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Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Re: **SR-NASD-2002-154** (Proposed Amendments to Rules Governing Research Analyst Conflicts of Interest) – Response to Comments

Dear Mr. Brigagliano:

NASD hereby submits its response to comments received by the Securities and Exchange Commission ("SEC" or "Commission") on SR-NASD-2002-154, a proposed rule change to amend NASD rules governing research analyst conflicts of interest. The proposal, and a parallel rule filing submitted by the New York Stock Exchange ("NYSE"; together with NASD, the "SROs")[1], would augment NASD Rule 2711 to provide additional investor safeguards with respect to equity securities research reports and public appearances by research analysts.

The proposal, incorporating Amendment No. 1, was published for comment in the Federal Register on January 7, 2003 (the "Original Notice"). On May 20, 2003, NASD filed with the SEC Amendment No. 2 to the proposal, which implemented certain changes to comply with the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"). Amendment No. 2 was published for comment in the Federal Register on May 29, 2003 (the "Sarbanes-Oxley Notice").[2] The Sarbanes-Oxley Notice also asked for supplemental comment on the Original Notice in light of the April 28, 2003 settlement among the SEC, the SROs, state regulators, and a number of the nation's largest investment banking firms (the "Global Settlement").

Background

Generally, the rule change proposal would further separate analyst compensation from investment banking influence; prohibit analysts from issuing "booster shot" research reports; prohibit analysts from soliciting investment banking business; require members to publish a final research report when they terminate coverage of a subject company; impose registration,

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[1] *See* SR-NYSE-2002-49.

[2] SEC Release No. 34-47110 (Dec. 31, 2002), 68 Fed. Reg. 826 (Jan. 7, 2003), and SEC Release No. 34-47912 (May 22, 2003), 68 Fed. Reg. 32148 (May 29, 2003).

qualification and continuing education requirements on research analysts; and make certain other changes. The proposal also would revise NASD Rule 2711 to the extent necessary to comply with the requirements of the Sarbanes-Oxley.

The Commission received 19 comment letters in response to the Original Notice and seven comment letters in response to the Sarbanes-Oxley Notice.[3] On July 29, 2003 NASD filed Amendment No. 3 to its rule filing with the Commission. The amendment revises certain provisions of the proposal in response to the comments received on both the Original Notice and the Sarbanes-Oxley Notice. Those changes are noted throughout this letter and are marked to show revisions from Amendment No. 2 to the rule filing.

Several commenters suggested that NASD adopt certain provisions of the Global Settlement. We have addressed those comments individually below. However, we note generally that the purposes behind NASD Rule 2711 and the current proposed changes may differ from the objectives in seeking a resolution to an enforcement matter. Accordingly, some NASD views expressed in this response to comments reflect a more restrictive policy than the terms agreed to by the many parties, including NASD, to the Global Settlement.

Definition of "Public Appearance"

SIA commented that the current definition of "public appearance" should be changed to more closely resemble the definition of "public appearance" in Regulation AC. In this regard, the SIA recommended that the definition be changed from an appearance "in which a research analyst makes a recommendation or offers an opinion concerning an equity security" to an appearance "in which the research analyst makes a specific recommendation or provides information reasonably sufficient upon which to base an investment decision on an equity security."

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[3] The SEC received comment letters from the following organizations and individuals on the Original Notice: The Advest Group, Inc., the Association for Investment Management and Research ("AIMR"), Bloomberg News, The Charles Schwab Corporation ("Schwab"), Foley & Lardner (on behalf of Adams, Harkness & Hill, Inc., AG Edwards, Keefe, Bruyette & Woods, Inc., Pacific Growth Equities, LLC, RBC Capital Markets, Stephens Inc., Stifel Nicolaus & Company, and William Blair & Company) ("Foley"), Gibson, Dunn & Crutcher LLP (on behalf of The Associated Press, Dow Jones & Company, Inc., Forbes Inc., Gannett Company, Inc., The McGraw-Hill Companies, Inc., The Newspaper Association of America, The New York Times Company, Reuters, Time Inc., Tribune Company, and The Washington Post Company), the Investment Company Institute ("ICI"), the Investment Counsel Association of America ("ICAA"), Investorside Research Association ("Investorside"), Vahan Janjigian, Robert Lin, the Newspaper Association of America, the North American Securities Administrators Association, Inc. ("NASAA"), the Securities Industry Association (two letters) ("SIA"), Stifel, Nicolaus & Company, Incorporated ("Stifel"), SunTrust Robinson Humphrey ("SunTrust"), Weiss Ratings Inc. ('Weiss") and Wilmer, Cutler & Pickering (on behalf of Banc of America Securities LLC ("BofA"), Credit Suisse First Boston LLC, Goldman, Sachs & Co., JPMorgan Securities Inc., Lehman Brothers Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated, Morgan Stanley & Co. Incorporated, and UBS Warburg LLC) ("Wilmer"). The SEC received comment letters from AIMR, BofA, ICI, Schwab, SIA, Sullivan & Cromwell LLP ("Sullivan"), and Wilmer on the Sarbanes-Oxley Notice.

