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Assistant General Counsel

December 18, 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: **SR-NASD-2002-154, Amendment No. 1** – Proposed Amendments to Rules Governing  
Research Analyst Conflicts of Interest

Dear Ms. England:

Pursuant to our conversations with James Brigagliano of the Division of Market Regulation, NASD hereby submits Amendment No. 1 to SR-NASD-2002-154, which was filed with the Securities and Exchange Commission (“SEC”) on October 25, 2002 (the “Rule Filing”). As discussed in more detail below, this amendment makes four changes to the rule proposal. First, NASD is inserting language in proposed Rule 1050 to clarify that only research analysts who are directly responsible for the preparation of research reports (as opposed to indirect supervisors or others who are not directly responsible) would be required to register with NASD and pass a qualification examination. Second, NASD is conforming its proposed research analyst compensation provisions to comparable provisions in the New York Stock Exchange’s (“NYSE”) research analyst rule amendments.<sup>1</sup> Third, NASD is amending the definition of “research report” to conform it with the requirements of the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”). Fourth, NASD is revising certain language that was contained in the discussion of the proposed amendment concerning print media interviews and articles.

Exhibit A (attached) shows all of the changes from current NASD rules that would result from the Rule Filing and this Amendment No. 1.

*Research Analyst Registration and Qualification*

The Rule Filing included a new proposed NASD Rule 1050, which would require all persons who function as research analysts as that term is defined in NASD Rule 2711 to register with NASD and pass a qualification examination. The NYSE Proposal would amend NYSE Rule 344 to require “securities analysts” to be registered with, qualified by and approved by the NYSE. The NYSE proposal defines “securities analyst” as “any member, allied member or employee who is directly responsible for the preparation of research reports.”

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<sup>1</sup> See SR-NYSE-2002-49 (October 9, 2002) Relating to Amendments to NYSE Rules 344, 345A, 351 and 472.

The NASD proposal differs from the NYSE proposal in that the NASD proposal would require all persons meeting the definition of “research analyst” under NASD Rule 2711 to register and pass a qualification exam. This term includes any 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. Thus, the definition of “research analyst” under NASD Rule 2711 is broader than the definition of “securities analyst” under NYSE Rule 344.

To make the NASD and NYSE research analyst registration and qualification requirements consistent, NASD is amending proposed Rule 1050 to define the term “research analyst” for purposes of that rule the same as “securities analyst” is defined under NYSE Rule 344. In this regard, the second paragraph on page 2 of the Rule Filing, and the last paragraph on page 17 of the Rule Filing, are revised as follows (new language is double underlined, and deleted text is bracketed):

**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. For purposes of this Rule 1050, “research analyst” shall mean an associated person who is directly responsible for the preparation of research reports.

In addition, the second paragraph on page 13 of the Rule Filing, and the first full paragraph on page 28 of the Rule Filing, are revised as follows (new language is underlined, and deleted text is bracketed):

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. For purposes of Rule 1050, “research analyst” would be defined as any associated person who is directly responsible for the preparation of research reports. 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.

*Research Analyst Compensation*

The Rule Filing would create new Rule 2711(d)(2), which would require a member that employs research analysts to establish a compensation review committee that reports to the member’s board of directors, of if there is no board, to a senior executive of the member. The

compensation review committee could not include representation from the member's investment banking department. The committee also would have to consider the following factors when reviewing a research analyst's compensation: (i) the research analyst's individual performance, including the analyst's productivity and research quality; (ii) the correlation between the analyst's recommendations and the stock price performance; and (iii) overall ratings received from clients, sales force and peers independent of the investment banking department, and other independent ratings services.

NASD recognizes that not all of these factors will apply in all cases. For example, a research analyst may not have received a rating from an independent ratings service. Accordingly, we are revising this provision to require consideration of these factors only to the extent they are applicable. In this regard, proposed Rule 2711(d)(2) on pages 5-6 and 21 of the Rule Filing is revised as follows (new text is double underlined):<sup>2</sup>

(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, if applicable:

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

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

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

The committee may not consider as a factor in 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.

In addition, the second full paragraph on page 11 of the Rule Filing and the carryover paragraph on pages 25-26 of the Rule Filing are amended as follows (new text is underlined):

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<sup>2</sup> We note that paragraphs (A), (B) and (C) of Rule 2711(d)(2) erroneously appeared as paragraphs (D), (E) and (F) on page 21 of the Rule Filing. Please regard this amendment as a correction of those typographical errors.

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, if applicable, 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.

*Definition of "Research Report"*

To comply with Sarbanes-Oxley, the NASD proposal would revise the definition of "research report" to eliminate the requirement that a report include a recommendation. While Sarbanes-Oxley likely will require additional changes to Rule 2711, NASD is proposing to amend this definition now to be consistent with the NYSE proposal. Accordingly, the Rule Filing is amended by deleting the fourth line on page 5 and the fourteenth line on page 20 (both of which read "(6) – (9) (No change.)") and replacing those lines with the following:

(6) – (7) (No change.)

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

(9) (No change.)

*Definition of "Public Appearance"*

The NASD proposal would revise the definition of "public appearance" to include print media interviews and articles. As a result of this change, a research analyst would be required to make the same disclosures in print media interviews and articles written by the analyst as is currently required in appearances on television and radio.

The proposal reflects NASD's strong belief that research analysts who make recommendations in the print media should disclose conflicts that could influence their objectivity and affect investor decisions. However, an analyst would not violate the proposed rule if the analyst makes the required disclosures in good faith, even if the media outlet does not

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print the disclosures. This position applies not only with respect to disclosure to the print media, but to disclosure to the radio and television media as well. The amendment clarifies NASD's position by revising the first full paragraph on page 14 of the Rule Filing and the first full paragraph on page 29 of the Rule Filing as follows (new text is underlined and deleted text is bracketed):

Additionally, the definition of "public appearance" would be revised to include interviews with print media and the writing of a print media article by a research analyst. [NASD believes that]In NASD's experience, the opinions and recommendations by research analysts made in the print media, specifically in opinion pieces, have created some of the same concerns [carry the same need for transparency] as those made in radio and television [interviews] appearances, which are covered by the current definition. [As]NASD is modifying the guidance discussed in NASD's Notice to Members 02-39 concerning the making of the required disclosures in public appearances with media outlets. An [an] analyst would not violate the rule if the analyst makes the required disclosures to the print, radio or television media in good faith, even if the media outlet does not print or broadcast the information. NASD thus recognizes the independent editorial discretion of the print, radio and television media.[, 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.]

This amendment reflects the position of NASD but not necessarily that of the NYSE.

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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](mailto:philip.shaikun@nasd.com). The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Philip Shaikun  
Assistant General Counsel

**EXHIBIT A**

**Changes From Current NASD Rules Resulting From  
SR-NASD-2002-154 and Amendment No. 1 Thereto**

**Rule 1050. Registration of Research Analysts**

All persons associated with a member who are to function as research analysts shall be registered with NASD. Before their registrations can become effective, they shall pass a Qualification Examination for Research Analysts as specified by the Board of Governors. For the purposes of this Rule 1050, “research analyst” shall mean an associated person who is directly responsible for the preparation of research reports.

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**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) – (7) (No change.)

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

(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, if applicable:

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

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

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

The committee may not consider as a factor in 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.)