SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-45908; File No. SR-NASD-2002-21; SR-NYSE-2002-09)

May 10, 2002

Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the National Association of Securities Dealers, Inc. and the New York Stock Exchange, Inc. and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. and Amendment No. 1 to the Proposed Rule Change by the New York Stock Exchange, Inc. Relating to Research Analyst Conflicts of Interest

I. INTRODUCTION

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act")[1] and Rule 19b-4 thereunder,[2] on February 13, 2002, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary, NASD Regulation, Inc. ("NASDR"), and on February 27, 2002, the New York Stock Exchange, Inc. ("NYSE" or "Exchange"), filed with the Securities and Exchange Commission ("SEC" or "Commission") proposed rule changes relating to research analyst conflicts of interest. On March 7, 2002, NASDR submitted Amendment No. 1 ("NASD Amendment No. 1") to its proposed rule change.[3] The proposed rule changes, as amended, were published for

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 See Letter from Thomas M. Selman, Senior Vice President, Investment Companies, Corporate Financing, NASDR, to Katherine A. England, Assistant Director, Division of Market Regulation ("Division"), Commission (March 7, 2002) ("NASDR Amendment No. 1"). In Amendment No. 1, NASDR revised its response to Items 1(b) and 1(c) of the Form 19b-4 to indicate the impact that proposed NASD Rule 2711 would have on NASD Rule 2210. Additionally, NASDR inserted language in its Purpose section to clarify how the current disclosure requirements regarding securities recommendations in NASD Rule 2210 would apply if proposed NASD Rule 2711 was approved by the SEC. Finally, NASDR revised the provisions requiring disclosure of actual material conflicts of interest to conform its provisions to those of the NYSE.

comment in the Federal Register on March 14, 2002.[4]

On April 2, 2002, the Commission extended the comment period until April 18, 2002.[5] The Commission received 55 comment letters on the proposed rule changes from 52 different commenters.[6] On April 30, 2002, the NYSE submitted Amendment No. 1 ("NYSE

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4 Release No. 34-45526 (March 8, 2002), 67 FR 11526 (March 14, 2002).

5 Release No. 34-45679 (April 2, 2002), 67 FR 11526 (April 4, 2002). In response to the solicitation of comments, the Commission received two requests to extend the comment period. See Letters to Jonathan G. Katz, Secretary, Commission, from: Securities Industry Association, dated March 15, 2002; Pickard and Djinis LLP, dated March 28, 2002. In response to these requests, the Commission extended the comment period from April 4, 2002 until April 18, 2002.

6 See Letters to Jonathan G. Katz, Secretary, Commission, as of the time that this order was prepared, from: The Alliance in Support of Independent Research, dated May 1, 2002 ("Alliance letter"); A.G. Edwards & Sons, Inc., dated April 17, 2002 ("A.G. Edwards letter"); American Bankers Association, ABA Securities Association, dated April 18, 2002 ("ABASA letter"); American Society of Corporate Secretaries, dated April 17, 2002 ("ASCS letter"); Association for Investment Management and Research, dated April 18, 2002 ("AIMR letter"); Ramesh Bodapati, dated March 4, 2002 ("Bodapati letter"); BBVA Securities Inc., dated March 22, 2002 ("BBVA letter"); Biotech Monthly, dated April 26, 2002 ("Biotech Monthly letter"); Charles Schwab & Co., Inc., dated April 18, 2002 ("Charles Schwab letter"); Cleary, Gottlieb, Steen & Hamilton, dated April 4, 2002 ("Cleary letter"); Credit Suisse First Boston, dated April 19, 2002 ("CSFB letter"); Davenport & Company LLC, dated April 17, 2002 ("Davenport letter"); Dorsey & Whitney LLP, dated April 18, 2002 ("Dorsey letter"); Edward Jones & Co., dated April 3, 2002 ("Edward Jones letter"); First Analysis Securities Corp., dated March 20, 2002 and First Analysis Securities Corp., dated April 17, 2002 (First Analysis letter"); Fried Frank Harris Shriver & Jacobson, dated April 18, 2002 ("Fried Frank letter"); Goldman Sachs, dated April 18, 2002 ("Goldman Sachs letter"); David Hauck, dated May 5, 2002 ("Hauck letter"); HSBC Securities (USA) Inc., dated April 4, 2002 ("HSBC letter"); Investment Company Institute, dated April 18, 2002 ("ICI letter"); Investment Counsel Association of America, dated April 23, 2002 ("ICAA letter"); Dan Jamieson, dated May 6, 2002 ("Jamieson letter"); Janney Montgomery Scott LLC, dated April 17, 2002 ("Janney Montgomery Scott letter"); Jefferies & Company, Inc., dated April 17, 2002 ("Jefferies & Co. letter"); Jovus, Inc., dated April 18, 2002 ("Jovus letter"); Legg Mason, Inc., dated April 17, 2002 ("Legg Mason letter"); Bruce Locke, dated February 8, 2002 ("Locke letter"); Congressman Edward J. Markey, dated May 7, 2002 ("Congressman Markey letter"); Merrill Lynch, Pierce, Fenner & Smith Incorporated, dated April 18, 2002 ("Merrill Lynch letter"); David Miller, dated April 26, 2002 ("Miller letter"); Morgan Lewis, dated April 18, 2002 ("Morgan Lewis letter"); Morgan Stanley, dated April 22, 2002 ("Morgan Stanley letter"); National Investor Relations Institute, dated April 15, 2002 ("NIRI letter"); New York State Bar Association Committee on Securities Regulation, dated April 17, 2002 ("NYSBA letter"); Nomura Securities International, Inc., dated March 19, 2002 ("Nomura letter"); North American Securities Administrators Association, Inc., dated April 18, 2002 ("NASAA

Amendment No. 1") to its proposed rule change.[7] On May 2, 2002, the NASDR submitted Amendment No. 2 ("NASD Amendment No. 2") to its proposed rule change.[8] On May 2, 2002, the NASD submitted a letter responding to comments.[9] On May 3, 2002, the NYSE also submitted a letter responding to comments.[10]

This order approves the proposed rule changes, as amended. The Commission also seeks comment from interested persons on NYSE Amendment No. 1 and NASD Amendment No. 2.

II. DESCRIPTION OF THE PROPOSED RULE CHANGES

The NYSE and the NASD ("SROs") proposed to amend their rules to address conflicts of interest that are raised when research analysts recommend securities in public communications. These conflicts can arise when analysts work for firms that have investment banking or other business relationships with issuers of the recommended securities, or when

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letter"); Thomas Olsen, dated April 25, 2002 ("Olsen letter"); Pacific Growth Equities, Inc., dated April 18, 2002 ("Pacific Growth letter"); Pickard and Djinis LLP, dated March 28, 2002 and Pickard and Djinis LLP, dated April 15, 2002 ("Pickard and Djinis letter"); Prudential Securities Incorporated, dated April 22, 2002 ("PSI letter"); RBC Capital Markets, dated May 3, 2002 ("RBC letter"); Charles Rothschild, dated March 8, 2002 ("Rothschild letter"); Ryan Beck & Co., LLC, dated April 3, 2002 ("Ryan Beck letter"); Salomon Smith Barney Inc., dated April 18, 2002 ("SSB letter"); Securities Industry Association, dated March 15, 2002 and Securities Industry Association, dated April 11, 2002 ("SIA letter"); Kevin Silverman, dated February 26, 2002 ("Silverman letter"); StarMine Corporation, dated April 18, 2002 ("StarMine letter"); Sullivan & Cromwell, dated April 18, 2002 ("Sullivan & Cromwell letter"); Sun Trust Capital Markets, Inc., dated April 18, 2002 ("Sun Trust letter"); UBS Warburg LLC, dated April 25, 2002 ("UBS letter"); Wachovia Securities, Inc., dated April 18, 2002 ("Wachovia letter"); and Wells Fargo Securities, dated March 15, 2002 ("Wells Fargo letter").