NASD disagrees with this comment and believes that the definitions under Rule 2711 and Regulation AC serve different purposes. The definition of "public appearance" in Rule 2711 triggers "quiet periods" that restrict appearances following public offerings of securities and disclosure requirements that apply when an analyst recommends or expresses an opinion concerning an equity security. NASD believes that it is important for these restrictions and requirements to apply any time a research analyst expresses an opinion about an equity security in order to minimize and disclose conflicts of interest. In contrast, Regulation AC requires a research analyst to attest that the views expressed in a public appearance accurately reflect the analyst's personal views at that time. It may be more appropriate to require attestation only when a research analyst makes a recommendation or provides information sufficient upon which to base an investment decision, rather than only expressing an opinion.

Wilmer commented that the definition of "public appearance" should exclude conference calls and webcasts between a member firm and its clients that are not open to the public. NASD does not agree that every such call or webcast should be excluded from the definition of public appearance. Accordingly, NASD does not believe a blanket exception is appropriate; rather, NASD believes it is better to analyze such scenarios on a case-by-case basis.

Definitions of "Research Report" and "Research Analyst"

Several commenters expressed concern about the proposal's amended definition of "research report." The proposal adopts almost verbatim the definition of research report contained in Sarbanes-Oxley[4] by defining "research report" as 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." In so doing, the proposal eliminates the current definitional requirement that a research report contain a recommendation.

While these commenters acknowledge the mandates of Sarbanes-Oxley, some nevertheless urge NASD to interpret the Sarbanes-Oxley deletion of a recommendation requirement to be a non-substantive change to the current Rule 2711 definition of "research report." Wilmer, for example, believes NASD should interpret the Sarbanes-Oxley definition effectively to continue to require a recommendation or a "subjective view or conclusion." Absent such an interpretation, Wilmer and SIA contend that the proposed amended definition is ambiguous and overinclusive and could encompass many types of communications that traditionally have not been classified as research reports, including those by individuals who are not typically considered research analysts. For example, Wilmer suggested that communications such as prospectuses, trading commentary or company profiles could be deemed research reports under the proposed definition. Consequently, these commenters assert that if the change is given substantive import, the scope of the definition would result in unnecessary regulation of benign communications and could constrict the flow of information to investors due to the costs of regulation.

[4] To make its definition identical to that in Sarbanes-Oxley, NASD is making a minor grammatical amendment to Rule 2711(a)(8).

In a related comment, Wilmer and SIA argued that NASD should amend or interpret the definition of "research analyst" to apply only to those persons whose primary job responsibility is to issue research about companies. In this way, salespersons, traders and investment bankers, for example, would not be subject to Rule 2711, even if their communications contained the elements set forth in the Sarbanes-Oxley definition of "research report."

NASD does not believe the commenters' suggested interpretations or amendments are consistent with the legislative intent of Sarbanes-Oxley. Congress adopted a definition of "research report" that is essentially identical to the definition that already existed in Rule 2711, except that it deleted the requirement of a recommendation. Fundamental rules of statutory construction require NASD to give import to that purposeful change. As such, NASD does not believe that it can interpret that definition in a way that would render a conscious congressional act to be wholly superfluous, even if such an interpretation is more practical. In this regard, NASD notes that the Commission adopted the same proposed definition of "research report" in its Regulation AC and declined to incorporate any interpretations suggested by commenters that would continue to require a recommendation or subjective conclusion. With that precedent established, NASD does not believe it has the latitude to interpret more narrowly an identical definition derived from the same federal law.

For similar reasons, NASD also disagrees that the application of Rule 2711 should be limited to those who carry the title of research analyst or whose primary jobs is to cover companies and issue research reports. Sarbanes-Oxley also essentially adopted the Rule 2711 definition of "research analyst" (referred to as "securities analyst" in Sarbanes-Oxley) in Rule 2711. That definition encompasses those persons responsible for preparation of the substance of a communication that meets the definition of "research report" and those who report directly or indirectly to such persons, irrespective of job titles. Regulation AC contains a similar construct: adopting the same definition of "research report" and tying the definition of "research analyst" to the person who is primarily responsible for the content of such a report.

Thus, NASD believes it would be contrary to the plain language of Sarbanes-Oxley to interpret Rule 2711 to decouple the definitions of "research analyst" and "research report." Moreover, an interpretation to exclude large classes of individuals based on title or an organizational chart job function could undermine investor protection by inviting the distribution of biased opinions, unaccompanied by important disclosures, through those insulated channels within a firm. To the extent a communication with the public meets the definitional elements of a "research report," NASD believes the same potential conflicts of interest arise. For example, a trader or salesperson that publishes or otherwise distributes a "research report" equally could be pressured by investment banking to favor a client's securities, or could be influenced by a personal financial stake in the subject security.

Commenters also suggested several other measures to narrow the scope of the proposed "research report" definition. Sullivan recommended that NASD follow the terms of the Global Settlement and limit its definition of "research report" to communications "furnished by the firm

to investors in the U.S." Sullivan asserted that such limitation would be appropriate "as a matter of comity" and would lessen the likelihood that members would be disadvantaged competitively with regard to foreign broker/dealers that are not subject to similar rules. NASD disagrees and believes that all research reports produced by its members, irrespective of where or to whom it is distributed, should embody the standards of integrity and disclosures required by Rule 2711. For the same reasons, NASD also disagrees with Sullivan's additional suggestion that NASD apply Rule 2711 only to research that relates either to a U.S. company or a non-U.S. company for which a U.S. market is the principal equity trading market.

