

February 8, 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-2002-21**– Proposed Rule Regarding 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, NASD Regulation, Inc., 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.

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Form 19b-4

Proposed Rule Change

by

**NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.**

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”), the National Association of Securities Dealers, Inc. (“NASD” or “Association”), through its wholly owned subsidiary, NASD Regulation, Inc. (“NASD Regulation”), is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to establish NASD Rule 2711 to address 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 2711. Research Analysts and Research Reports**

**(a) Definitions**

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

(1) “Investment banking department” means any department or division, whether or not identified as such, that performs any investment banking service on behalf of a member.

(2) “Investment banking services” include, without limitation, acting as an underwriter in an offering for the issuer; acting as a financial adviser in a merger or acquisition; providing venture capital, equity lines of credit, PIPEs or similar investments; or serving as placement agent for the issuer.

(3) “Member of a research analyst’s household” means any individual whose principal residence is the same as the research analyst’s principal residence.

(4) “Public appearance” means any participation in a seminar, forum (including an interactive electronic forum), radio or television interview, or other public speaking

activity in which a research analyst makes a recommendation or offers an opinion concerning an equity security.

(5) “Research analyst” means the associated person who is principally responsible for, and any associated person who reports directly or indirectly to such a research analyst in connection with, preparation of the substance of a research report, whether or not any such person has the job title of “research analyst.”

(6) “Research analyst account” means any account in which a research analyst or member of the research analyst’s household has a beneficial interest, or over which such analyst or household member has discretion or control, other than an investment company registered under the Investment Company Act of 1940.

(7) “Research department” means any department or division, whether or not identified as such, that is principally responsible for preparing the substance of a research report on behalf of a member.

(8) “Research report” means a written or electronic communication that the member has distributed or will distribute with reasonable regularity to its customers or the general public, which presents an opinion or recommendation concerning an equity security.

(9) “Subject company” means the company whose equity securities are the subject of a research report or recommendation in a public appearance.

**(b) Restrictions on Investment Banking Department Relationship with Research**

**Department**

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

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

(3) Investment banking personnel may review a research report before its publication as necessary only to verify the factual accuracy of information in the research report or to review the research report for any potential conflict of interest, provided that:

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

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

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

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

(2) A member may submit sections of such a research report to the subject company before its publication for review as necessary only to verify the factual accuracy of information in those sections, provided that:

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

(B) a complete draft of the research report is provided to the legal or compliance department before sections of the report are submitted to the subject company; and

(C) if after submitting the sections of the research report to the subject company the research department intends to change the proposed rating or price target, it must first provide written justification to, and receive written authorization from, the legal or compliance department for the change. The member must retain copies of any draft and the final version of such a research report for three years following its publication.

(3) The member may notify a subject company that the member intends to change its rating of the subject company's securities, provided that the notification occurs on the business day before the member announces the rating change, after the close of trading in the principal market of the subject company's securities.

**(d) Prohibition of Certain Forms of Research Analyst Compensation**

No member may pay any bonus, salary or other form of compensation to a research analyst that is based upon a specific investment banking services transaction.

**(e) Prohibition of Promise of Favorable Research**

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

**(f) Imposition of Quiet Periods**

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

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

or

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

provided that this provision 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.

**(g) Restrictions on Personal Trading by Research Analysts**

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

(2) No research analyst account may purchase or sell any security issued by a company that the research analyst follows, or any option on or derivative of such security, for a period beginning 30 calendar days before and ending five calendar days after the publication of a research report concerning the company or a change in a rating or price target of the company's securities; provided that:

(A) a member may permit a research analyst account to sell all of the securities held by them that are issued by a company that the research analyst follows,

within 30 calendar days after the research analyst began following the company for the member;

(B) a member may permit a research analyst account to purchase or sell any security issued by a subject company within 30 calendar days before the publication of a research report or change in the rating or price target of the subject company's securities due to significant news or a significant event concerning the subject company, provided that the member's legal or compliance department pre-approves the research report and any change in the rating or price target.

(3) No research analyst account may purchase or sell any security or any option on or derivative of such security in a manner inconsistent with the research analyst's recommendation as reflected in the most recent research report published by the member.

(4) A member's legal or compliance department may authorize a transaction otherwise prohibited by paragraphs (g)(2) and (g)(3) based upon significant personal financial circumstances of the beneficial owner of the research analyst account, provided that:

(A) the legal or compliance department authorizes the transaction before it is entered;

(B) each exception is granted in compliance with policies and procedures adopted by the member that are reasonably designed to ensure that these transactions do not create a conflict of interest between the professional responsibilities and the personal trading activities of a research analyst; and

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

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

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

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

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

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

(iii) the investment fund does not distribute securities in kind to the research analyst or household member before the issuer's initial public offering.

**(h) Disclosure Requirements**

(1) *Ownership and Material Conflicts of Interest*

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

(A) if the research analyst or a member of the research analyst's household has a financial interest in the securities of the subject company, and the nature of the financial interest (including, without limitation, whether it consists of any option, right, warrant, future, long or short position);

(B) if, as of five business days before the publication of the research report or the public appearance, the member or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company;

(C) any other actual, material conflict of interest of the research analyst of which the research analyst or member knows or has reason to know at the time of publication of the research report, or of which the research analyst knows or has reason to know at the time of the public appearance; and

(D) any other actual, material conflict of interest of the member of which the member knows or has reason to know at the time of publication of the research report, or of which the research analyst knows or has reason to know at the time of the public appearance.

(2) *Receipt of Compensation*

(A) A member must disclose in research reports if:

(i) the research analyst principally responsible for preparation of the report received compensation that is based upon (among other factors) the member's investment banking revenues; and

(ii) the member or its affiliates received compensation from the subject company within twelve months before, or reasonably expects to receive

compensation from the subject company within three months following, publication of the research report.

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

(3) *Position as Officer or Director*

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

(4) *Meaning of Ratings*

A member must define in its research reports the meaning of each rating used by the member in its rating system. The definition of each rating must be consistent with its plain meaning.

(5) *Distribution of Ratings*

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

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

(C) The information that is disclosed under paragraphs (h)(5)(A) and (h)(5)(B) must be current as of the end of the most recent calendar quarter (or the second most recent calendar quarter if the publication date is less than 15 calendar days after the most recent calendar quarter).

(6) *Price Chart*

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

(A) indicate the dates on which the member assigned or changed each rating or price target;

(B) depict each rating and price target assigned or changed on those dates; and

(C) be current as of the end of the most recent calendar quarter (or the second most recent calendar quarter if the publication date is less than 15 calendar days after the most recent calendar quarter).

(7) *Price Targets*

A member must disclose in research reports the valuation methods used to determine a price target. Price targets must have a reasonable basis and must be accompanied by a disclosure concerning the risks that may impede achievement of the price target.

(8) Market Making

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

(9) Disclosure Required by Other Provisions

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

(10) Prominence of Disclosure

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

**(i) Supervisory Procedures**

Each member subject to this rule must adopt and implement written supervisory procedures reasonably designed to ensure that the member and its employees comply with the provisions of this rule , and a senior officer of such a member must attest annually to the Association that it has adopted and implemented those procedures.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The Board of Directors of NASD Regulation approved the proposed rule change at its meeting on January 23, 2002, and authorized the filing of the rule change with the SEC. NASD Regulation provided counsel for The Nasdaq Stock Market and NASD Dispute Resolution an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by the NASD to its Subsidiaries. The NASD Board of Governors approved the proposed rule change at its meeting on January 24, 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.