7 See Letter from Richard P. Bernard, Assistant Corporate Secretary, NYSE, to James A. Brigagliano, Assistant Director, Division, Commission (April 30, 2002).

8 See Letter from Philip Shaikun, Assistant General Counsel, NASDR, to James A. Brigagliano, Assistant Director, Division, Commission (May 2, 2002).

9 See Letter from Philip Shaikun, Assistant General Counsel, NASDR, to James A. Brigagliano, Assistant Director, Division, Commission (May 2, 2002).

10 See Letter from Darla Stuckey, Corporate Secretary, NYSE, to James A. Brigagliano, Assistant Director, Division, Commission (May 3, 2002).

the analyst or firm owns securities of the recommended issuer. The approved rules implement structural reforms designed to increase analysts' independence and further manage conflicts of interest, and require increased disclosure of conflicts in research reports and public appearances.

A. Current Rules Governing Disclosure of Conflicts of Interest

NYSE Rule 472 and NASD Rule 2210 currently require member firms to disclose certain conflicts of interest whenever a firm (or one of its analysts) recommends the purchase or sale of a specific security. Under existing rules, a firm must disclose if it makes a market in the recommended security and if it was manager or co-manager of a public offering of the issuer within the last three years. In addition, a firm generally must divulge if it has a financial interest in the recommended security.

The NYSE and NASD disclosure requirements are similar, but contain some significant differences, which have led to gaps and inconsistencies between the two rules. For instance, NASD Rule 2210 requires a firm and/or its officers or partners affirmatively to disclose ownership of options, rights or warrants to purchase any of the securities of the issuer whose securities are recommended (unless such ownership is nominal), but it does not mandate they disclose ownership of common shares of a recommended issuer. Nor does NASD Rule 2210 require that the analyst who prepared a research report disclose ownership of any financial interest in a recommended issuer. NYSE Rule 472, on the other hand, requires disclosure of all financial positions (including common shares) held by a firm and its analysts, but permits the use of conditional disclosure language such as, " … the firm or employees may own options of a recommended issuer."

Although the conflict disclosure obligations are triggered by the making of a recommendation, neither rule has historically been applied by the SROs to oral recommendations by analysts appearing on television. In addition, these rules are not designed to mitigate the various pressures to which analysts are subject. For instance, reporting structures at firms where analysts are under the supervision or control of investment banking personnel, and where compensation arrangements tie analyst pay to specific investment banking deals, may exert such pressures.

B. Proposed Changes to NYSE and NASD Rules

The proposed rule changes address analyst conflicts of interest in connection with the preparation and publication of research reports for equity securities.[11] We provide here a general overview of the proposed rule changes.[12]

First, the proposals limit the relationships and communications between a firm's investment banking department and its research department. Specifically, no research analyst may be supervised or controlled by a firm's investment banking department. In addition, the investment banking personnel may not discuss pending research reports with research analysts prior to distribution, unless the communication was intermediated by staff from the legal/compliance department. Similarly, the research report may not be reviewed by the company that is the subject of the report, except for checking factual sections for accuracy.

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[11] The SRO rules apply only to research reports on equity securities. Therefore, research reports on debt securities are not within the scope of these rules. Telephone conversation between NYSE, NASD, and Division Staff, on May 3, 2002.

[12] The NASD and NYSE rules, as amended, are substantially identical and are intended to operate identically. The text of the proposed rules as originally filed, and all amendments, are available at http://www.nasdr.com/filings/rf02_21.asp and http://www.nyse.com/regulation/regulation.html.

Second, the proposed changes to SRO rules place various restrictions on, and impose certain disclosure requirements with respect to, analyst and firm compensation arrangements. An analyst's compensation may not be tied to specific investment banking transactions. If an analyst received compensation that was based on the firm's general investment banking revenues, that fact must be disclosed in the firm's research reports. The firm also would have to disclose in a company's research report if it or its affiliates have managed or co-managed a public offering of equity securities for or received investment banking compensation from the subject company in the past 12 months, and if it expects to receive or intends to seek compensation for investment banking services in the next three months. Finally, if an analyst recommends a security in a public appearance, and the issuer was a client of his or her firm, the analyst must disclose that fact.

Third, the proposed rule changes would take certain measures to prevent promises of favorable research. A firm may not offer a favorable research rating or specific price target to a company as consideration or inducement for the receipt of business or compensation. The proposal also would require "quiet periods" during which a firm acting as manager or co-manager of a securities offering could not issue a report on a company: within 40 days after an initial public offering ("IPO") or within 10 days after a secondary offering of an inactively traded security.

Fourth, the proposals place various restrictions on an analyst's personal trading. In general, no analyst (or household member) may purchase or receive an issuer's securities prior to its IPO, if the company engages in a type of business covered by the analyst. In addition, no analyst may trade securities issued by companies the analyst follows for the

period beginning 30 days prior to the issuance of the research report and ending five days after the date of the report. The analyst also may not engage in trading contrary to the analyst's most recent recommendations.

Fifth, the proposed rule changes require certain disclosures about the ownership of securities by the firm and the analyst. An analyst must disclose in public appearances, and a firm must disclose in research reports, if the analyst or a member of his or her household has a financial interest in the securities of a recommended company. If, as of the previous month end, the firm owns one percent or more of any equity class of the company, that fact also must be disclosed during the analyst's public appearance or in the research report.

Finally, the proposal requires specific additional disclosures in research reports to provide investors with better information to make assessments of a firm's research. Firms must define in research reports the meaning of all ratings used in the ratings system and the definition of each rating must be consistent with its plain meaning (e.g., "hold" must mean hold and not "sell"). In addition, regardless of the ratings system employed, firms must provide the percentage of all ratings assigned to buy/hold/sell categories. The proposal also requires a price chart that maps the historical price movements of the recommended security and indicates those points at which ratings or price targets were assigned or changed.