Some commenters noted that the Regulation AC applies only to "covered persons," generally exempting from the rule those affiliates of a broker or dealer that have no officers or employees in common with the broker or dealer. Sullivan suggested that NASD similarly narrow the scope of Rule 2711 to carve out "departments or divisions that have a sufficient level of independence from the member firm" and are not subject to pressure from investment banking.

NASD does not believe that the "covered persons" definition in Regulation AC could ever exclude a department within a member but is instead intended to exempt certain independent affiliates of a broker or dealer from the rule's requirements. As such, NASD does not believe it necessary or appropriate to adopt a "covered persons" definition. In contrast to the SEC, whose jurisdiction is much broader than NASD's and includes non-broker/dealer affiliates, NASD's jurisdiction extends only to its members. As such, research produced by non-member affiliates already is excluded from the scope of Rule 2711; moreover, the Joint Memorandum in Notice to Members 02-39 limits the provisions of Rule 2711 applicable to members that distribute research produced by non-member affiliates.

To the extent that the concern is more specifically about the application of Rule 2711 to investment advisers, generally NASD has already addressed this issue. In this regard, NASD has interpreted the definition of "research analyst" to exclude advisers that may express an opinion regarding an equity security in a public appearance or a mutual fund shareholder communication, but are not primarily responsible for preparing the substance of a research report. Additionally, we adopt below the exception contained in Regulation AC to exclude communications that address the performance of investment companies.

Wilmer also requested that NASD affirm that its previous guidance set forth in the Joint Memorandum that excludes certain communications from the definition of "research report" will not change in light of the new proposed definition. Moreover, commenters further asked NASD also to exclude from the definition certain additional communications excepted by either Regulation AC or the terms of the Global Settlement.

Upon SEC approval of the rule change proposal, NASD intends to review its existing interpretive guidance generally for continued applicability. However, NASD believes that the guidance in the Joint Memorandum excluding certain communications from the definition of "research report" will remain effective if the rule change proposal is approved as amended.

Moreover, NASD agrees that two other categories of communications excluded by the Regulation AC approval order similarly do not fall within the amended definition of "research report." Thus, NASD believes that the following communications also generally would not be considered research reports:

?? Periodic reports or other communications prepared for investment company shareholders or discretionary account clients discussing past performance or the basis for previously made discretionary investment decisions.

?? An analysis prepared for a specific person or limited group of fewer than fifteen persons.

NASD does not believe it appropriate to adopt at this time any additional exceptions contained in the terms of the Global Settlement to the extent they differ from those identified above or in the Joint Memorandum. Whether a particular communication falls within the definition of "research report" is dependent on specific facts and circumstances. Accordingly, NASD will continue with NYSE to address interpretive issues on a case-by-case basis and to periodically give more general public guidance where appropriate.

Finally, some commenters asserted that all "technical analysis" and "quantitative" research should be excluded from the definition of "research report." As discussed in more detail in the section on "Personal Trading Restrictions," NASD does not agree that such exclusions are appropriate beyond its current interpretations.

Research Analyst Solicitation of Investment Banking Business

Several commenters expressed concerns regarding the proposal to prohibit research analysts from issuing research reports or making public appearances about a company with which an analyst had engaged in communications "in furtherance of obtaining investment banking business." Under the proposal, an analyst would be prohibited from issuing such reports or making public appearances with respect to a subject company if the analyst participated in "pitch" meetings or other communications to obtain investment banking business prior to the time the company had entered into a letter of intent or other written agreement that designated the analyst's firm as an underwriter for an initial public offering. The proposal created an exception for "due diligence" communications, where the sole purpose is to analyze the financial condition and business operations of the subject company.

NASAA and AIMR strongly supported the proposal, and NASAA advocated extending the ban to communications in furtherance of not just initial public offerings, but any future investment banking business. Other commenters generally supported the intent of the proposal – to eliminate tacit promises of favorable research in exchange for investment banking business – but several found the language "in furtherance of" to be vague and potentially overbroad. These commenters suggested alternative language or sought a specific delineation of prohibited communications. And while commenters generally agreed that due diligence communications

should be allowed as part of an analyst's responsibilities, some similarly questioned the contours of such permissible communications.

SIA and Wilmer also questioned whether the signing of a letter of intent or other written agreement to be an underwriter was an appropriate time benchmark for permissible communications with a subject company. They noted that letters of intent are either not universally used or are often signed just before a deal closes, rendering them an arbitrary point of reference. Foley, SIA and Wilmer suggested that the SROs instead limit the proscribed communications to a fixed time period – 180 days, for example – prior to the filing of an IPO or issuing research. These commenters and SunTrust also suggested that the rule limit to a definite period after the communication or offering any ban on issuing research and making public appearances by those who engaged in communications in furtherance of obtaining investment banking. They also felt that the ban should not carry over when an analyst changes firms.

In light of the foregoing comments, and upon additional consideration, NASD is amending its proposal to prohibit outright an analyst from "participating in efforts to solicit investment banking business." The amendment tracks similar language contained in the terms of the Global Settlement. NASD believes this amendment is more straightforward and not only will promote regulatory consistency, but also will further the overriding goals of research objectivity and investor confidence by eliminating all participation by research analysts in solicitation efforts that could suggest a promise of favorable research in exchange for underwriting business. Since the same potential conflict exists with respect to solicitation of all investment banking business, the amendment is not limited to initial public offerings – a point underscored by NASAA in its comment letter.