The 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, NASD Regulation, Office of General Counsel, at (202) 728-8451.

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

(a) Purpose

Under the leadership of SEC Chairman Harvey Pitt, NASD Regulation has worked closely with the New York Stock Exchange to develop rules to address conflicts of interest that can arise when research analysts recommend equity securities in research reports and public appearances. This comprehensive proposed rule change is intended to improve the objectivity of

research and provide investors with more useful and reliable information when making investment decisions.

To that end, the proposed rule change generally would minimize the influence that a member's investment banking department has over its research department and would restrict analysts' personal trading of securities. The proposed rule change also would require disclosure of financial interests held by the member firm, the analyst and his or her family members, and any other material conflict of interest associated with a recommendation of a security. The proposed rule change also would require firms to clarify the meanings of their research ratings and provide historical price and ratings distribution data in research reports to better enable investors to evaluate and compare the quality of research.

A more detailed discussion of the proposed rule's provisions follows.

*1. Definitions*

The terms "research analyst" and "research report" are used frequently throughout the proposed rule change. "Research analyst" would be defined to mean an "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.'" "Research report" would be defined to mean "a written or electronic communication that the member has distributed or will distribute with reasonable regularity to its customers or the general public, which presents an opinion or recommendation concerning an equity security."

Accordingly, the term "research analyst" would not include every associated person who may express an opinion on an equity security. Thus, for example, most mutual fund portfolio

managers are not principally responsible for the preparation of “research reports” as defined by the proposed rule change. Consequently, a mutual fund portfolio manager generally would not be deemed to be a “research analyst,” even if the portfolio manager is an associated person of a member firm and discusses the mutual fund’s portfolio holdings in a television interview.

The NASD specifically requests comments on these definitions. Would the definition of “research analyst” have any regulatory gaps? Would it impose any unnecessary burdens on members, particularly by including any associated person who reports to a research analyst? Would the definition of “research report” properly exclude those communications that do not present the types of concerns that the proposed rule change is designed to address?

The proposed rule change would require research analysts to make various types of disclosures in their public appearances. The term “public appearance” would be defined to include any participation in a seminar, forum (including an interactive electronic forum), radio or television interview, or other public speaking activity in which a research analyst makes a recommendation or offers an opinion concerning an equity security. Consequently, this term also would include any public conference call in which a research analyst expresses an opinion on an equity security. The proposed rule change would require only that a research analyst make these disclosures. An independent decision by the sponsor of the public appearance, such as a television program sponsor, to edit out the required disclosures, would not constitute a violation of the proposed rule change. Comment is solicited on whether the scope of this definition is adequate to address the concerns raised by a research analyst’s public speaking activities and whether it might impose any unnecessary burdens on members or their research analysts.

The term “member of a research analyst’s household” is used in connection with the proposed rule change’s personal trading restrictions and disclosure requirements. This term is defined to include any individual whose principal residence is the same as the research analyst’s residence. Thus, it would include any family member living with the research analyst, as well as any other individual living in the same principal residence. Comment is sought on whether this definition is appropriate.

The term “research analyst account” is used in connection with the proposed rule change’s personal trading restrictions. This term is defined to include any account in which a research analyst or a member of the research analyst’s household has a beneficial interest, or over which such analyst or household member has discretion or control. The term would not include an investment company registered under the Investment Company Act of 1940 that is managed by a research analyst or a member of the analyst’s household.

2. *Investment Banking Department Relationship with Research Department*

There exists a potential conflict between a firm’s responsibility to provide fair, objective and unbiased research and its interest in obtaining or retaining investment banking business from a company that is the subject of a research report (“subject company”). The proposed rule change would adopt several measures to address this potential conflict.

(A) *Supervision and Control of Research Department*

The proposed rule change would prohibit a member’s investment banking department from supervising or controlling the member’s research department and from reviewing or approving research reports before their publication. “Investment banking department” would be defined to include any department or division, whether or not identified as such, that performs

any investment banking service on behalf of the member. “Investment banking services” would encompass a broad array of services typically offered to investment banking clients, including acting as an underwriter in an offering for the issuer, acting as a financial advisor in a merger or acquisition, providing venture capital, equity lines of credit, PIPES or similar investments, or serving as placement agent for the issuer. Comment is sought on whether this definition of “investment banking services” is appropriate or inclusive enough in light of the purposes of the proposed rule change.

This provision would better ensure that research is shielded from the influence of the investment banking department’s relationship with the subject company. Under the proposed rule change, investment banking personnel could communicate with research personnel concerning a research report before the report’s publication only to ensure the report’s factual accuracy and to screen for conflicts of interest. The proposed rule change would require an authorized legal or compliance official to act as intermediary for all such communications. The term “legal or compliance department” as used in the proposed rule change would include any department or division that is principally responsible for compliance with applicable securities laws, regardless of whether the department or division is named “legal” or “compliance.” The proposed rule change would not restrict or impose conditions on any communication between a research department and an investment banking department that does not concern a proposed research report.

The proposed rule change also would address the concern that the subject company may attempt to influence the conclusions provided in a research report. The proposed rule change would prohibit a member from submitting a research report to the subject company for approval.

The proposed rule change would allow the subject company to review only certain sections of a research report before its publication to ensure that it is factually accurate. However, a member could not submit in advance to the subject company those sections of the report that contain the research summary, the rating or the price target. The proposed rule change would require that if a research analyst intends to make changes to the proposed rating or price target after review by the subject company, the research analyst would first have to receive written approval from the member's legal and compliance department.

The NASD requests comment on the "gate-keeping" functions that the proposed rule change would impose on the legal or compliance department. The NASD recognizes that these responsibilities may require members to hire additional legal or compliance staff and to dedicate resources to these gate-keeping functions. Nevertheless, the possibility that investment banking departments exert undue influence over the contents of a research report has necessitated the proposed gate-keeping provisions. Comment is requested on whether these provisions adequately address these concerns about undue influence and whether any alternative provisions would be equally effective. Should the gate-keeper approach that the proposed rule change would impose with respect to contact with the subject company also apply to contacts with the investment banking department?

*(B) Research Analyst's or Member's Investment Banking Compensation*

The proposed rule change would prohibit a member from tying analyst compensation to specific investment banking transactions. The NASD requests comment on whether this provision might impose unnecessary burdens on smaller members that may have the same employee perform investment banking and research services. To the extent that this provision

might impose such unnecessary burdens, how widespread would this problem be? What, if any, alternative measure would respond to the concerns that this provision is intended to address without imposing these burdens?

Since research analysts, as part of their job responsibilities, do advise investment banking departments concerning such matters as whether a potential underwriting client is financially or operationally prepared for an initial public offering, the proposed rule change would permit a member to compensate its research analysts based on their overall performance, which may include these services to the investment banking department. However, a member would have to disclose in research reports if a research analyst received compensation based in whole or in part on the member's investment banking revenues.