III. SUMMARY OF COMMENTS

The Commission received 55 comments from 52 commenters on the proposed rule changes. Although the vast majority of commenters supported the fundamental goals and objectives behind the proposed rule changes, many commenters also believed the initial

proposal needed to be revised and suggested substantive changes.[13] In response to various concerns and suggestions raised by commenters, the NYSE and the NASD filed amendments to their proposals. The NYSE and NASD responded to the comments in separate letters.[14]

IV. DISCUSSION

After careful review, the Commission finds, as discussed more fully below, that the proposed rule changes, as amended, are consistent with the requirements of the Exchange Act and the regulations thereunder applicable to the NYSE and NASD.[15] In particular, the Commission believes that the changes are consistent with Sections 6(b)(5) and 6(b)(8) of the Exchange Act,[16] and also Sections 15A(b)(6) and 15A(b)(9) of the Exchange Act.[17]

Section 6(b)(5) requires, among other things, that the rules of an exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of free trade, to remove impediments to and perfect the mechanism of a free and open market, and to protect investors and the public interest. Section 6(b)(5) also requires that the rules of an exchange not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers. Section 6(b)(8) of the Exchange Act prohibits the rules of an exchange from imposing any burden on competition not necessary or appropriate in furtherance of the purposes of the statute.

Section 15A(b)(6) requires that the rules of a registered national securities association be designed to prevent fraudulent and manipulative acts and practices, to promote just and

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13 See, e.g., SIA letter; Morgan Stanley letter.

14 See notes 9 and 10 above.

15 See 15 U.S.C. 78c(f).

16 15 U.S.C. 78f(b)(5) and (8).

17 15 U.S.C. 78o-3(b)(6) and (9).

equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. Section 15A(b)(9) requires that the rules of an association not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Section 3(f) directs the Commission to consider, in addition to the protection of investors, whether approval of the rule change will promote efficiency, competition, and capital formation.[18] In approving the proposed rule changes, the Commission has considered their impact on efficiency, competition, and capital formation.

The Commission believes the rule changes, as amended, represent an important step towards helping to rebuild investors' confidence in the integrity of research and in the equities markets as a whole.

A. Definition of the Term "Research Reports"

There was substantial concern among commenters regarding inconsistencies between the NASD's and NYSE's definitions of research reports, and requests that the SROs harmonize their language.[19] Many commenters also argued that the scope of the proposed definitions of research report was overbroad and would impede the flow of information to investors. They asserted that the definitions may be read to include quantitative technical analysis, other general market commentary, company updates not containing a change in

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[18] 15 U.S.C. 78c(f).

[19] See, e.g., Charles Schwab letter.

rating or target, other reports concerning indexes, baskets, or market sectors, and sales literature.[20] They also requested exceptions for reports distributed solely to institutions and for commentaries not including a recommendation.[21] The commenters argued that those sorts of communications were either subject to other rules or that the disclosures mandated for research reports were not warranted or suitable for such communications because, for example, they were directed at registered representatives or institutional investors or did not include an analysis and a recommendation.

In response to these comments, the NASD and NYSE amended their proposal to harmonize the definitions of "research report" under both rules. "Research report" is now defined as "a written or electronic communication which includes an analysis of equity securities of individual companies or industries, and which provides information reasonably sufficient upon which to base an investment decision and includes a recommendation."[22] In addition, the types of communications covered by the new requirements have been narrowed because the NYSE eliminated the phrase "but not limited to" in its definition. Further, the SROs stated their intentions to address, through written interpretation, in a manner consistent with the rules, practical issues raised by commenters. In particular, they will examine various communications, such as abstracts, updates, weekly and monthly summaries, industry/market sector reports, portfolio strategy pieces, quantitative research and technical analysis, and

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20 See, e.g., SIA letter; NYSBA letter.

21 See, e.g., SIA letter; Pickard and Djinis letter.

22 This definition of research reports is narrower in scope than the reports covered by the Commission's Rules 137, 138 and 139 under the Securities Act of 1933 ("Securities Act") and should not be construed as relating to those rules.

general market commentary and trading strategies, to determine whether they meet the definition of research reports.

Commenters also raised concerns regarding their ability to meet all disclosure requirements under the proposed rules when issuing compendium reports on numerous issuers.[23] They argued that the disclosures required for all of the issuers in such reports would be voluminous and would be difficult to include in the reports. Specifically, including a price chart for each security in a research report that discusses multiple securities could add considerable length to such communications. Commenters noted that technological limitations would make it impossible to transmit electronically the required disclosures for each subject company through many systems. [24]

The NASD and NYSE responded to these concerns by providing that, instead of including the required disclosures in compendiums, research reports covering six or more subject companies may use prominent disclosure that advises the reader as to where the required disclosures can be accessed. The SROs stated their intention to issue additional guidance on the mechanics of satisfying the disclosure requirements for compendium reports, whether they are issued electronically or in paper format.

Commenters' concerns also included whether the research report definition would capture reports by investment advisers not principally responsible for preparation of research, and reports distributed by third party research vendors. One commenter stated that "a significant portion of this research provided by broker-dealers to institutional money managers consists of independent and disinterested research (sometimes referred to as 'third

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[23] See, e.g., CSFB letter.

[24] See, e.g., PSI letter.

party research')," which is produced by third parties that are "independent and unaffiliated" with the broker-dealer providing the research.[25] This commenter urged that the NASD's definition of "research report" be modified to mean a report that the broker-dealer has "authored, prepared or over which he has editorial control," rather than one that the "member has distributed."[26]

Many commenters also inquired as to whether the proposals' disclosure requirements would apply to research reports that are distributed by SRO member firms to their customers, but have been prepared by non-member organizations affiliated with or not affiliated with the member, including investment advisers or foreign broker-dealers.

The SROs have acknowledged that the distribution of research reports prepared by non-member firms raises complex issues that will vary depending on the type of report, the entity that created the report, and the member's participation in the production or distribution of the report. The SROs intend to review the application of the rules to research reports not produced by the member firm on a case-by-case basis; however, generally where a member firm is distributing in the United States research of its affiliate, the member firm should disclose applicable conflicts that must include the disclosures required by the rules regarding the member. These rules do not require the member firm to include disclosures about the non-member affiliate or its employees.[27] The disclosure requirements will not apply to

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25 Alliance letter.

26 Id.

27 Some firms may choose to disclose that the non-member affiliates and their employees are not subject to the SROs' disclosure rules, which apply to members and associated persons. We note, however, that other provisions, including antifraud provisions such as Exchange Act Section 10(b) and Rule 10b-5, apply to non-member affiliates and their employees.

independently produced research such as that distributed pursuant to the provisions of Exchange Act Section 28(e).[28]

The Commission finds that the rules defining the term "research report," as amended, are consistent with the Exchange Act, and specifically, Exchange Sections 6(b)(5) and 15A(b)(6) in that the rules should help prevent fraudulent and manipulative practices, help perfect the mechanism of a free and open market, and protect investors and the public interest. Further, consistent with Exchange Act Sections 6(b)(8) and 15A(b)(9), the Commission believes that the definition of research report, as amended, does not impose any burden on competition not necessary or appropriate in furtherance of the Exchange Act. We note that the SROs have tailored the definition to capture the communications that are most likely to benefit from the coverage of the rules, while at the same time tailoring the definition and the rules' application in response to concerns expressed by commenters. This amendment preserves for readers of research reports the availability of important disclosures while allowing compendium reports to remain succinct and manageable. We believe that the SROs' expressed intent to provide interpretive guidance should help refine the rules' application to achieve the SROs' intended goals.