NASD further believes that the amendment effectively addresses any vagueness concerns. To that end, NASD notes that while SIA stopped short of endorsing such an amendment, it did favor the amendment over the original proposal and commented that the language "is a fairly comprehensible test of what is and is not permitted." NASD further notes that the amendment would not curtail research analyst's from performing activities traditionally associated with research functions that do not involve solicitation of investment banking, such as helping to screen potential investment banking clients.

Accordingly, NASD is amending Rule 2711(c)(4) of the proposal as follows (deleted text is bracketed; new text is underlined):

> No research analyst may <u>participate in efforts to solicit investment banking business. Accordingly, no research analyst may, among other things, participate in any "pitches" for investment banking business to prospective investment banking clients, or have other communications with companies for the purpose of soliciting investment banking business</u>**[**publish or otherwise distribute 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**]**.

Restrictions on Research Analyst Compensation

Some commenters sought clarification of certain aspects of the proposed restrictions on analyst compensation. SIA noted that proposed Rule 2711(d)(2) used inconsistent terms when describing the role of the analyst compensation committee. NASD is amending the proposal to clarify that the committee must review and approve a research analyst's compensation, but is not required to determine initially that compensation.

SIA also asserted that the proposal to prohibit the committee from considering an analyst's "contribution to the member's investment banking business" should not preclude compensating an analyst in part for effectively screening potential investment banking deals. Proposed Rule 2711(d)(2)(A) requires the committee to consider, if applicable, the analyst's "individual performance, including the analyst's productivity and the quality of the analyst's research." NASD believes screening potential investment banking clients is one of many factors to measure the quality of an analyst's research. As such, it may be considered in determining an analyst's compensation; however, it may not be given undue weight relative to evaluating the quality of other research work product. Moreover, the size of any resultant or excluded investment banking deals should be irrelevant in assessing the quality of research.

SIA and Sullivan asked for clarification that a member's overall profitability may be considered in determining a research analyst's compensation. Foley requested confirmation that a research analyst's compensation could be based not only on a member's overall profitability, but also on the profitability of a firm's capital markets division, investment banking department or an industry group within an investment banking department. Sullivan further asked that NASD explicitly acknowledge certain additional permissible compensation factors that are set forth in the Global Settlement.

NASD agrees that the general financial success of a member may be considered in determining analyst compensation as it would with respect to other non-investment banking departments. However, it would not be appropriate for a member to determine a research analyst's compensation based upon the profitability of the member's capital markets division, investment banking department, or some subgroup of such a division or department. As to other permissible factors to consider, NASD notes that the rule proposal contains only certain required and prohibited factors. While NASD acknowledges that several other factors may be appropriate to consider, the rule does not attempt to list all other permissible considerations, and we similarly do not think it necessary to do so here. NASD notes that members must document the basis of the compensation awarded.

Sullivan and SIA further suggested that NASD limit the compensation restrictions to those principally responsible for the preparation of the substance of a research report. As proposed, the compensation provisions would apply to anyone who meets the definition of research analyst, which includes not only the persons principally responsible for the preparation of the substance of a research report, but also those who report directly or indirectly to that person. Sullivan and SIA contended that the current proposal unnecessarily brings within the restrictions persons who play secondary roles in preparing a research report.

NASD agrees and has determined that the compensation restrictions should apply only to those research analysts who are required to provide a certification under SEC Regulation AC. Regulation AC applies its certification requirements only to those analysts who are primarily responsible for the preparation of the content of a research report. Thus, research analysts who are not primarily responsible for a research report's contents, such as junior analysts who report to the lead analyst, would not be covered by Rule 2711(d)(2)'s compensation restrictions. NASD also is substituting throughout the rule the term "primarily" for "principally" – a non-substantive change – to make the rule more consistent with Regulation AC.

Lock-up Agreements

Proposed Rule 2711(f)(4) would prohibit a member that has acted as a manager or co-manager of a securities offering from distributing a research report or making a public appearance concerning a subject company 15 days prior to and after the expiration, waiver or termination of a lock-up agreement that restricts the sale of securities held by the subject company or its shareholders after the completion of a securities offering. SIA commented that this provision would raise difficult compliance issues, since co-managing underwriters often have no knowledge of a lead manager's waiver of a lock-up agreement. SIA also expressed concern that this provision could dissuade issuance of lock-up waivers prior to their normal expiration time. SIA recommended as an alternative that NASD bar firms and their analysts from issuing research reports for the purpose of affecting the price of an issuer's securities to benefit a selling shareholder.

NASD believes that these concerns can be addressed through provisions in an underwriting agreement that require a lead or co-managing underwriter to notify the other managers or co-managers of its intention to grant such a waiver a specified number of days prior to doing so. NASD believes that these types of notifications will avoid the inadvertent issuance of research reports or making of public appearances within the blackout periods surrounding waivers of lock-up agreements.

Commenters also requested that this blackout period not apply to the publication of research reports pursuant to SEC Rule 139 regarding a subject company with actively traded securities as defined in SEC Regulation M, or to public appearances regarding such companies. These commenters noted that since the quiet period following secondary offerings does not apply to these types of companies, the quiet period surrounding waivers or expirations of a lock-up agreement also should not apply. NASD agrees and will amend the provision accordingly.

NASD notes that such an exception would not be appropriate in the context of an initial public offering, where there is not a developed secondary market or widespread research coverage.

Termination of Coverage of a Subject Company

Proposed Rule 2711(f)(5) would require members to make available a final research report on a subject company before discontinuing research coverage of the company. The proposed rule also would specify that "notice of this withdrawal must be made in the same manner as when research coverage was first initiated by the member."