The proposed rule change also would require a member to disclose in research reports if the member or its affiliates received compensation from the subject company within the last 12 months, or expected to receive compensation within the next three months following publication of the report. This disclosure requirement, like all of the other disclosure requirements of the proposed rule change, would mandate definitive disclosure. Ambiguous or conditional language, such as disclosure that the member "may have" received compensation from the subject company, would not comply with the disclosure requirements of the proposed rule change.

The NASD recognizes the possibility that this requirement might necessitate disclosure of compensation related to non-public transactions. This type of compensation presents the same conflicts as the receipt of compensation related to transactions that have been publicly disclosed. Moreover, we do not believe that the proposed rule change would alert the research department or the investing public concerning non-public transactions, for at least two reasons. First, the

proposed rule change would require only disclosure that compensation was received by the member or one of its affiliates. It would not require disclosure concerning the nature of the transaction, such as the fact that the member received the compensation in connection with non-public merger and acquisition services, or even that the compensation was received by the member (as opposed to one of its affiliates that is not engaged in investment banking). Second, the term “compensation” is to be broadly interpreted to include the receipt of any consideration from the subject company. Given the breadth of the meaning of “compensation,” this disclosure requirement should not alert the research department whether the compensation related to a non-public transaction. Nevertheless, the NASD does request comment on the efficacy of this disclosure requirement, and whether any alternative, definitive disclosure would be effective.

A research analyst would have to disclose in public appearances if the issuer of a recommended security is a client of the member or its affiliates, provided the analyst knows or has reason to know this fact. For purposes of this provision, an issuer would be deemed a “client” of the member if the member or its affiliates received compensation from the issuer within the previous twelve months, or reasonably expects to receive compensation from the issuer within the next three months. This disclosure requirement thus would not apply with regard to a non-public transaction in which the issuer is a client of the member or its affiliates and the research analyst does not know and has no reason to know of this fact due to an information barrier imposed by the member.

### *3. Promises of Favorable Research*

The proposed rule change would include a provision that expressly prohibits a member from offering or threatening to change favorable research, a specific research rating or a specific

price target as consideration or inducement for the receipt of business or compensation. Such behavior already constitutes a violation of just and equitable principles of trade (NASD Rule 2110) and could violate the anti-fraud provisions of the federal securities laws. The proposed rule change would make this prohibition explicit. A member would violate this provision simply by making such an offer or threat, whether or not the member provided any service to or received any compensation or business from the issuer.

#### *4. Quiet Periods*

The proposed rule change would impose two “quiet periods” on the issuance of research reports. The proposed rule change would prohibit a member from issuing a research report regarding a subject company for which the member acted as an underwriting manager or co-manager for 40 days following the date of an initial public offering and 10 days following the date of a secondary offering. For purposes of this provision, the “date” of an IPO is the date on which the IPO’s registration statement becomes effective. The “date” of a secondary offering is the date on which a member commences sales on behalf of an issuer or selling security holders pursuant to an underwriting agreement or similar agreement that governs the transaction.

The quiet periods are intended to reduce a manager’s ability to improperly reward the subject company for its underwriting business by publishing favorable research after completion of the offering. The proposed rule change would not prohibit a manager or co-manager from issuing a research report during these quiet periods due to significant news or a significant event concerning the subject company. In general, a “significant” news item or event would constitute a news item or event that is expected to have a material impact on, or that reflects a material change to, the subject company’s earnings, operations or financial condition.

The NASD specifically seeks comment on the proposed quiet period after secondary offerings. How significant is a manager's opportunity to engage in this behavior with respect to a public company that conducts a secondary offering? Should the NASD adopt an exception to this provision for seasoned companies qualified to issue their securities in an initial public offering under Form S-3? Would the \$75 million public float and one-year reporting requirements applicable to S-3 companies provide a sufficiently high threshold to ensure that the quiet period for secondary offerings is effective? Would an alternative standard, such as the \$150 million public float value for actively traded securities under Regulation M, be more appropriate?

Comment is also solicited on whether the proposed quiet periods should apply not only to the issuance of research reports, but also to any public appearance by a research analyst employed by the manager or co-manager of the underwriting.

5. *Research Analysts' Personal Trading*

The proposed rule change would impose certain restrictions on an analyst's personal trading activities to help ensure that research reports and recommendations are not influenced by the prospect of personal enrichment and to ensure that analysts do not profit from the issuance of a research report or change in a rating or price target. The proposed rule change would prohibit a research analyst account (which would include any account of the research analyst or member of the analyst's household, and any account over which the analyst or household member has discretion or control) from purchasing or receiving securities of a company in the industry the analyst covers before that company's initial public offering. This provision is designed to

prevent a research analyst from receiving “cheap stock” before the initial public offering of a company that the analyst may subsequently cover.

The proposed rule change also would prohibit a research analyst account from trading a subject company’s securities during a “blackout” period beginning 30 calendar days before, and ending five calendar days after, the issuance of a research report or change in the research rating or price target for the subject company’s securities. This prohibition would apply not only to transactions in the subject company’s securities themselves (including short sales), but also any derivative security, such as an option, right, warrant or future. Furthermore, the proposed rule change would prohibit a research analyst account from trading in a manner inconsistent with the analyst’s most current recommendation concerning a security. Thus, for example, the proposed rule change would prohibit a research analyst from selling or effecting a short sale in a security while maintaining a “buy,” “hold” or “neutral” recommendation.

The proposed rule change would permit members to adopt certain exceptions to these prohibitions that are reasonable in light of the purposes of the personal trading restrictions. For example, the proposed rule change would permit a transaction within 30 calendar days before the member publishes a research report or changes a rating or price target due to significant news or a significant event concerning the subject company. This exception is designed to ensure that the 30-day blackout provision does not impede the member’s ability to publish a research report or change a rating or price target in these circumstances. The exception would require that the member’s legal or compliance department pre-approve any research report or change in a rating or price target made in connection with a significant news item or event. The legal or compliance department should consider, among other factors, whether the research analyst knew

or had reason to know of the significant news or event before the research analyst account entered into the transaction that occurred less than 30 days prior to the new research report, rating or price target.

The proposed rule change would permit members to authorize an exception to the blackout period and prohibition of trading against recommendations to allow a research analyst account to trade securities due to significant personal financial circumstances, provided certain conditions are met. Reliance on this provision should be rare. In most cases, a research analyst account should not hold such a significant interest in a subject company's securities as to necessitate reliance on this provision. Moreover, this provision is meant to be narrowly construed to permit an exception in extremely limited circumstances such as when the beneficial owner of a research analyst account must liquidate securities holdings in order to have funds available for an unforeseen medical emergency.

The restrictions on personal trading would not apply to transactions in shares of registered diversified investment companies as defined under Section 5(b)(1) of the Investment Company Act of 1940, even if the diversified investment company held shares of a subject company.<sup>1</sup> The restrictions also would not apply to transactions in holdings of any other investment fund (including a non-diversified investment company) over which neither the research analyst nor a household member has any investment discretion or control, provided that the fund meets certain conditions. First, the research analyst account could not own more than one percent of the fund's

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<sup>1</sup> Under Section 5(b)(1) of the Investment Company Act of 1940, a "diversified" investment company's assets are divided into two baskets, one representing 75% of its assets and one representing 25% of its assets. The restrictions focus on the 75% basket: its assets must consist of cash, government securities, securities of other investment companies, and "other securities." The "other securities" of a single issuer may not account for more than 5% of the fund's assets, and the fund may not hold more than 10% of a single issuer's voting securities. The 25% basket is not subject to these restrictions.

assets. Second, the fund could not invest more than 20 percent of its assets in securities of issuers principally engaged in the same types of business as companies that the research analyst covers. Third, the fund could not distribute securities in kind to the research analyst or household member before the issuer's initial public offering. Comment is solicited on whether this investment fund exception would create a regulatory gap that could undermine the effectiveness of the personal trading restrictions. Alternatively, would it impose any unnecessary restrictions on a research analyst's ability to invest appropriately in certain investment funds?