B. Relationships and Communications between Research, Investment Banking, and Subject Companies

The proposed rules prohibit research analysts from being subject to the supervision or control of a firm's investment banking department, and require legal and compliance personnel to act as intermediaries between research and investment banking with regard to the

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[28] 15 U.S.C. 78bb(e). Telephone conversation between NYSE, NASD, and Division Staff, on May 3, 2002.

contents of research reports. The proposals also limit the extent to which subject companies can review research reports prior to distribution, and require legal or compliance personnel to receive copies of the portions of reports that are submitted to subject companies and approve any resultant changes to ratings or price targets.

Commenters opposing these provisions primarily argued that compliance personnel are not suited for the gatekeeper role called for in the proposal.[29] For example, one commenter asserted the proposal would require legal/compliance departments to have a direct role in the preparation of research and act, in essence, as supervisory analysts.[30] Unlike senior research management, they argued, legal/compliance staff would be unable to independently assess the credibility of a claim by a research analyst that a recommendation was changed as a result of information given by the subject company.[31] Commenters also argued that the proposed compliance structure would impose inordinate cost burdens, especially on smaller firms that may be driven out the research business as a result.[32] One commenter argued that this might ultimately reduce research coverage, especially of smaller companies.[33] On the other hand, one commenter stated that analysts are expected to be experts in fact gathering, and that there was therefore no reason to allow a draft research report to be shown to the investment banking unit or the issuer.[34] At least one commenter supported the "gatekeeper" provisions for legal/compliance personnel and suggested only minor clarifying changes,

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29 See, e.g., SIA letter; Morgan Lewis letter; PSI letter; NASAA letter. NASAA argued that analysts should be prohibited from showing draft research reports to investment banking or issuer personnel.

30 See, e.g., ABA letter.

31 SIA letter.

32 See, e.g., Ryan Beck letter; Janney Montgomery Scott letter; Pacific Growth letter.

33 SIA letter.

34 NASAA letter.

noting these provisions "go to the heart of the public perception issues with respect to analyst independence issues." [35]

The NYSE and NASD considered commenters' concerns, but retained the limits on relationships and communications in the proposed rules. The SROs stated their belief that increased involvement by legal/compliance personnel is necessary to bolster their traditional role of monitoring for potential conflicts of interest between a firm's research department and investment banking department, which is already codified in the SROs' rules. Moreover, their participation would further the purpose of this regulatory initiative by reducing the possibility of any undue influence or pressure by investment banking or subject companies on the integrity and objectivity of a research report.

The NYSE stated its belief that the benefits of the "gatekeeper" function far outweigh the unavoidable costs and administrative burdens to member organizations, and are necessary to restore integrity to the research process and the marketplace as a whole. The NYSE stated these are common concerns to the SROs and member organizations, both large and small. The NASD considered possible exemptions for small firms, but believes that some smaller firms' environments may present similar conflicts of interest as large firms. The NASD intends to review this issue again in the future to determine what accommodations may be made consistent with investor protection.

The Commission considers this provision to be a significant improvement over current SRO rules. The Commission believes the prohibition on research department personnel being subject to the supervision or control of the investment banking department helps protect

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[35] See, e.g., Goldman Sachs letter.

analysts from undue influences.[36] The Commission also believes the communication restrictions between analysts and investment banking and between analysts and subject companies are appropriate. These new requirements are designed to foster an environment where research analysts, and the research reports they write, remain independent of the inappropriate influences of investment banking departments and covered companies. The Commission notes that the prohibition is limited to communications regarding pending research reports and does not apply to interdepartmental communications that are not about reports. Therefore, the rules only prohibit the type of communications that raise the core concern of investment banking pressuring the research department personnel into issuing a particular report or rating. Communications intermediated by legal/compliance personnel should allow for the issuance of factually accurate research reports while shielding analysts from improper pressures and influences.[37]

The SROs have represented that legal/compliance personnel are not expected to become as knowledgeable as analysts about the content of research reports or ratings.[38] Rather, as "gatekeepers," they are expected to verify that only appropriate communications about the content of research reports take place between analysts and personnel in investment banking or at issuers, and that any changes that are made to reports after such communications appear to have a substantial basis. The Commission also notes that the SROs

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36 This prohibition codifies one of the guidelines recommended by the SIA in its "Best Practices for Research," published in June 2001.

37 As noted by the SROs, this is not an entirely new role for member compliance departments. For example, member compliance departments presently are expected to perform substantive supervision of interdepartmental communications. See "NASD/NYSE Joint Memo on Chinese Wall Policies and Procedures" (July 1991).

38 Telephone conversation between NYSE, NASD, and Division Staff, on May 3, 2002.

intend to review the application of this provision to determine possible accommodations for small firms.

The Commission finds that the rules addressing the relationships between research, investment banking and companies that are the subject of research analyst reports should further the purposes of the Exchange Act. Specifically, the rules address the potential pressures on research analysts by adopting measures designed to reduce the possibility of undue influence or pressure by investment banking departments or the subjects of the research report. We believe these rules should help prevent fraudulent and manipulative practices, help perfect the mechanism of a free and open market, and protect investors and the public interest. Further, we believe that the rules will not impose any burden on competition that is not necessary or appropriate to achieve the goals of the Exchange Act.

C. Disclosure of Firm Compensation from Covered Companies

In the initial filing of the proposed rule changes, firms would have been required to disclose in research reports and public appearances if the member organization or its affiliates received compensation from the subject company within the past twelve months, or reasonably expected to receive compensation from the subject company within three months following the publication of the research report.

Industry commenters raised three primary concerns. First, commenters expressed concerns about the potential for "signaling" or "tipping" about non-public transactions.[39] One commenter noted "the required disclosures could serve to alert investors and public side employees of the member firm, such as research analysts and traders, to the existence of a

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[39] See, e.g., CSFB letter; ASCS letter; Sullivan & Cromwell letter.

confidential investment banking transaction or assignment."[40] Second, commenters argued that the provision's scope was overly broad in that it required disclosure of all forms of compensation from the issuer, including compensation received or reasonably expected by affiliates of the member firm, which would result in a large volume of meaningless disclosures to investors.[41] Third, commenters noted that it would be extremely expensive for firms to implement compensation tracking systems for members and their affiliates.[42] However, one commenter stated that the disclosure periods should be expanded to three years before and one year after publication of the research report.[43]

In response to these concerns, the SROs modified their proposals to require disclosure if the member or its affiliates (1) managed or co-managed a public offering of securities for the subject company in the past twelve months; (2) received compensation for investment banking services from the subject company in the past twelve months; or (3) expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months.

The amended proposals continue to require disclosure of member and affiliate compensation. However, the scope is focused on the core concern, compensation from investment banking services, as some commenters suggested.[44] Investment banking services are defined for purposes of these rules as including: acting as an underwriter in an offering for the issuer; acting as a financial adviser in a merger or acquisition; providing venture capital,

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40 Morgan Stanley letter.

41 See, e.g., SIA letter; Legg Mason letter; Wachovia letter.

42 See, e.g., SIA letter.

43 NASAA letter.

44 See, e.g., SIA letter. The SIA, however, recommended limiting the disclosure to publicly announced transactions.

equity lines of credit, PIPEs (private investment, public equity transaction) or similar investments; or serving as placement agent for the issuer. Therefore, the amended proposals are now targeted to the potential for conflicts of interest arising from the receipt of investment banking revenue. Limiting reporting of compensation to investment banking services should also significantly reduce the costs and difficulties associated with tracking the relevant information compared with the original proposal.