SIA generally supported proposed Rule 2711(f)(5), but had several comments and questions. First, the SIA noted that the proposed rule language used both "discontinue" and "withdrawal" to describe a member's termination of coverage. SIA also provided examples of temporary cessations in a member's coverage of a subject company that it did not regard as withdrawals of coverage, such as a firm that skips a single instance of an otherwise quarterly issued research report. The SIA recommended that the rule only use the term "withdrawal" and define the term to exclude temporary lulls in coverage.

SIA also questioned the proposed requirement that notice of withdrawal of coverage be made in the "same manner as when coverage was first initiated by the member." SIA suggested that notice be required by the same medium in which the penultimate report was circulated. Finally, the SIA requested confirmation that the proposal would not require a substantive final research report or rating, but rather simply a notice that the firm is withdrawing its coverage, that repeats its most recent rating, and that states that a reader should not rely on that rating.

NASAA, which supported the proposed change, recommended that the rule require members that discontinue coverage of an issuer to provide an explanation of the reasons for termination.

In response to these comments, NASD is making several changes to proposed Rule 2711(f)(5). First, the rule provision will use only "terminate" rather than "discontinue" or "withdrawal" to describe a member's termination of coverage. To the extent factual issues arise as to what constitutes termination of coverage, NASD will address these issues on a case-by-case basis. Second, the rule will be revised to require that the final report be made available using means of dissemination equivalent to those the member ordinarily uses to provide the customer with its research reports on the subject company. This standard is similar to the standard used in the Global Settlement provisions regarding termination of coverage. Third, the rule will be revised to make clear that the final report must be comparable in scope and detail to prior research reports, and must include a final recommendation or rating unless impracticable. If it is impracticable to produce a final rating or recommendation, such as where the research analyst covering the subject company or sector has left the member or if the member terminates coverage of an industry or sector, the report must disclose the rationale for terminating coverage.

Accordingly, proposed Rule 2711(f)(5) will be revised as follows (new language is underlined and deletions are bracketed):

> (5) If a member intends to **[**discontinue**]** terminate its research coverage of a subject company, notice of this [withdrawal]termination must be made. [in the same manner as when research coverage was first initiated by the member**]** The member must make available a final research report on the subject company using the means of dissemination equivalent to those it ordinarily uses to provide the customer with its research reports on the subject company. The report must be comparable in scope and detail to prior research reports and must include a final recommendation or rating, unless it is impracticable for the member to produce a comparable report (e.g., if the research analyst covering the subject company or sector has left the member or if the member terminates coverage of the industry or sector). If it is impracticable to produce a final recommendation or rating, the final research report must disclose the member's rationale for the decision to terminate coverage.

Personal Trading Restrictions

The proposal would expand the definition of "research analyst," solely to extend the personal trading restrictions contained in Rule 2711(g) to include such other persons as the director of research, supervisory analyst, or member of a committee who have direct influence or control with respect to the preparation of research reports or establishing or changing a rating or price target of a subject company's equity securities. SIA, Schwab, Stifel and Wilmer objected to this proposed change.

Commenters argued that many persons who supervise or oversee research analysts review a wide range of research reports, including in some cases reports on all of the subject companies covered by a member. They noted that expansion of the personal trading restrictions to supervisory personnel would effectively prevent these persons from owning any equity securities except diversified investment companies. This effect would discourage many qualified persons from acting in supervisory capacities because of Rule 2711(g)'s trading blackout provisions and the prohibitions on trading against current recommendations. Commenters recommended that the SROs adopt less restrictive provisions regarding supervisory personnel, such as having legal or compliance personnel review their securities holdings and trades on an ongoing basis to ensure there is no conflict of interest.

Sullivan commented that while both NASD and the NYSE proposed to expand their respective definitions of "research analyst" and "associated person" to include supervisory personnel, NASD limited this expansion "solely for the purpose of" the personal trading restrictions, while NYSE did not. Sullivan recommended that NYSE also limit the expansion of this definition solely for the purpose of the personal trading restrictions in order to be clear.

In response to these comments, NASD is revising its proposed changes to the personal trading restrictions in several respects. First, NASD will not revise the definition of "research

analyst" to include supervisory personnel. Accordingly, this term will remain the same as it is currently defined, except that it replaces the term "principally" with "primarily" to be consistent with the definition in Regulation AC – a non-substantive change. Second, rather than applying the same trading restrictions to supervisory personnel that apply to research analysts, Rule 2711(g) will be amended to require a member's legal or compliance personnel to pre-approve all transactions of persons who oversee research analysts to the extent that the transactions involve securities of subject companies covered by research analysts that they supervise.