6. *Members' or Research Analysts' Financial Interests*

The proposed rule change would impose several disclosure requirements on members and research analysts concerning their financial interest in a subject company's securities. First, the proposed rule change would require members and research analysts to disclose in research reports and public appearances if the research analyst (or a member of the research analyst's household) has a financial interest in a subject company, and the nature of the financial interest. This "financial interest" could include any option, right, warrant, future, long or short position in the subject company's securities. Comment is solicited on whether members and research analysts also should be required to disclose if any discretionary account managed by the research analyst or a member of the analyst's household (other than a registered investment company) has a financial interest in a subject company, and the nature of this interest.

Second, the proposed rule change would require members and analysts to disclose if the member or its affiliates beneficially own one percent or more of any class of a subject company's common equity securities. Members could determine whether they or their affiliates

“beneficially own” a security by relying upon the standards set forth in Section 13(d) and Section 13(g) of the Act, as interpreted by the Commission.

Finally, the proposed rule change contains a provision that would require disclosure in research reports and public appearances of any other actual, material conflict of interest of which the member or analyst knows or has reason to know. Comment is requested on this provision. What types of guidance would members need in order to know when this disclosure is necessary? The proposed rule change would explicitly require that members and their research analysts comply with the disclosure requirements of other applicable laws and regulations, including NASD Rule 2210 and the anti-fraud provisions of the federal securities laws. In light of this explicit requirement, is the general admonishment to disclosure “other, actual material conflicts of interest” necessary?

#### *7. Other Disclosures*

The proposed rule change would require additional disclosures in research reports to clarify the meaning of a member’s ratings system and provide investors with better information to evaluate and compare the quality of a firm’s research and the influence of possible conflicts on the assignment of ratings.

First, the proposed rule change would require that research reports disclose the meaning of all ratings used in the member’s rating system. The proposed rule change also would require that the definition of each rating be consistent with its plain meaning. For example, a “hold” rating could not mean that an investor should sell the security.

Second, the proposed rule change would require a member to disclose in its research reports the percentage of all securities rated by the member to which the member would assign a

“buy,” “hold/neutral” or “sell” rating, regardless of whether the member’s rating system uses other categories. The proposed rule change would require a member to determine based on its own rating system into which of the three categories each securities rating falls. Thus, for example, a rating of “market outperform” or “strong buy” might constitute a “buy” under this requirement. The member then would provide the percentage of all of its ratings in each of these categories. For example, a research report might disclose that the member has assigned a “buy” rating to 70% of the securities that it follows, a “hold” rating to 25%, and a “sell” rating to 5% (even if the member employs a system that assigns five different ratings to the securities that it follows). Comment is requested on whether another set of terms would be more appropriate than “buy,” “hold/neutral” or “sell,” such as a numerical rating system of “one,” “two” and “three.”

Third, the member would have to disclose the percentage of subject companies within each of these three rating categories for which the member has provided investment banking services within the previous twelve months. For example, if 20 of the 25 companies that a member categorizes with a “buy” rating are investment banking clients, the member would have to disclose that 80 percent of the companies in the “buy” rating category are its investment banking clients. All of this information would have to be current as of the most recent calendar quarter (or the second most recent calendar quarter if the publication date is less than 15 calendar days after the most recent calendar quarter).

Fourth, the proposed rule change would require that research reports present a price chart that maps the historical price movements of the recommended security and indicates those points at which the member assigned or changed a research rating or price target. This chart should enable investors to compare the ratings and price targets that a member has assigned with the

stock performance of the recommended security. A sample price chart that complies with this proposed rule provision is attached as Exhibit 3 to this Form 19b-4.

This disclosure requirement would apply only to securities on which the member has assigned a rating for at least one year, in recognition of the long-term nature of many ratings. The provision also would require that the price chart cover the period that the member has rated the security or three years, whichever is shorter. The price chart would have to be current as of the end of the most recent calendar quarter (or the second most recent calendar quarter if the publication date is less than 15 calendar days after the most recent calendar quarter).

Fifth, the proposed rule change would require disclosure in research reports of the valuation methods used in developing the research rating price target. The price target must have a reasonable basis and must be accompanied by a disclosure concerning the risks that may impede achievement of the price target. The requirement that the price target have a reasonable basis is based upon the current requirement in NASD Rule 2210(d)(2)(B)(i) that any member securities recommendation in an advertisement or item of sales literature have a reasonable basis.

Sixth, the proposed rule change would require the member to disclose if it makes a market in the subject company's securities. The market-making provisions are similar to requirements that exist under NASD Rule 2210. Ambiguous or conditional language, such as the fact that a member "may" make a market, or "usually" makes a market in the security, would not comply with this disclosure requirement.<sup>2</sup>

Seventh, the proposed rule change would require disclosure in research reports and public appearances of whether a research analyst or a member of the research analyst's household is an

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<sup>2</sup> To the extent that there are differences in the disclosure requirements regarding market making between the proposed rule change and current Rule 2210, the proposed rule change provisions would govern.

officer, director or advisory board member of the subject company. Comment is solicited as to whether this disclosure requirement should extend to *any* employment with the subject company, including recent past employment.

Finally, in addition to the disclosure required by this proposed rule change, members and research analysts would be required to provide disclosure in research reports and public appearances that is required by applicable law or regulation, including NASD Rule 2210 and the anti-fraud provisions of the federal securities laws.

Disclosures required by the proposed rule change either would have to be presented on the front page of a research report, or the report's front page would have to refer to the page on which the disclosures are found. The proposed rule change would require disclosures to be clear, comprehensive and prominent. As discussed elsewhere, ambiguous or conditional disclosures would not meet this standard.

#### 8. *Supervisory Procedures/Reporting Requirements*

The proposed rule change would require each member that is subject to the proposed rule to adopt written supervisory procedures reasonably designed to ensure that the member and its employees comply with the rule. A member's senior officer also would have to attest annually to the Association that the member has established and implemented procedures reasonably designed to comply with the rule. This provision is similar to New York Stock Exchange Rule 351, which requires NYSE members to submit to the NYSE annually a letter signed by a senior officer of a member that the member has met certain supervisory requirements. Comment is sought on whether attestation to the Association is necessary, or whether this provision should simply require members to maintain records of such annual attestations. Comment is also sought

as to whether this attestation should be submitted only to a member's designated examining authority (generally the NYSE or the NASD).

(b) Statutory Basis

NASD Regulation 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 the Association'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. The 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. The 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 Regulation 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. Previously, the NASD published for comment in NASD Notice to Members 01-45 (July 2, 2001) a more limited proposal to amend NASD Rule 2210, Communications With The Public. The NASD received 850 comments in response to that Notice. The NASD has not included a discussion of the comments received on that proposal because the proposed rule change is significantly different and more comprehensive.

