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.”

Solely for purposes of paragraph (g), the term “research analyst” also includes such other persons as the director of research, supervisory analyst, or member of a committee who have direct influence or control with respect to (A) the preparation of research reports, or (B) establishing or changing a rating or price target of a subject company’s equity securities.

(6) – (9) (No change.)

(b) (No change.)

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

(1) – (3) (No change.)

(4) No research analyst may issue a research report or make a public appearance concerning a subject company if the research analyst engaged in any communication with the subject company in furtherance of obtaining investment banking business prior to the time the subject company entered into a letter of intent or other written agreement with the member designating the member as an underwriter of an initial public offering by the

subject company. This provision shall not apply to any due diligence communication between the research analyst and the subject company, the sole purpose of which was to analyze the financial condition and business operations of the subject company.

(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) A research analyst's compensation 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 a research analyst's compensation:

- (D) the research analyst's individual performance, including the analyst's productivity and the quality of the analyst's research;
- (E) the correlation between the research analyst's recommendations and the stock price performance; and
- (F) 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 determining the research analyst's compensation his or her contributions to the member's investment banking business.

The committee must document the basis upon which each research analyst's

compensation was established. The annual attestation required by Rule 2711(i) must certify that the committee reviewed and approved each 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 a research report regarding a subject company or recommend a subject company's securities in a public appearance 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 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)](ii) paragraph (f)[(2)](1)(B) 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).

(3) No member that has acted as a manager or co-manager of a securities offering may publish 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 a research report concerning the effects of significant news or a significant event on the subject company within such period, provided that the legal and compliance department authorized publication of that research report before it is issued.

(4) If a member intends to discontinue its research coverage of a subject company, notice of this withdrawal must be made in the same manner as when research coverage was first initiated by the member and must include the member's final recommendation or rating.

(g) – (i) (No changes.)

* * *

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

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) **Purpose**

1. *Background*

In May 2002, the SEC approved new NASD Rule 2711 and similar amendments to existing New York Stock Exchange (“NYSE”) rules that increased the regulation of research analysts and research reports.³ The new rules are intended to improve the objectivity of research and provide investors with more useful and reliable information when making investment decisions. Most of the new rules’ provisions became effective on July 9, 2002, although some provisions took effect on September 9, 2002, and one provision will take effect on November 6, 2002. Additionally, in July 2002, the SEC approved an NASD rule proposal to delay until November 6, 2002 the effectiveness of certain provisions for certain members with foreign affiliates, certain research analysts that are divesting the securities of all subject companies that they cover, and certain defined small firms.⁴

³ See SEC Release No. 34-45908 (May 10, 2002), 67 Fed. Reg. 34968 (May 16, 2002). See also SEC Release No. 34-46402 (June 6, 2002), 67 Fed. Reg. 40361 (June 12, 2002) (correcting language contained in Rule 2711(h)).

⁴ See SEC Release No. 34-46165 (July 3, 2002), 67 Fed. Reg. 46555 (July 15, 2002).

In June 2002, NASD and the NYSE issued a joint memorandum that provided members with the new rule language, as well as interpretive guidance on a number of Rule 2711's provisions.⁵ NASD and the NYSE also have been examining members' research practices to determine compliance with the new research analyst rules.

As a result of the examinations and further discussions with the SEC staff, NASD and NYSE agreed that additional rules governing members' research activities are necessary to protect investors. This rule change proposal would effectuate those additional safeguards. Generally, the proposed amendments would further separate analyst compensation from investment banking influence, prohibit analysts from issuing "booster shot" research reports, prohibit analysts from participating in "bake-off" meetings with prospective investment banking clients, require members to publish a final research report when they terminate coverage of a subject company, impose registration, qualification and continuing education requirements on research analysts, and make certain other changes.

These amendments do not implement changes that may be required pursuant to the research analyst provisions of the Sarbanes-Oxley Act of 2002. NASD anticipates filing additional proposed amendments to Rule 2711 in the future to meet the requirements of that Act after further discussions with NYSE and SEC staff.

A more detailed discussion of the proposed rule change follows.

2. *Analyst Compensation*

The proposed amendments would require members to further separate analyst compensation from investment banking influence by imposing new restrictions on the manner in

⁵ See Notice to Members 02-39 (July 2002).

which research analysts may be compensated. The rule proposal would require members to employ a compensation committee that reports to the member's board of directors (or if the member does not have a board of directors, a senior executive officer of the member) responsible for reviewing and approving analyst compensation at least annually. The committee could not have representation from the member's investment banking department. In determining an analyst's compensation, the committee would have to consider the research analyst's individual performance, including the analyst's productivity and research quality, the correlation between the analyst's recommendations and stock price performance, and overall ratings of clients, sales force, and peers independent of the member's investment banking department. The committee could not consider the analyst's contributions to the member's investment banking business.