In this regard, proposed Rule 2711(a)(5) is amended as follows (deleted text is bracketed):

> "Research analyst" means the associated person who is **[**principally **]**primarily responsible for, and any associated person who reports directly or indirectly to such a research analyst in connection with, preparation of the substance of a research report, whether or not any such person has the job title of "research analyst." **[**Solely for purposes of paragraph (g), the term "research analyst" also includes such other persons as the director or 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.**]**

In addition, a new Rule 2711(g)(6) is inserted as follows (new text is underlined):

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

SIA also commented that the NYSE rules exempt from the personnel trading restrictions managed accounts not controlled by the account owner, while the NASD rules do not exempt these accounts. In practice, NASD and NYSE both have interpreted the provision to exclude from the personal trading restrictions only so-called "blind trusts" of research analysts or their household members where the account owner is unaware of the account's holdings or transactions. NASD is amending the definition of "research analyst account" (Rule 2711(a)(6)) to exclude expressly these blind trusts, as follows (new text is underlined):

> "Research analyst account" means any account in which a research analyst or member of the research analyst's household has a financial interest, or over which such analyst has discretion or control, other than an investment company registered under the Investment Company Act of 1940. This term does not include a "blind trust" account that is controlled by a person other than the research analyst or member of the research analyst's

household where neither the research analyst nor a member of the research analyst's household knows of the account's investments or investment transactions.

SIA and Schwab suggested that "technical analysis" and "quantitative" research should be treated differently under the rules because those models of research do not present the same conflicts concerns. These commenters also asserted that the personal trading restrictions effectively bar many of these "technical" and "quantitative" research analysts from owning any stocks because the universe of securities they cover makes ownership impractical. As such, SIA and Schwab suggested that NASD either interpret the definition of "research report" to exclude "technical analysis" and "quantitative research" or amend Rule 2711 to require only pre-approval and some type of disclosure requirements for such research analysts.

In response, NASD first notes that the Joint Memorandum already excludes from the definition of "research report" communications of "technical analysis concerning the demand and supply for a sector, index or industry based on trading volume and price." NASD does not believe it is consistent with the purposes of the rule to extend the exclusion to such technical analysis of individual securities. Such an interpretation could allow a research analyst to cherry pick for coverage without any disclosures a security of an issuer with which the member has a lucrative investment banking relationship or where the analyst has a significant personal financial stake – some of the very conflicts Rule 2711 addresses. NASD notes that the SEC similarly excluded from the definition of "research report" in Regulation AC only sector, index and industry technical analysis.

NASD believes the term "quantitative" as applied to research is vague and open to many interpretations. Indeed, NASD believes that many research reports typically labeled "quantitative" by members can and do raise conflicts concerns. SIA, for example, asserts that "quantitative" reports are "based on objective criteria, such as mathematical models." However, NASD does not agree that all mathematical models are inherently "objective." Many such models are based on subjective formulas where a person or persons selects the inputs; for example, a particular performance ratio or consensus earnings estimates. NASD believes that such mathematical models can be manipulated to produce an expected result, depending on the ratios or other criteria selected, the universe of securities, and the formula employed.

Consequently, NASD does not believe it appropriate or practicable to exclude from the scope of Rule 2711 any blanket definition of "quantitative research." Nonetheless, NASD does not foreclose the possibility that certain "quantitative models" devised by members may effectively eliminate the role of a "research analyst" and sufficiently guard against any potential conflicts of interest to render them outside the definition of a "research report." However, NASD believes such facts and circumstances are best considered on a case-by-case basis.

Regarding the practical difficulties of owning securities by those research analysts that cover a large universe of securities, NASD notes that Rule 2711(g) provides for exceptions to the trading restrictions for certain investment funds, including investments in registered diversified investment companies as defined in Section 5(b)(1) of the Investment Company Act of 1940.

NASD does not believe it appropriate to provide special trading provisions for a certain class of individuals who meet the definition of "research analyst."

Disclosure of Compensation

BofA, Schwab, SIA and Wilmer all expressed serious reservations with the proposed provisions in the Sarbanes-Oxley Notice that would revise the disclosure requirements regarding compensation received from the subject company. In particular, these commenters asserted that the proposal to require disclosure of *any* compensation received by a member and its affiliates from the subject company would be extremely burdensome and complex and therefore not in the public interest, inconsistent with Sarbanes-Oxley's requirements that the mandated rules be "reasonably designed to address conflicts of interest," and provide little useful information to investors. SIA and Wilmer recommended that NASD adopt a narrower version of this proposal that would tie disclosure of the receipt of compensation, including investment banking compensation, by a member or its affiliates from a subject company to the research analyst's knowledge of such compensation. NASD does not think such a standard is appropriate.

Nonetheless, NASD is sensitive to these concerns and does not wish to adopt new rules whose burdens outweigh their benefits. On the other hand, NASD must be true to the statutory language and purposes of Sarbanes-Oxley. In relevant part, Section 15D of the Securities Exchange Act of 1934 (as adopted pursuant to Sarbanes-Oxley) requires "rules reasonably designed to require [disclosure of] … conflicts of interest that are known or should have been known by the securities analyst or broker or dealer …" Section 15D(b)(2) includes among the those conflicts of interest "whether any compensation has been received by the registered broker or dealer, or any affiliate thereof, including the securities analyst . . . as is appropriate in the public interest and consistent with the protection of investors."

NASD believes the cited Sarbanes-Oxley language requires disclosure of certain compensation received by a member or its affiliates, in addition to investment banking services compensation, that could influence the content of a research report or public appearance.[5] However, NASD does not believe such concerns arise where the receipt of affiliate compensation is not known or should not be known by the research analyst or employees of the member who are in a position to influence the content of research reports or public appearances. Accordingly, NASD is revising its proposed Rule 2711(h)(2) as follows (new text is underlined; deletions are bracketed):

[5] Certain provisions of Rule 2711(h)(2) require disclosure of compensation if the member, research analyst or an employee with the ability to influence the content of a research report has "reason to know" of the compensation. NASD has chosen to use this standard since it is already incorporated in current Rules 2711(h)(1)(C) and (h)(2)(B) and NASD has provided guidance on this standard in Notice to Members 02-39. Although Sarbanes-Oxley requires that rules be adopted to disclose conflicts of interest that "should have been known by the securities analyst or the broker or dealer," we believe that the "reason to know" standard is substantively the same and thus meets the statutory requirements.