6. Extension of Time Period for Commission Action

NASD Regulation 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 is expected to file with the Commission a rule proposal 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 rule proposal will differ in the language used from this proposed rule change, its proposed rule change 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.
2. NASD Notice to Members 01-45 (July 2001).
3. Sample Price Chart for proposed Rule 2711(h)(6).

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

NASD REGULATION, INC.

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

Date: February 8, 2002

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34- ; File No. SR-NASD-2002-21)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Research Analysts Conflicts of Interest

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on February 8, 2002, the National Association of Securities Dealers, Inc. (“NASD”), through its wholly owned subsidiary, NASD Regulation, Inc. (“NASD Regulation”) 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 Regulation. 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 Regulation is proposing to amend the rules of the National Association of Securities Dealers, Inc. (“NASD” or “Association”), 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.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

**Rule 2711. Research Analysts and Research Reports**

**(a) Definitions**

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

(1) “Investment banking department” means any department or division, whether or not identified as such, that performs any investment banking service on behalf of a member.

(2) “Investment banking services” include, without limitation, acting as an underwriter in an offering for the issuer; acting as a financial adviser in a merger or acquisition; providing venture capital, equity lines of credit, PIPEs or similar investments; or serving as placement agent for the issuer.

(3) “Member of a research analyst’s household” means any individual whose principal residence is the same as the research analyst’s principal residence.

(4) “Public appearance” means any participation in a seminar, forum (including an interactive electronic forum), radio or television interview, or other public speaking activity in which a research analyst makes a recommendation or offers an opinion concerning an equity security.

(5) “Research analyst” means the associated person who is principally responsible for, and any associated person who reports directly or indirectly to such a research analyst in connection with, preparation of the substance of a research report, whether or not any such person has the job title of “research analyst.”

(6) “Research analyst account” means any account in which a research analyst or member of the research analyst’s household has a beneficial interest, or over which such

analyst or household member has discretion or control, other than an investment company registered under the Investment Company Act of 1940.

(7) “Research department” means any department or division, whether or not identified as such, that is principally responsible for preparing the substance of a research report on behalf of a member.

(8) “Research report” means a written or electronic communication that the member has distributed or will distribute with reasonable regularity to its customers or the general public, which presents an opinion or recommendation concerning an equity security.

(9) “Subject company” means the company whose equity securities are the subject of a research report or recommendation in a public appearance.

**(b) Restrictions on Investment Banking Department Relationship with Research**

**Department**

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

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

(3) Investment banking personnel may review a research report before its publication as necessary only to verify the factual accuracy of information in the research report or to review the research report for any potential conflict of interest, provided that:

(A) any written communication between investment banking and research department personnel concerning such a research report must be made either

through an authorized legal or compliance official of the member or in a transmission copied to such an official; and

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

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

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

(2) A member may submit sections of such a research report to the subject company before its publication for review as necessary only to verify the factual accuracy of information in those sections, provided that:

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

(B) a complete draft of the research report is provided to the legal or compliance department before sections of the report are submitted to the subject company; and

(C) if after submitting the sections of the research report to the subject company the research department intends to change the proposed rating or price target, it must first provide written justification to, and receive written authorization from, the legal or compliance department for the change. The

member must retain copies of any draft and the final version of such a research report for three years following its publication.

(3) The member may notify a subject company that the member intends to change its rating of the subject company's securities, provided that the notification occurs on the business day before the member announces the rating change, after the close of trading in the principal market of the subject company's securities.

**(d) Prohibition of Certain Forms of Research Analyst Compensation**

No member may pay any bonus, salary or other form of compensation to a research analyst that is based upon a specific investment banking services transaction.

**(e) Prohibition of Promise of Favorable Research**

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

**(f) Imposition of Quiet Periods**

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

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

or

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

provided that this provision 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.

**(g) Restrictions on Personal Trading by Research Analysts**

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

(2) No research analyst account may purchase or sell any security issued by a company that the research analyst follows, or any option on or derivative of such security, for a period beginning 30 calendar days before and ending five calendar days after the publication of a research report concerning the company or a change in a rating or price target of the company's securities; provided that:

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

(B) a member may permit a research analyst account to purchase or sell any security issued by a subject company within 30 calendar days before the publication of a research report or change in the rating or price target of the subject company's securities due to significant news or a significant event concerning the subject company, provided that the member's legal or compliance department pre-approves the research report and any change in the rating or price target.

(3) No research analyst account may purchase or sell any security or any option on or derivative of such security in a manner inconsistent with the research analyst's recommendation as reflected in the most recent research report published by the member.

(4) A member's legal or compliance department may authorize a transaction otherwise prohibited by paragraphs (g)(2) and (g)(3) based upon significant personal financial circumstances of the beneficial owner of the research analyst account, provided that:

(A) the legal or compliance department authorizes the transaction before it is entered;

(B) each exception is granted in compliance with policies and procedures adopted by the member that are reasonably designed to ensure that these transactions do not create a conflict of interest between the professional responsibilities and the personal trading activities of a research analyst; and

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

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

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

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

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

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

(iii) the investment fund does not distribute securities in kind to the research analyst or household member before the issuer's initial public offering.

**(h) Disclosure Requirements**

(1) Ownership and Material Conflicts of Interest

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

(A) if the research analyst or a member of the research analyst's household has a financial interest in the securities of the subject company, and the nature of the financial interest (including, without limitation, whether it consists of any option, right, warrant, future, long or short position);

(B) if, as of five business days before the publication of the research report or the public appearance, the member or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company;

(C) any other actual, material conflict of interest of the research analyst of which the research analyst or member knows or has reason to know at the time of publication of the research report, or of which the research analyst knows or has reason to know at the time of the public appearance; and

(D) any other actual, material conflict of interest of the member of which the member knows or has reason to know at the time of publication of the research report, or of which the research analyst knows or has reason to know at the time of the public appearance.

(2) *Receipt of Compensation*

(A) A member must disclose in research reports if:

(i) the research analyst principally responsible for preparation of the report received compensation that is based upon (among other factors) the member's investment banking revenues; and

(ii) the member or its affiliates received compensation from the subject company within twelve months before, or reasonably expects to receive compensation from the subject company within three months following, publication of the research report.

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

(3) Position as Officer or Director

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

(4) Meaning of Ratings

A member must define in its research reports the meaning of each rating used by the member in its rating system. The definition of each rating must be consistent with its plain meaning.

(5) Distribution of Ratings

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

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

(C) The information that is disclosed under paragraphs (h)(5)(A) and (h)(5)(B) must be current as of the end of the most recent calendar quarter (or the second most recent calendar quarter if the publication date is less than 15 calendar days after the most recent calendar quarter).

(7) Price Chart

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

- (A) indicate the dates on which the member assigned or changed each rating or price target;
- (B) depict each rating and price target assigned or changed on those dates; and
- (C) be current as of the end of the most recent calendar quarter (or the second most recent calendar quarter if the publication date is less than 15 calendar days after the most recent calendar quarter).

(7) Price Targets

A member must disclose in research reports the valuation methods used to determine a price target. Price targets must have a reasonable basis and must be accompanied by a disclosure concerning the risks that may impede achievement of the price target.