The development of this disclosure requirement reflects the tension between disclosure that (1) is specific enough to provide meaningful information to investors about a firm's interest in obtaining revenue from providing services to an issuer covered by its research, but also may reveal (i.e., "tip") information about confidential transactions; and (2) is so general that it will not reveal significant information about non-public transactions, but also will not alert investors to the nature of the firm's conflict of interest. The tipping concern is addressed by the amendments. First, "investment banking services" is broadly defined so that the existence of the compensation is clear, but the type of transaction(s) involved is not. It is not limited to public transactions as some commenters urged[45] because, as the NASD has noted, the receipt of investment banking revenue for non-public transactions can provide an equally strong incentive to publish favorable research.[46] Second, the forward-looking disclosure provision now requires disclosure of compensation for investment banking services that the firm "expects to receive or intends to seek" from the issuer in the next three months. This addresses the concern of commenters that the prior formulation requiring disclosure if

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45 See, e.g., SIA letter.

46 Release No. 34-45526 (March 8, 2002), 67 FR 11526, 11534.

the firm "reasonably expects to receive" compensation from the issuer had substantial interpretive uncertainty.[47]

Various scenarios are set forth by commenters where the proposed disclosures could tip the research department or investors that an undisclosed investment banking transaction was in the offing. The SROs believe that the present form of disclosure reduces these concerns by including compensation the firm "intends to seek." Thus, it represents a reasonable balance between broad, meaningless disclosure, and disclosure that would reveal confidential information. In some rare cases a firm may have to choose between making the disclosure and refraining from issuing research, in order to preserve client confidences in connection with an investment banking transaction.

Some commenters predict that the forward-looking disclosure will become boilerplate and not meaningful for investors because all firms will state that they intend to seek investment banking business from every issuer. However, this disclosure does have meaningful content. First, if the securities firm does not in fact plan to seek investment banking business in three months, including the language in disclosures would constitute a false statement. Even if firms regularly state that they intend to seek compensation, the inclusion of this disclosure can put investors on notice of potential conflicts concerning any recommendations that the firm may make about the issuer's securities. Finally, for firms that produce research but do not provide investment banking services, the absence of the disclosures (because the firm does not have the types of conflicts covered by the SRO rules) can be meaningful to investors.

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47 See, e.g., SIA letter.

Finally, we believe it is appropriate for the SROs to require that the firm disclose if it was the manager or co-manager of a public offering for the subject company within the past twelve months, given that this is a more limited statement of an existing requirement.[48]

In conclusion, as discussed in detail above, we find that the SROs rules relating to disclosures of broker-dealer compensation from companies covered by the broker-dealers in research analyst reports meet the requirements of the Exchange Act, including Sections 6(b)(5), 6(b)(8), 15A(b)(6) and 15A(b)(9).

D. Research Analyst Compensation Arrangements

The proposed rules provide that SRO members may not pay any bonus, salary, or other form of compensation to a research analyst that is based upon a specific investment banking services transaction. In addition, analysts must disclose if their compensation is based upon (among other factors) the member's investment banking revenues. Generally, commenters agreed that analyst compensation should not be based on specific investment banking services transactions. Some commenters believed that if investment banking services transactions factored into analyst compensation in any way, there would be a competing incentive creating a conflict of interest.[49] Other commenters believed that analyst compensation should be tied to the merit and success of recommendations, which would align analysts' compensation interest with research performance. [50] Other commenters noted that research analysts provide valuable services to investment banking business and they should therefore be able to receive some form of compensation for their expertise and

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48 NYSE Rule 472; NASD Rule 2210. Retention of this disclosure requirement was also suggested by some commenters. See, e.g., SIA letter.

49 See, e.g., Pacific Growth letter.

50 See, e.g., AIMR letter.

contributions.[51] One commenter argued that the prohibition on compensation for specific investment banking transactions should be limited to transactions for public company clients.[52]

The NYSE and NASD believe that the proposed restrictions on analyst compensation are appropriate. By prohibiting compensation from specific investment banking transactions, the proposals would significantly curtail a potentially major influence on a research analyst's objectivity, without preventing a research analyst from sharing generally in the overall success of the firm, which may derive in part from investment banking transactions for subject companies. The SROs believe that investors can consider disclosure in research reports of whether the research analyst has been compensated based in part upon the member's investment banking revenues, in evaluating the objectivity of a research report.

The Commission believes that the proposed amendments are a significant improvement on the existing SRO rules, which neither prohibit tying analyst compensation to specific investment banking activities nor require disclosure of analyst compensation arrangements. Moreover, the proposed disclosure requirements provide investors with material information regarding possible conflicts that an analyst may have, allowing them to better determine the value of the research in making investment decisions. Therefore, we find that the amendments relating to analyst compensation are consistent with the Exchange Act, including Sections 6(b)(5), 6(b)(8), 15A(b)(6) and 15A(b)(9).

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51 See, e.g., Wachovia letter; NYSBA letter.

52 SunTrust letter.

E. Price Charts

The proposed rules require disclosure of the percentage of all securities rated by the member to which the member would assign a "buy," "hold/neutral," or "sell" rating, and 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. The proposed rules also require members to present a line graph/chart of the security's daily closing prices for certain periods when the member has assigned a rating on that security for at least one year. The line graph/chart must indicate the dates on which the member assigned or changed each rating or price target and each rating and price target assigned or changed on those dates. In addition, the rules require members to provide the meanings of all ratings used by the member.

Generally, commenters agreed with the goal of providing investors with information about the distribution of a firm's recommendations and price information about rated securities. However, some commenters argued that this information would be costly to broker-dealers while providing little actual benefit to investors.[53] Other commenters expressed concern that certain electronically transmitted reports will not technologically support a price chart format, and that tables should therefore be permitted in those instances.[54]

The SROs did not amend these provisions. We understand the SROs intend to provide guidance on a case-by-case basis that tables will be acceptable in situations where charts are not feasible so long as the table contains the information required by the rule.[55]

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53 See, e.g., Morgan Stanley letter.

54 See, e.g., CSFB letter.

55 Telephone conversation between NYSE, NASD, and Division Staff, on May 3, 2002.

The Commission believes that these disclosures, including ratings distributions and price charts, are consistent with the Exchange Act. These provisions should help to address public concerns regarding the fact that analysts have issued very few sell ratings, and that firms often did not change recommendations even when a security's price was falling precipitously.[56] The rule will assist investors in evaluating what value to place on the ratings assigned to securities.

As a result, the Commission finds that the disclosures relating to ratings distributions and price charts should help perfect the mechanism of a free and open market, and protect investors and the public interest, consistent with the Exchange Act, particularly Sections 6(b)(5) and 15A(b)(6). Further, the Commission finds that such disclosure imposes no burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act, consistent with the requirements of Exchange Act Sections 6(b)(8) and 15A(b)(9).