(2) Receipt of Compensation

(A) A member must disclose in research reports:

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

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

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

(ii) **[**(B) A member must disclose in research reports**]** if the member or any affiliate:

[(i)**]**a. managed or co-managed a public offering of securities for the subject company in the past 12 months; [or]

[(ii)**]**b. received compensation for investment banking services from the subject company in the past 12 months; or

[(iii)**]**c. expects to receive or intends to seek compensation for investment banking services from the subject company in the next 3 months.

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

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

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

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

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

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

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

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

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

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

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

(iii) if, to the extent the research analyst knows or has reason to know, the subject company currently is, or during the 12-month period preceding the date of

distribution of the research report was, a client of the member. In such cases, the research analyst must disclose the types of services provided to the subject company, if known by the research analyst.

[(D) A member must disclose in research reports and a research analyst must disclose in public appearances if the research analyst received any compensation from the subject company in the past 12 months.**]**

[(E) A research analyst must disclose in public appearances (if the analyst knows or has reason to know) if the member of any affiliate received any compensation from the subject company in the past 12 months.**]**

[(F) A member must disclose in research reports and a research analyst must disclose in public appearances (if the analyst knows or has reason to know) if the subject company currently is a client of the member or was a client of the member during the 12-month period preceding the date of distribution of the research report or date of the public appearance. In such cases, the member or research analyst (if the analyst knows or has reason to know) also must disclose the types of services provided to the subject company. For purposes of this paragraph (h)(2)(E), the types of services provided to the subject company may be described as investment banking services, non-investment banking securities-related services, and non-securities services.**]**

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

Some commenters also sought guidance on the definition of "client" for the purposes of disclosure of such relationships as required by Sarbanes-Oxley. Generally, NASD would interpret a client relationship to exist with a subject company if the member had received compensation from the company within the past 12 months or if the member had entered into an agreement during that time to provide products or services. NASD recognizes that in certain instances, the client disclosure provision could result in the dissemination of material, non-public information. Accordingly, the proposal includes an exemption from that provision where disclosure would reveal non-public material information.

The Joint Memorandum previously explained that a research analyst is deemed to have "reason to know" a fact that should be reasonably discovered in the ordinary course of business. With respect to the "reason to know" standard for public appearances in Rule 2711(h)(B), NASD expects a research analyst in the ordinary course of business to review recent research reports issued or otherwise distributed by the member on the subject company and to be familiar with those subject companies from whom the member or its affiliates have received compensation pursuant to Rules 2711(h)(2)(A)(iii) and (v)(a), if applicable.

Qualification and Registration of Research Analysts

Proposed new Rule 1050 would create a new registration category for research analysts who are directly responsible for the preparation of research reports. Proposed amendments to Rule 1120 would impose both the regulatory element and the firm element of NASD's continuing education requirements on registered research analysts.

Commenters expressed several concerns with this proposal. First, commenters requested clarification as to which research analysts would be subject to registration. Second, commenters recommended that research analysts who have a certain level of industry experience, or who have already attained a commonly used industry qualification, such as the Level One qualification for Chartered Financial Analysts, be exempt from any NASD qualification examination. Investorside argued that research analysts that work for members that are not engaged in investment banking should be exempt as well. Third, commenters noted that NASD and the NYSE differed as to whether the regulatory element component of their continuing education requirements applies to research analysts.

In response to these comments, NASD agrees with commenters that the registration requirement should apply only to research analysts primarily responsible for the content of research reports and to any other research analyst whose name appears on the cover of a research report. NASD will amend proposed Rule 1050 accordingly. Second, NASD is discussing with NYSE the possibility of exempting certain research analysts from portions of the qualification requirements. However, since the qualification examination will cover in part the provisions of Rule 2711 and the research analyst provisions of NYSE Rule 472, it is unlikely that any current research analysts will be wholly exempt from all parts of the qualification examination. Third, NASD and the NYSE have agreed that research analysts and their immediate supervisors must complete both the regulatory element and the firm element of the continuing education requirements.

Attestation Requirement

NYSE Rule 351(f) and NASD Rule 2711(i) require a senior officer of each member to attest annually that the member has adopted and implemented procedures reasonably designed to ensure compliance with the analyst conflict rules. SIA and Wilmer suggested that the SROs should require only that members submit the certification to their designated examining authority. Alternatively, SIA suggests that the SROs coordinate the dates that the attestation must be submitted. In response, NASD has agreed to change the date by which its attestation must be filed to April 1 – the same deadline currently employed by NYSE. NASD is amending Rule 2711(i) to include that specific deadline. In so doing, the amendment achieves the uniformity requested by commenters without invoking a member's designated examining authority; rather, a firm sends an attestation to the SRO of which it is a member. Dual members need only send a copy of the attestation to each SRO at the same time. Members will be required to submit their next attestation no later than April 1, 2004.