(8) Market Making

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

(9) Disclosure Required by Other Provisions

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

(10) Prominence of Disclosure

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

**(i) Supervisory Procedures**

Each member subject to this rule must adopt and implement written supervisory procedures reasonably designed to ensure that the member and its employees comply with the provisions of this rule , and a senior officer of such a member must attest annually to the Association that it has adopted and implemented those procedures.

**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 Regulation 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 Regulation 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**

Under the leadership of SEC Chairman Harvey Pitt, NASD Regulation has worked closely with the New York Stock Exchange to develop rules to address conflicts of interest that can arise when research analysts recommend equity securities in research reports and public appearances. This comprehensive proposed rule change is intended to improve the objectivity of research and provide investors with more useful and reliable information when making investment decisions.

To that end, the proposed rule change generally would minimize the influence that a member's investment banking department has over its research department and would restrict analysts' personal trading of securities. The proposed rule change also would require disclosure of financial interests held by the member firm, the analyst and his or her family members, and any other material conflict of interest associated with a recommendation of a security. The proposed rule change also would require firms to clarify the meanings of their research ratings and provide historical price and ratings distribution data in research reports to better enable investors to evaluate and compare the quality of research.

A more detailed discussion of the proposed rule's provisions follows.

2. *Definitions*

The terms "research analyst" and "research report" are used frequently throughout the proposed rule change. "Research analyst" would be defined to mean an "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.’” “Research report” would be defined to mean “a written or electronic communication that the member has distributed or will distribute with reasonable regularity to its customers or the general public, which presents an opinion or recommendation concerning an equity security.”

Accordingly, the term “research analyst” would not include every associated person who may express an opinion on an equity security. Thus, for example, most mutual fund portfolio managers are not principally responsible for the preparation of “research reports” as defined by the proposed rule change. Consequently, a mutual fund portfolio manager generally would not be deemed to be a “research analyst,” even if the portfolio manager is an associated person of a member firm and discusses the mutual fund’s portfolio holdings in a television interview.

The NASD specifically requests comments on these definitions. Would the definition of “research analyst” have any regulatory gaps? Would it impose any unnecessary burdens on members, particularly by including any associated person who reports to a research analyst? Would the definition of “research report” properly exclude those communications that do not present the types of concerns that the proposed rule change is designed to address?

The proposed rule change would require research analysts to make various types of disclosures in their public appearances. The term “public appearance” would be defined to include any participation in a seminar, forum (including an interactive electronic forum), radio or television interview, or other public speaking activity in which a research analyst makes a recommendation or offers an opinion concerning an equity security. Consequently, this term also would include any public conference call in which a research analyst expresses an opinion on an equity security. The proposed rule change would require only that a research analyst make these

disclosures. An independent decision by the sponsor of the public appearance, such as a television program sponsor, to edit out the required disclosures, would not constitute a violation of the proposed rule change. Comment is solicited on whether the scope of this definition is adequate to address the concerns raised by a research analyst's public speaking activities and whether it might impose any unnecessary burdens on members or their research analysts.

The term "member of a research analyst's household" is used in connection with the proposed rule change's personal trading restrictions and disclosure requirements. This term is defined to include any individual whose principal residence is the same as the research analyst's residence. Thus, it would include any family member living with the research analyst, as well as any other individual living in the same principal residence. Comment is sought on whether this definition is appropriate.

The term "research analyst account" is used in connection with the proposed rule change's personal trading restrictions. This term is defined to include any account in which a research analyst or a member of the research analyst's household has a beneficial interest, or over which such analyst or household member has discretion or control. The term would not include an investment company registered under the Investment Company Act of 1940 that is managed by a research analyst or a member of the analyst's household.

## 2. *Investment Banking Department Relationship with Research Department*

There exists a potential conflict between a firm's responsibility to provide fair, objective and unbiased research and its interest in obtaining or retaining investment banking business from a company that is the subject of a research report ("subject company"). The proposed rule change would adopt several measures to address this potential conflict.

(A) *Supervision and Control of Research Department*

The proposed rule change would prohibit a member's investment banking department from supervising or controlling the member's research department and from reviewing or approving research reports before their publication. "Investment banking department" would be defined to include any department or division, whether or not identified as such, that performs any investment banking service on behalf of the member. "Investment banking services" would encompass a broad array of services typically offered to investment banking clients, including acting as an underwriter in an offering for the issuer, acting as a financial advisor in a merger or acquisition, providing venture capital, equity lines of credit, PIPES or similar investments, or serving as placement agent for the issuer. Comment is sought on whether this definition of "investment banking services" is appropriate or inclusive enough in light of the purposes of the proposed rule change.

This provision would better ensure that research is shielded from the influence of the investment banking department's relationship with the subject company. Under the proposed rule change, investment banking personnel could communicate with research personnel concerning a research report before the report's publication only to ensure the report's factual accuracy and to screen for conflicts of interest. The proposed rule change would require an authorized legal or compliance official to act as intermediary for all such communications. The term "legal or compliance department" as used in the proposed rule change would include any department or division that is principally responsible for compliance with applicable securities laws, regardless of whether the department or division is named "legal" or "compliance." The proposed rule change would not restrict or impose conditions on any communication between a

research department and an investment banking department that does not concern a proposed research report.

The proposed rule change also would address the concern that the subject company may attempt to influence the conclusions provided in a research report. The proposed rule change would prohibit a member from submitting a research report to the subject company for approval. The proposed rule change would allow the subject company to review only certain sections of a research report before its publication to ensure that it is factually accurate. However, a member could not submit in advance to the subject company those sections of the report that contain the research summary, the rating or the price target. The proposed rule change would require that if a research analyst intends to make changes to the proposed rating or price target after review by the subject company, the research analyst would first have to receive written approval from the member's legal and compliance department.

The NASD requests comment on the "gate-keeping" functions that the proposed rule change would impose on the legal or compliance department. The NASD recognizes that these responsibilities may require members to hire additional legal or compliance staff and to dedicate resources to these gate-keeping functions. Nevertheless, the possibility that investment banking departments exert undue influence over the contents of a research report has necessitated the proposed gate-keeping provisions. Comment is requested on whether these provisions adequately address these concerns about undue influence and whether any alternative provisions would be equally effective. Should the gate-keeper approach that the proposed rule change would impose with respect to contact with the subject company also apply to contacts with the investment banking department?

*(B) Research Analyst's or Member's Investment Banking Compensation*

The proposed rule change would prohibit a member from tying analyst compensation to specific investment banking transactions. The NASD requests comment on whether this provision might impose unnecessary burdens on smaller members that may have the same employee perform investment banking and research services. To the extent that this provision might impose such unnecessary burdens, how widespread would this problem be? What, if any, alternative measure would respond to the concerns that this provision is intended to address without imposing these burdens?

Since research analysts, as part of their job responsibilities, do advise investment banking departments concerning such matters as whether a potential underwriting client is financially or operationally prepared for an initial public offering, the proposed rule change would permit a member to compensate its research analysts based on their overall performance, which may include these services to the investment banking department. However, a member would have to disclose in research reports if a research analyst received compensation based in whole or in part on the member's investment banking revenues.

The proposed rule change also would require a member to disclose in research reports if the member or its affiliates received compensation from the subject company within the last 12 months, or expected to receive compensation within the next three months following publication of the report. This disclosure requirement, like all of the other disclosure requirements of the proposed rule change, would mandate definitive disclosure. Ambiguous or conditional language, such as disclosure that the member "may have" received compensation from the subject company, would not comply with the disclosure requirements of the proposed rule change.