F. Prominence of Disclosures

The proposed SRO rules require that the front page of a research report either must include the disclosures required under the rules, or must refer the reader to the page or pages in the report on which each such disclosure is found. Disclosures, and references to disclosures, are required to be clear, comprehensive and prominent. No commenters disagreed with these requirements. However, some commenters argued that the provisions

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[56] See, e.g., Keenan, "Bad Advice: How Wall Street Analysts Burn Investors," *Bloomberg*, July 2000, page 24; Oppel, Jr., "Wall Street Analysts Faulted on Enron," *New York Times*, February 28, 2002; Smith & Lucchetti, "Analysts' Picks of Enron Stock Face Scrutiny," *Wall Street Journal*, February 26, 2002.

requiring that disclosures be prominent may present difficulties in the context of electronic reports.[57]

The Commission believes that these proposals are essential to alert investors to analysts' conflicts. With respect to compendium reports, the SROs' response to provide alternative access where the required disclosures would be voluminous is reasonable. Importantly, a compendium must contain clear and prominent information about where investors may obtain disclosures about securities discussed in the compendium. Therefore, the Commission finds that these provisions are consistent with the Exchange Act, specifically Sections 6(b)(5), 6(b)(8), 15A(b)(6) and 15A(b)(9).

G. Quiet Periods Following the Issuance of Research Reports

Commenters heavily criticized the SROs' proposal to bar firms that acted as manager or co-manager of the subject company's offering from publishing research about the issuer for forty days following an IPO and for ten days following a secondary (i.e., non-IPO) offering. Commenters argued that these prohibitions were inconsistent with the spirit of Rules 138, 139, and 174 of the Securities Act[58] as well as Regulation M,[59] and that the rules would impede the flow of information at a time when information is most useful.[60] Commenters also argued that the provisions should not apply to secondary offerings for seasoned issuers, because underwriter research would not have as great an influence on these securities.[61] Commenters further argued that the rules would unfairly discriminate against managers and

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57 See, e.g., Wachovia letter; PSI letter.

58 17 CFR 230.138, 230.139, and 230.174.

59 17 CFR 242.101 - 105.

60 See, e.g., Sullivan & Cromwell letter; Merrill Lynch letter; SSB letter.

61 See, e.g., SIA letter; Goldman Sachs letter.

co-managers as compared to other syndicate members that are not subject to the quiet periods.[62] Many commenters also asserted that the provisions would disadvantage domestic firms that would be subject to these restrictions as compared to foreign competitors who would not need to comply with the rules when distributing research to institutions under Exchange Act Rule 15a-6.[63] These commenters noted that, therefore, the restrictions would harm retail investors who, unlike institutional investors, would not have access to research from the manager or co-manager during this period.[64] One commenter, however, supported the proposals and argued that there should be no exceptions for seasoned issuers.[65]

With regard to commenters' concerns, the NYSE and NASD noted that the rules are not intended to prevent a managing or co-managing underwriter from issuing a positive research report. Rather, the quiet period will reinforce the prohibition against a member offering to reward a subject company for its securities underwriting business by publishing favorable research right after the completion of the distribution. The SROs also stated their belief that the quiet period for an IPO will permit market forces to determine the price of the security in the aftermarket unaffected by research reports issued by firms with the most substantial interest in the offering. Finally, the SROs noted that while the rules will prohibit the managers and co-managers from publishing research reports during the quiet period, other broker-dealers will be able to initiate and maintain research coverage on the subject company.

The NASD and NYSE filed amendments to respond to commenters' concerns about the proposed quiet period for secondary offerings. The amendments provide an exception for

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62 See, e.g., Cleary letter; A.G. Edwards letter; Morgan Lewis letter.

63 17 CFR 240.15a-6. See, e.g., Dorsey letter; HSBC letter; Fried Frank letter.

64 See, e.g., Morgan Stanley letter.

65 AIMR letter.

research reports that are issued under Rule 139 under the Securities Act as to those issuers whose securities are actively traded as defined in Rule 101(c)(1) of Regulation M.[66] The SROs noted the proposed amendments would support market efficiency by permitting the dissemination of research reports for certain actively traded securities.

We believe that the determination of the SROs to impose a quiet period for IPOs, while different from the requirements under Commission rules under the Securities Act, is consistent with the Exchange Act. Some commenters stated that the forty-day quiet period was inconsistent with Securities Act Rule 174.[67] We do not agree. Under Section 4(3) of the Securities Act[68] and Rule 174 thereunder, a dealer (including an underwriter no longer acting as an underwriter) may not distribute a prospectus (including a research report) unless accompanied or preceded by a prospectus satisfying the requirements of Section 10 of the Securities Act[69] during the twenty-five days following an IPO for a security listed on a national securities exchange or on Nasdaq. For most IPOs of other securities, the prospectus delivery period is ninety days. In practice, dealers (including the underwriters) do not issue research during this period (and it also has been called a quiet period).

The NASD and NYSE rules apply only to the manager and co-manager(s) of an IPO. With respect to these firms, the rules in effect extend the quiet period in many cases by fifteen days. The quiet period should act to reinforce the prohibition on the use of research reports as an inducement for investment banking business. A promise of favorable research as an inducement to an issuer to use a particular firm's investment banking services will likely not

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66 17 CFR 242.101(c)(1).
67 17 CFR 230.174. See, e.g., ABA letter.
68 15 U.S.C. 77(d)(3).
69 15 U.S.C. 77j.

be as attractive if the research potentially will follow research issued by other analysts. During this period, investors will not be bereft of information, as they will be able to consider the reports of independent analysts as well as other syndicate members for fifteen days until the lead underwriters may again publish research. In our view, the quiet period is an acceptable means to mitigate the pressures to solicit business on the basis of favorable research.

We agree with the conclusion of the SROs that the argument that institutions will have greater access to research (such as from foreign firms) than will U.S. retail investors during the forty-day quiet period is not determinative of the value of these rules. If the security is followed by others than the manager or co-manager, this research may be available to institutions and retail investors alike. The fact that institutions may have greater access to research from sources not subject to these rules does not diminish the salutary effect of the quiet period with respect to research issued by managers or co-managers of offerings.

The SROs have a valid rationale for imposing the forty-day quiet period for IPOs and there is no conflict with Securities Act Rule 174. Thus, we view the rules as consistent with the Exchange Act.

The SROs' determination to except from the ten-day quiet period research in connection with secondary offerings for seasoned issuers whose securities are actively traded appears consistent both with the spirit of the proposals and the securities laws. As many commenters have pointed out, Rules 139 of the Securities Act and Regulation M recognize

that research on large seasoned issuers will have a relatively lower market impact.[70] Because there is likely to be substantial information regarding these issuers in the marketplace, investors are less likely to be influenced by any one research report, even one issued by a managing underwriter, and there is a lower likelihood that investment banking business will be tied to a favorable research report.

As discussed above, the Commission believes that the SROs' rules relating to quiet periods should permit market forces to determine the price of the security in the aftermarket unaffected by research reports issued by firms with the most substantial interest in the offering. The Commission finds that, as a result, these rules are consistent with the Exchange Act, particularly Sections 6(b)(5), 6(b)(8), 15A(b)(6) and 15A(b)(9), in that they should help prevent fraudulent and manipulative practices, help perfect the mechanism of a free and open market, and protect investors and the public interest. Further, we believe that the rules will not impose any burden on competition that is not necessary or appropriate to achieve the goals of the Exchange Act.