The committee would be required to document the basis for establishing the analyst's compensation. The member also would have to attest annually to NASD that the committee reviewed and approved each analyst's compensation and documented the basis upon which the compensation was established.

4. Restrictions on Publishing Research Reports and Public Appearances

The proposed amendments would make several changes to current Rule 2711(f), which imposes "quiet periods" on members during which members may not publish research reports following an initial or secondary public offering of securities. First, the proposed amendments would extend the quiet period prohibitions to public appearances by research analysts as well as to the issuance of research reports.

Second, the proposed amendments would prohibit "booster shot" research reports or public appearances around the time of the expiration, waiver or termination of a "lock-up"

agreement. Members often enter into lock-up agreements with subject companies or their shareholders that restrict or prohibit the sale of a subject company's or its shareholder's securities for a defined period after the completion of a securities offering. This provision would prohibit members from publishing a research report or making a public appearance concerning a subject company for 15 days prior to or after the expiration, waiver or termination of a lock-up agreement, thus helping prevent members from publishing favorable research that is intended to benefit the shareholders whose lock-up agreement is no longer in effect by driving up the price of the issuer's shares. However, the rule proposal includes an exception that would allow members to publish research reports during this quiet period to comment on the effect of significant news or a significant event on the subject company, provided that the legal and compliance department authorizes the publication of the report before it is issued. A similar exception exists with respect to quiet periods in the current rule.

Third, the proposed amendments would require a member that decides to terminate coverage of a subject company to publish a notice of this termination, and to publish a final rating or recommendation of the subject company's securities (assuming the member had issued a prior rating or recommendation). This provision is intended to eliminate the practice of dropping coverage of a subject company rather than lowering a rating or recommendation.

4. Bake-offs

The proposed amendments would prohibit a research analyst from issuing a research report or making a public appearance concerning a subject company if the research analyst communicated with the subject company in furtherance of obtaining investment banking business before the subject company had entered into a letter of intent or other written agreement

designating the member as an underwriter of an initial public offering of the subject company. This provision would not apply to due diligence communications between an analyst and a subject company where the sole purpose is to analyze the financial condition and business operations of the subject company. The purpose of this provision is to prevent research analysts from attending “bake-off” meetings or otherwise communicating with a subject company where the intention is to pitch the member’s investment banking services.

5. *Registration, Qualification and Continuing Education of Research Analysts*

The proposed amendments would create new NASD Rule 1050, which would require all persons associated with a member that function as research analysts, as that term is defined in Rule 2711, to register with NASD. Before these persons’ registrations could become effective, they would be required to pass a qualification examination for research analysts specified by NASD. The proposed amendments also would amend Rule 1120 to require research analysts to participate in the regulatory element and firm element of a member’s continuing education program. The firm element program would have to include research analysts’ training and education in ethics, professional responsibility and the requirements of Rule 2711.

6. *Definitions*

The proposed amendments would revise the definition of “research analyst” to include supervisors of research analysts, including directors of research and members of supervisory committees. The proposed expanded definition would apply only with respect to the personal trading restrictions of Rule 2711(g). NASD believes the amendment is necessary because these supervisory personnel review and often greatly influence the content of and recommendation contained in research reports and therefore should be subject to the same trading restrictions,

such as the prohibition on trading against the member's recommendation. The other provisions of Rule 2711 that govern research analyst conduct and disclosures would not apply to supervisors of research analysts.

Additionally, the definition of "public appearance" would be revised to include interviews with print media and the writing of a print media article. NASD believes that opinions and recommendations made in the print media carry the same need for transparency as those made in radio and television interviews, which are covered by the current definition. As discussed in NASD's *Notice to Members* 02-39, an analyst would not violate the rule if, after making all the required disclosures in a public appearance, the media outlet edits out the disclosures before final publication. However, when an analyst or a member is aware that a particular media outlet has previously edited out the required disclosures, the analyst would be expected to decline further interviews with that media outlet, absent assurances that the disclosures would not be edited out.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which require, among other things, that NASD's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that this proposed rule change will eliminate or expose conflicts of interest and thereby significantly curtail the potential for fraudulent and manipulative acts. NASD further believes that the proposed rule change will provide investors with better and more reliable information with which to make investment decisions.

(B) Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received for this proposed rule change.

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

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- A. by order approve such proposed rule change, or
- B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those

that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Jonathan G. Katz
Secretary