The NASD recognizes the possibility that this requirement might necessitate disclosure of compensation related to non-public transactions. This type of compensation presents the same conflicts as the receipt of compensation related to transactions that have been publicly disclosed. Moreover, we do not believe that the proposed rule change would alert the research department or the investing public concerning non-public transactions, for at least two reasons. First, the proposed rule change would require only disclosure that compensation was received by the member or one of its affiliates. It would not require disclosure concerning the nature of the transaction, such as the fact that the member received the compensation in connection with non-public merger and acquisition services, or even that the compensation was received by the member (as opposed to one of its affiliates that is not engaged in investment banking). Second, the term “compensation” is to be broadly interpreted to include the receipt of any consideration from the subject company. Given the breadth of the meaning of “compensation,” this disclosure requirement should not alert the research department whether the compensation related to a non-public transaction. Nevertheless, the NASD does request comment on the efficacy of this disclosure requirement, and whether any alternative, definitive disclosure would be effective.

A research analyst would have to disclose in public appearances if the issuer of a recommended security is a client of the member or its affiliates, provided the analyst knows or has reason to know this fact. For purposes of this provision, an issuer would be deemed a “client” of the member if the member or its affiliates received compensation from the issuer within the previous twelve months, or reasonably expects to receive compensation from the issuer within the next three months. This disclosure requirement thus would not apply with regard to a non-public transaction in which the issuer is a client of the member or its affiliates

and the research analyst does not know and has no reason to know of this fact due to an information barrier imposed by the member.

3. *Promises of Favorable Research*

The proposed rule change would include a provision that expressly prohibits a member from offering or threatening to change favorable research, a specific research rating or a specific price target as consideration or inducement for the receipt of business or compensation. Such behavior already constitutes a violation of just and equitable principles of trade (NASD Rule 2110) and could violate the anti-fraud provisions of the federal securities laws. The proposed rule change would make this prohibition explicit. A member would violate this provision simply by making such an offer or threat, whether or not the member provided any service to or received any compensation or business from the issuer.

4. *Quiet Periods*

The proposed rule change would impose two “quiet periods” on the issuance of research reports. The proposed rule change would prohibit a member from issuing a research report regarding a subject company for which the member acted as an underwriting manager or co-manager for 40 days following the date of an initial public offering and 10 days following the date of a secondary offering. For purposes of this provision, the “date” of an IPO is the date on which the IPO’s registration statement becomes effective. The “date” of a secondary offering is the date on which a member commences sales on behalf of an issuer or selling security holders pursuant to an underwriting agreement or similar agreement that governs the transaction.

The quiet periods are intended to reduce a manager’s ability to improperly reward the subject company for its underwriting business by publishing favorable research after completion

of the offering. The proposed rule change would not prohibit a manager or co-manager from issuing a research report during these quiet periods due to significant news or a significant event concerning the subject company. In general, a “significant” news item or event would constitute a news item or event that is expected to have a material impact on, or that reflects a material change to, the subject company’s earnings, operations or financial condition.

The NASD specifically seeks comment on the proposed quiet period after secondary offerings. How significant is a manager’s opportunity to engage in this behavior with respect to a public company that conducts a secondary offering? Should the NASD adopt an exception to this provision for seasoned companies qualified to issue their securities in an initial public offering under Form S-3? Would the \$75 million public float and one-year reporting requirements applicable to S-3 companies provide a sufficiently high threshold to ensure that the quiet period for secondary offerings is effective? Would an alternative standard, such as the \$150 million public float value for actively traded securities under Regulation M, be more appropriate?

Comment is also solicited on whether the proposed quiet periods should apply not only to the issuance of research reports, but also to any public appearance by a research analyst employed by the manager or co-manager of the underwriting.

##### *5. Research Analysts’ Personal Trading*

The proposed rule change would impose certain restrictions on an analyst’s personal trading activities to help ensure that research reports and recommendations are not influenced by the prospect of personal enrichment and to ensure that analysts do not profit from the issuance of a research report or change in a rating or price target. The proposed rule change would prohibit a

research analyst account (which would include any account of the research analyst or member of the analyst's household, and any account over which the analyst or household member has discretion or control) from purchasing or receiving securities of a company in the industry the analyst covers before that company's initial public offering. This provision is designed to prevent a research analyst from receiving "cheap stock" before the initial public offering of a company that the analyst may subsequently cover.

The proposed rule change also would prohibit a research analyst account from trading a subject company's securities during a "blackout" period beginning 30 calendar days before, and ending five calendar days after, the issuance of a research report or change in the research rating or price target for the subject company's securities. This prohibition would apply not only to transactions in the subject company's securities themselves (including short sales), but also any derivative security, such as an option, right, warrant or future. Furthermore, the proposed rule change would prohibit a research analyst account from trading in a manner inconsistent with the analyst's most current recommendation concerning a security. Thus, for example, the proposed rule change would prohibit a research analyst from selling or effecting a short sale in a security while maintaining a "buy," "hold" or "neutral" recommendation.

The proposed rule change would permit members to adopt certain exceptions to these prohibitions that are reasonable in light of the purposes of the personal trading restrictions. For example, the proposed rule change would permit a transaction within 30 calendar days before the member publishes a research report or changes a rating or price target due to significant news or a significant event concerning the subject company. This exception is designed to ensure that the 30-day blackout provision does not impede the member's ability to publish a research report or

change a rating or price target in these circumstances. The exception would require that the member's legal or compliance department pre-approve any research report or change in a rating or price target made in connection with a significant news item or event. The legal or compliance department should consider, among other factors, whether the research analyst knew or had reason to know of the significant news or event before the research analyst account entered into the transaction that occurred less than 30 days prior to the new research report, rating or price target.

The proposed rule change would permit members to authorize an exception to the blackout period and prohibition of trading against recommendations to allow a research analyst account to trade securities due to significant personal financial circumstances, provided certain conditions are met. Reliance on this provision should be rare. In most cases, a research analyst account should not hold such a significant interest in a subject company's securities as to necessitate reliance on this provision. Moreover, this provision is meant to be narrowly construed to permit an exception in extremely limited circumstances such as when the beneficial owner of a research analyst account must liquidate securities holdings in order to have funds available for an unforeseen medical emergency.

The restrictions on personal trading would not apply to transactions in shares of registered diversified investment companies as defined under Section 5(b)(1) of the Investment Company Act of 1940, even if the diversified investment company held shares of a subject company.<sup>3</sup> The

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<sup>3</sup> Under Section 5(b)(1) of the Investment Company Act of 1940, a "diversified" investment company's assets are divided into two baskets, one representing 75% of its assets and one representing 25% of its assets. The restrictions focus on the 75% basket: its assets must consist of cash, government securities, securities of other investment companies, and "other securities." The "other securities" of a single issuer may not account for more than 5% of the fund's assets, and the fund may not hold more than 10% of a single issuer's voting securities. The 25% basket is not subject to these restrictions.

restrictions also would not apply to transactions in holdings of any other investment fund (including a non-diversified investment company) over which neither the research analyst nor a household member has any investment discretion or control, provided that the fund meets certain conditions. First, the research analyst account could not own more than one percent of the fund's assets. Second, the fund could not invest more than 20 percent of its assets in securities of issuers principally engaged in the same types of business as companies that the research analyst covers. Third, the fund could not distribute securities in kind to the research analyst or household member before the issuer's initial public offering. Comment is solicited on whether this investment fund exception would create a regulatory gap that could undermine the effectiveness of the personal trading restrictions. Alternatively, would it impose any unnecessary restrictions on a research analyst's ability to invest appropriately in certain investment funds?