H. Disclosure of Firm Ownership of Securities

The SROs' original proposals would have required disclosure in reports or appearances if, as of five business days before the publication of the research report or a public appearance, the firm or its affiliates beneficially owned 1% or more of any class of common equity securities of the subject company.

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[70] The SROs have not included a reference to Securities Act Rule 138 in their rule amendments, as some commenters suggested, because the quiet period applies only to offerings of equity securities. Telephone conversation between NYSE, NASD, and Division Staff, on May 3, 2002.

Commenters almost uniformly opposed this provision.[71] Most commenters argued the ownership threshold and rolling look-back component were impractical, because they imposed a lower ownership disclosure and more onerous timing than Sections 13(d) and 13(g) of the Exchange Act.[72] Several commenters noted that concerns would be mitigated if firms were permitted instead to disclose 5% beneficial ownership on a quarterly basis, as required under Section 13.[73] Otherwise, commenters argued, member firms would incur costly systems changes to track beneficial ownership at the proposed 1% threshold on a rolling five-day look back basis.[74]

In response to these concerns, the SROs filed amendments with a more flexible approach that does not undermine the effectiveness of the proposals. The amended provisions require disclosure of the 1% ownership as of the month-end prior to issuance of the research report or public appearance, determined within ten calendar days after the month-end. In the event that the research report or public appearance is made less than ten calendar days from the end of the previous month, the 1% disclosure may be as of the end of the second most recent month.

The Commission believes that this disclosure will provide investors with useful information to better evaluate the nature and extent of a firm's financial interest in a recommended company. The Commission believes the disclosure requirements under the proposals represent a significant improvement over the current ownership disclosure rules of the NASD and NYSE, which are inconsistent with one another and allow for conditional

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71 See, e.g., Goldman Sachs letter; Morgan Stanley letter; UBS letter; SIA letter.

72 15 U.S.C 78m(d), (g).

73 See, e.g., UBS letter.

74 See, e.g., Morgan Stanley letter.

disclosure of financial interests. The amendments to the original proposal respond to commenters' concerns by reducing the burden of the frequency of calculations, while continuing to provide readers of research reports with reasonably timely disclosure of ownership. The snapshot approach of a monthly calculation is much less onerous than the original rolling requirement. The Commission also notes that although the 1% ownership threshold is lower than that tracked for Section 13 purposes, it is actually less burdensome than the current requirement under NASD Rule 2210, which has no minimum threshold. Therefore, the Commission finds that the rules relating to disclosure of firm ownership of securities is consistent with the Exchange Act, particularly Sections 6(b)(5), 6(b)(8), 15A(b)(6) and 15A(b)(9).

I. Restrictions on Personal Trading by Research Analysts

The proposal prohibits analysts and their household members from: (1) purchasing or receiving pre-IPO shares in companies/industries that are the subject of their research reports; (2) trading in recommended securities thirty days prior and five days after issuance of a research report or a change in rating or price target; and (3) trading in a manner contrary to the analyst's recommendations.

Some commenters believed that research analysts should not be singled-out for special restrictions.[75] Others argued that research analysts should only be required to obtain pre-approval of trades.[76] One commenter said that analysts should be banned from any trading in

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75 See, e.g., AIMR letter.

76 See, e.g., AIMR letter; A.G. Edwards letter.

securities that they cover.[77] There was general agreement among commenters that an analyst should not trade in a manner contrary to his or her recommendations.

The NYSE and NASD believe that disclosure alone is not sufficient to mitigate the conflicts of interest that can arise when a research analyst invests in securities of companies he covers, particularly with respect to the purchase or receipt of pre-IPO shares. Accordingly, the SROs included personal trading restrictions in addition to requiring associated persons to disclose any financial interest they or a household member may have in a subject company. Pre-IPO shares often are acquired at low cost, but are likely to generate substantial profits when a public offering is made of the issuer's equity. The desire to liquefy holdings of these securities can create a strong incentive for an analyst to publish favorable research. Commenters also expressed concern that the thirty and five-day trading restrictions could significantly interfere with the production of research. The effect of this provision is to prevent the analyst from issuing research if she has traded in securities of the subject company within the preceding thirty days. The firm could still publish research on the company if it is prepared by another analyst.

We think the trading restrictions, while stringent, have been justified by the SROs as needed to remove an incentive to trade around the time of issuing a research report that could affect the value of the acquired security, thereby increasing the reliability of published research. Moreover, the trading prohibitions are not absolute. They limit trading only close in time to the issuance of a research report. Changing holdings outside of these time frames is still permitted. The rules also contain an exception for significant changes in the analyst's

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77 NASAA letter.

financial circumstances if the analyst receives approval for a transaction from the legal/compliance department. In addition, the SRO rules provide that an analyst can dispose of an existing position in a security when the analyst initiates coverage of the issuer, to avoid being constrained from changing its holdings.

Finally, the proposed rules, as amended, also contain exceptions to the prohibitions on analyst personal trading for the purchase or sale of the securities of a registered diversified investment company as defined under Section (5)(b)(1) of the Investment Company Act of 1940, or any other investment fund that neither the analyst nor a member of the research analyst's household has any investment discretion or control, provided that: the research analyst accounts collectively own interests representing no more than 1% of the assets of the fund; 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, if the investment fund distributes securities in kind to the research analyst or household member before the issuer's initial public offering, the research analyst or household member must either divest those securities immediately or refrain from participating in the preparation of research reports regarding that issuer.

Some commenters suggested changes to these exceptions.[78] Commenters raised issues regarding the treatment of bank collective funds as compared to the treatment of diversified investment companies, as defined by the Investment Company Act of 1940;[79] potential difficulty in monitoring the 1% and 20% thresholds after the initial investment was made;[80]

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78 See, e.g., NYSBA letter.

79 ABASA letter.

80 See, e.g., Goldman Sachs letter; Nomura letter.

and interpretive questions regarding the 20% threshold.[81] The SROs did not make any changes to this exception other than to conform the text of their rules. We believe that these provisions are consistent with the Act and that these matters raised by commenters can be addressed through an interpretive process.

A number of commenters questioned whether the term "household member" would include roommates and other unrelated persons who occupy the same residence as an associated person.[82] These commenters argued "household member" should be limited to family members and others who are financially dependent on the associated person. While it seems appropriate that dependents be covered, it is not clear that the term should be limited to these relationships. The NYSE and NASD agree that interpretations may be necessary to address specific applications of the term. [83]

The NASD and NYSE rules relating to trading by analysts and their household members should help mitigate conflicts of interest that can arise when a research analyst invests in the securities of companies the analyst covers, particularly when that investment is in pre-IPO shares. The Commission finds that these rules are consistent with the Exchange Act, particularly Sections 6(b)(5) and 15A(b)(6)/ By reducing the likelihood that analysts will face conflicts of interest, these rules should help prevent fraudulent and manipulative acts and practices, help perfect the mechanism of a free and open market, and protect investors and the

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81 See, e.g., Moran Lewis letter; NASAA letter.