NASD also is amending Rule 2711(i) to reference specifically the requirement in Rule 2711(d)(2) that the attestation certify that an appropriate committee reviewed and approved each analyst's compensation and documented the basis thereof. The amendment is as follows (new rule language is underlined; deletions are bracketed):

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

SRO Exemptive Authority

Wilmer commented that the SEC should provide the SROs with exemptive authority in administering the SRO Rules because they are extremely complex and may lead to unintended consequences. Wilmer cited in particular the need for exemptive authority given the potential application of the personal trading restrictions to automatic dividend reinvestment plans ("DRIPs") or accounts over which a research analyst or household member has not discretion or control.

NASD does not believe it needs this exemptive authority to effectively administer Rule 2711. To the extent a members has sought an interpretation of the rule to date, NASD has worked closely with the SEC and NYSE staff to respond. NASD believes that process is sufficient, and therefore exemptive authority is not necessary and could complicate administration of the Rule. With regard to the examples given by Wilmer, NASD has already addressed the DRIP issue through interpretation, and has proposed to revise the definition of "research analyst account" so that the personal trading restrictions do not apply to blind trusts.

Small Firm Exemption

SIA asked that NASD clarify that definition of "investment banking services transactions" in the Rule 2711(k) small firm exemption excluded municipal securities transactions. NASD did not intend to include municipal securities transactions within that definition for the purposes of the small firm exemption. Accordingly, NASD is amending the provision to make the exclusion explicit.

NASD did not receive other comments on the proposed scope of Rule 2711(k). We note, however, that the provision is narrower than a temporary exemption that is in place until July 30, 2003. Under the temporary exemption, members that meet Rule 2711(k)'s investment banking revenue test are exempt from the provisions of Rules 2711(b) (which restricts a research department's relationships with other member departments) and 2711(c) (which restricts communications with the subject company of a research report). As proposed, Rule 2711(k)

would only exempt these firms from the provisions of Rule 2711(b). NASD determined not to extend the exemption to the provisions of Rule 2711(c) since we believe that sharing the contents of a research report with a subject company prior to publication is a voluntary act that does not present unique regulatory challenges for small firms.

Other Comments

Several commenters recommended that parts of Rule 2711 be substantially revised. In this regard, Weiss recommended that NASD create a comprehensive stock ratings database available to the public and require members to update their stock ratings on a regular basis. Weiss also recommended that the rules require firms to base analysts' incentive compensation exclusively on the accuracy of their research and ratings, eliminating all direct and indirect contributions from investment banking revenues. Weiss further recommended that NASD require firms to write all research reports in plain English, be more explicit in describing the nature and impact of conflicts, and require firms and their brokers to provide similar disclosures to investors when orally recommending securities.

NASD believes its existing rule and the current proposal adequately addresses most of these concepts. In this regard, we believe that the new analyst compensation provisions will much more closely align analyst compensation with the performance of an analyst's recommendations and ratings. In addition, we believe that the disclosure requirements will substantially inform investors of analysts' potential biases. To the extent there is demand for such a comprehensive stock ratings database, NASD believes a market response is most appropriate.

Investorside recommended that Rule 2711 be revised to exclude all member firms that produce research but that do not engage in investment banking. Investorside commented that the rule should provide for government certification of such firms, which would not be covered by the rule. NASD recognizes that firms that do not engage in investment banking may have fewer conflicts than firms that do so. In this regard, much of Rule 2711's disclosure, firm structure and compensation provisions do not apply to such members or their research analysts. Additionally, Rule 2711(k) specifically exempts firms that engage in limited investment banking from the internal structure restrictions of Rule 2711(b). Nevertheless, research analysts that work for such firms still may face certain conflicts, such as personal financial interests in, and trading of, securities that they follow. Accordingly, NASD does not believe that it would be appropriate to completely exempt these firms from the rule.

AIMR strongly supported the provision in the proposal to prohibit retaliation against research analysts by a member or an employee of a member's investment banking department but raised additional concerns about retaliatory measures and pressures on research analysts from the companies they cover. While NASD shares this concern, it has no jurisdiction to regulate the conduct of companies that are not NASD members.

Effective Dates

NASD believes that the proposed changes to Rule 2711 should take effect the below number of days following the SEC's approval of the proposed rule change:

?? Qualification, examination, registration and continuing education requirements for research analysts (proposed new Rule 1050 and proposed amendments to Rule 1120): 180 days or such longer period as determined by NASD.

?? New compensation and client disclosure provisions (proposed Rule 2711(h)(2)): 180 days, plus up to an additional 90 days as deemed appropriate on a case-by-case basis.

?? Rule 2711(h)(2)(C) – Exemption from Disclosure Requirements:

- As applied to disclosures under Rules 2711(h)(2)(A)(ii)(a) and (b): Immediate upon SEC approval of the rule change

- As applied to disclosures under Rule 2711(h)(2)(A)(iii)(b), (h)(2)(B)(i) and (iii): 180 days

?? Research analyst compensation review procedures (proposed Rule 2711(d)(2)): 90 days.

?? Prohibition against retaliation against research analysts (proposed Rule 2711(j)): immediately.

?? Exceptions for small firms (proposed Rule 2711(k)): immediately.

?? All other proposed rule changes: 60 days.

Please feel free to contact Thomas M. Selman, at (240) 386-4533, Joseph P. Savage, at (240) 386-4534, or Philip A. Shaikun, at (202) 728-8451, should you have any questions concerning the above.

Sincerely,

Philip A. Shaikun
Associate General Counsel

cc: Marc Menchel
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