6. *Members' or Research Analysts' Financial Interests*

The proposed rule change would impose several disclosure requirements on members and research analysts concerning their financial interest in a subject company's securities. First, the proposed rule change would require members and research analysts to disclose in research reports and public appearances if the research analyst (or a member of the research analyst's household) has a financial interest in a subject company, and the nature of the financial interest. This "financial interest" could include any option, right, warrant, future, long or short position in the subject company's securities. Comment is solicited on whether members and research analysts also should be required to disclose if any discretionary account managed by the research analyst or a member of the analyst's household (other than a registered investment company) has a financial interest in a subject company, and the nature of this interest.

Second, the proposed rule change would require members and analysts to disclose if the member or its affiliates beneficially own one percent or more of any class of a subject company's common equity securities. Members could determine whether they or their affiliates "beneficially own" a security by relying upon the standards set forth in Section 13(d) and Section 13(g) of the Act, as interpreted by the Commission.

Finally, the proposed rule change contains a provision that would require disclosure in research reports and public appearances of any other actual, material conflict of interest of which the member or analyst knows or has reason to know. Comment is requested on this provision. What types of guidance would members need in order to know when this disclosure is necessary? The proposed rule change would explicitly require that members and their research analysts comply with the disclosure requirements of other applicable laws and regulations, including NASD Rule 2210 and the anti-fraud provisions of the federal securities laws. In light of this explicit requirement, is the general admonishment to disclose "other, actual material conflicts of interest" necessary?

#### *7. Other Disclosures*

The proposed rule change would require additional disclosures in research reports to clarify the meaning of a member's ratings system and provide investors with better information to evaluate and compare the quality of a firm's research and the influence of possible conflicts on the assignment of ratings.

First, the proposed rule change would require that research reports disclose the meaning of all ratings used in the member's rating system. The proposed rule change also would require

that the definition of each rating be consistent with its plain meaning. For example, a “hold” rating could not mean that an investor should sell the security.

Second, the proposed rule change would require a member to disclose in its research reports the percentage of all securities rated by the member to which the member would assign a “buy,” “hold/neutral” or “sell” rating, regardless of whether the member’s rating system uses other categories. The proposed rule change would require a member to determine based on its own rating system into which of the three categories each securities rating falls. Thus, for example, a rating of “market outperform” or “strong buy” might constitute a “buy” under this requirement. The member then would provide the percentage of all of its ratings in each of these categories. For example, a research report might disclose that the member has assigned a “buy” rating to 70% of the securities that it follows, a “hold” rating to 25%, and a “sell” rating to 5% (even if the member employs a system that assigns five different ratings to the securities that it follows). Comment is requested on whether another set of terms would be more appropriate than “buy,” “hold/neutral” or “sell,” such as a numerical rating system of “one,” “two” and “three.”

Third, the member would have to disclose the percentage of subject companies within each of these three rating categories for which the member has provided investment banking services within the previous twelve months. For example, if 20 of the 25 companies that a member categorizes with a “buy” rating are investment banking clients, the member would have to disclose that 80 percent of the companies in the “buy” rating category are its investment banking clients. All of this information would have to be current as of the most recent calendar quarter (or the second most recent calendar quarter if the publication date is less than 15 calendar days after the most recent calendar quarter).

Fourth, the proposed rule change would require that research reports present a price chart that maps the historical price movements of the recommended security and indicates those points at which the member assigned or changed a research rating or price target. This chart should enable investors to compare the ratings and price targets that a member has assigned with the stock performance of the recommended security. A sample price chart that complies with this proposed rule provision is attached as Exhibit 3 to this Form 19b-4.

This disclosure requirement would apply only to securities on which the member has assigned a rating for at least one year, in recognition of the long-term nature of many ratings. The provision also would require that the price chart cover the period that the member has rated the security or three years, whichever is shorter. The price chart would have to be current as of the end of the most recent calendar quarter (or the second most recent calendar quarter if the publication date is less than 15 calendar days after the most recent calendar quarter).

Fifth, the proposed rule change would require disclosure in research reports of the valuation methods used in developing the research rating price target. The price target must have a reasonable basis and must be accompanied by a disclosure concerning the risks that may impede achievement of the price target. The requirement that the price target have a reasonable basis is based upon the current requirement in NASD Rule 2210(d)(2)(B)(i) that any member securities recommendation in an advertisement or item of sales literature have a reasonable basis.

Sixth, the proposed rule change would require the member to disclose if it makes a market in the subject company's securities. The market-making provisions are similar to requirements that exist under NASD Rule 2210. Ambiguous or conditional language, such as the

fact that a member “may” make a market, or “usually” makes a market in the security, would not comply with this disclosure requirement.<sup>4</sup>

Seventh, the proposed rule change would require disclosure in research reports and public appearances of whether a research analyst or a member of the research analyst’s household is an officer, director or advisory board member of the subject company. Comment is solicited as to whether this disclosure requirement should extend to *any* employment with the subject company, including recent past employment.

Finally, in addition to the disclosure required by this proposed rule change, members and research analysts would be required to provide disclosure in research reports and public appearances that is required by applicable law or regulation, including NASD Rule 2210 and the anti-fraud provisions of the federal securities laws.

Disclosures required by the proposed rule change either would have to be presented on the front page of a research report, or the report’s front page would have to refer to the page on which the disclosures are found. The proposed rule change would require disclosures to be clear, comprehensive and prominent. As discussed elsewhere, ambiguous or conditional disclosures would not meet this standard.

#### 8. *Supervisory Procedures/Reporting Requirements*

The proposed rule change would require each member that is subject to the proposed rule to adopt written supervisory procedures reasonably designed to ensure that the member and its employees comply with the rule. A member’s senior officer also would have to attest annually to the Association that the member has established and implemented procedures reasonably

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<sup>4</sup> To the extent that there are differences in the disclosure requirements regarding market making between the proposed rule change and current Rule 2210, the proposed rule change provisions would govern.

designed to comply with the rule. This provision is similar to New York Stock Exchange Rule 351, which requires NYSE members to submit to the NYSE annually a letter signed by a senior officer of a member that the member has met certain supervisory requirements. Comment is sought on whether attestation to the Association is necessary, or whether this provision should simply require members to maintain records of such annual attestations. Comment is also sought as to whether this attestation should be submitted only to a member's designated examining authority (generally the NYSE or the NASD).

**(b) Statutory Basis**

NASD Regulation 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 the Association'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. The 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. The 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 Regulation 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. Previously, the NASD published for comment in NASD Notice to Members 01-45 (July 2, 2001) a more limited proposal to amend NASD Rule 2210, Communications With The Public. The NASD received 850 comments in response to that Notice. The NASD has not included a discussion of the comments received on that proposal because the current proposed rule change is significantly different and more comprehensive.

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