82 See, e.g., SunTrust letter.

83 In this context and others where interpretations of terms may be required, we expect that the NYSE and NASD will consult with each other.

public interest.[84] In addition, consistent with Sections 6(b)(8) and 15A(b)(9) of the Exchange Act, burdens on competition not necessary or appropriate in the furtherance of the purposes of the Exchange Act.

J. Implementation

Several commenters requested that the rule changes be phased in over a staggered period, if adopted, because some of the proposals require the development of new disclosure systems and procedures that will require time to create, test, and implement.[85] At least one commenter suggested up to a twelve-month implementation period for certain disclosure provisions.[86] Commenters also noted that amendments to certain disclosures could significantly shorten the timeframe and reduce the costs for implementation.[87]

In response to the comments, the SROs decided upon the following implementation schedule for the proposed amendments (all time periods run from the date that the Commission approves the filings) in order to provide reasonable time periods for members and member organizations to develop and implement policies, procedures and systems to comply with the new requirements:

∗ Disclosure of 1% firm ownership positions – 180 calendar days.

∗ Legal/compliance department intermediation – 120 calendar days.

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84 The proposed rules require that a senior officer submit an annual attestation that the member organization has established and implemented procedures reasonably designed to comply with the new rules. One commenter thought that these rules should not be singled out for attestation. See A.G. Edwards letter. Another commenter thought that an attestation requirement should extend to individual analysts. See AIMR letter. The SROs determined to retain the attestation requirement. We find that this requirement is consistent with the Exchange Act.

85 See, e.g., SIA letter; CSFB letter; SSB letter.

86 See, e.g., SIA letter.

87 See, e.g., Morgan Stanley letter.

* Charts of ratings distribution – 120 calendar days.

* Price charts – 120 calendar days.

* All other provisions – 60 calendar days.

The Commission believes that the above implementation schedule suggested by the SROs is reasonable, especially given that the NYSE and NASD made a number of substantive amendments to their original proposal to reduce burdens in response to concerns raised by commenters.

Some commenters asserted that the proposed rules would aggravate the competitive imbalance between research practices within the United States ("U.S.") and those outside the U.S., and provide an incentive for issuers and institutional investors to turn to other capital markets and obtain research that is subject to less stringent regulation.[88] Maintaining the preeminent role of the U.S. capital markets and guarding against unfair competition are substantial concerns for the Commission. In today's dynamic environment, we believe that the proposed rule changes likely will increase confidence in the integrity of our markets, which may further attract issuers to the U.S. for their capital raising needs.[89] We also note that the SROs intend to further consider the issue of research prepared by affiliates, including foreign affiliates, distributed by members within the U.S.

Some aspects of the rules incorporate novel approaches to dealing with conflicts problems. In addition, the quiet periods and the "gatekeeper" requirements attracted

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88 See, e.g., ABA letter.

89 For example, the International Organization of Securities Commissions currently has a task force considering research dissemination.

substantial negative comment about their potential impact on firms and the markets.[90] The rules may have effects that cannot be foreseen at this time. Therefore, we believe that the NASD and the NYSE should assess the operation and effectiveness of the rule amendments approved today after they have been in effect for a suitable period. Accordingly, we request that the SROs prepare a report on the operation and effectiveness of these provisions and submit it, together with any recommendations for changes or additions to the rules, on or before November 1, 2003 or sooner if the SROs determine it is warranted. Moreover, on April 25, 2002, the Commission announced that it had commenced a formal inquiry into market practices concerning research analysts and the conflicts that can arise from the relationship between research and investment banking. It is possible that this inquiry will indicate the need for further SRO rulemaking or additional Commission action.[91]

V. ACCELERATED APPROVAL OF AMENDMENTS; SOLICITATION OF COMMENTS

The Commission finds good cause to approve NYSE Amendment No. 1 and NASD Amendment No. 2 to the proposed rule changes prior to the thirtieth day after the date of publication of notice of filing of the amendments in the Federal Register. The original

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90 See, e.g., SIA letter.

91 The Commission notes that when an analyst or her firm issues a recommendation that is knowingly false, or made without a reasonable basis in fact, it may operate as a fraud and deceit on investors in violation of the federal securities laws, including Securities Act Section 17(a) and Exchange Act Sections 10(b) and 15(c) and Rules 10b-5 and 15c1-2 thereunder. See, e.g., Heft, Kahn & Infante, Inc., 41 SEC 379, 386-390 (1963); See also Hanly v. SEC, 415 F.2d 589 (2d Cir. 1969); Mac Robbins & Co., 41 SEC 116, 119 (1962), aff'd sub nom. Berko v. SEC, 316 F.2d 137 (2d Cir. 1963) ("the making of recommendations to prospective purchasers without a reasonable basis, couched in terms of either opinion or fact designed to induce purchases, is contrary to the basic obligation of fair dealing borne by those who engage in the sale of securities to the public"). Cf. Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991) (discussing when false statements of opinion can give rise to anti-fraud liability under Exchange Act Section 14(a) and Rule 14a-9).

proposed rule changes and NASD Amendment No. 1 were published in the Federal Register.[92] The Commission believes that NYSE Amendment No. 1 and NASD Amendment No. 2 clarify the obligations of SRO members under the rules, refine the rules and make the NASD and NYSE proposals consistent with each other.[93] The amendments do not contain major modifications from the scope and purpose of the rules as originally proposed, and were developed from the original proposal. Further, the majority of the modifications contained in the amendments submitted by the NASD and NYSE were made in response to comments received on the proposed rule changes. The Commission believes, moreover, that approving NYSE Amendment No. 1 and NASD Amendment No. 2 will provide greater clarity, thus furthering the public interest and the investor protection goals of the Exchange Act. Finally, the Commission also finds that it is in the public interest to approve the rules as soon as possible to expedite the implementation of the new and amended rules.

Accordingly, the Commission believes good cause exists, consistent with Sections 6(b)(5), 15A(b)(6) and 19(b) of the Exchange Act,[94] to approve NYSE Amendment No. 1 and NASD Amendment No. 2 to the proposed rule changes on an accelerated basis.

Interested persons are invited to submit written data, views, and arguments concerning NYSE Amendment No. 1 and NASD Amendment No. 2, including whether the amendments are consistent with the Exchange Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Copies of the submission, all subsequent amendments,

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92 Release No. 34-45526 (March 8, 2002), 67 FR 11526 (March 14, 2002).

93 The text of the amendments are available at http://www.nasdr.com/filings/rf02_21.asp and http://www.nyse.com/regulation/regulation.html.

94 15 U.S.C. 78f(b)(5), 78*o*-3(b)(6), and 78s(b).

all written statements with respect to the proposed amendments that are filed with the Commission, and all written communications relating to the amendments 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 at the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of the SROs.

All submissions should refer to File No. SR-NASD-2002-21 and SR-NYSE-2002-09 and should be submitted by [insert 30 days from the date of publication].

VI. CONCLUSION

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act,[95] that the proposed rule changes (SR-NASD-2002-21; SR-NYSE-2002-09), as amended, are approved.

By the Commission.

Margaret H. McFarland
Deputy Secretary

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[95] 15 U.S.C. 78s(b)(2).