side would be identified as the reporting party.

Finally, it should be noted that the proposed rule change applies only to transactions that are reported to ACT, since Nasdaq does not have authority to establish rules governing the reporting of trades to non-Nasdaq systems. Thus, in circumstances where an ECN has the option to report trades to ACT or to another trade reporting system, such as the NASD's TRACS system, the rule does not mandate that the ECN use ACT for trade reporting. However, to the extent that the ECN or its subscribers opt to use ACT to report a particular transaction, all provisions of the proposed rule change would apply to that transaction.[8] In addition to the above changes, Nasdaq is also removing references to ''Select Net Service'' and the ''SmallCap Small Order Execution System'' from NASD Rule 5430(b)(8) because these systems are no longer in place.[9]

2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of section 15A of the Act,[10] in general, and with section 15A(b)(6) of the Act,[11] in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, and to protect investors and the public interest. Nasdaq purports that the proposed rule change will clarify the trade reporting obligations associated with transactions conducted through ECNs. Nasdaq believes that the adoption of clear, enforceable rules will provide guidance to market participants and thereby provide greater assurance of comprehensive reporting of ECN transactions.

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

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

[8] The proposed rule change also corrects several typographical errors in IM–6420.

[9] Telephone call between John Polise, Senior Special Counsel, Sonia Trocchio, Special Counsel, and Leah Mesfin, Attorney, Division, Commission, and John Yetter, Assistant General Counsel, and Peter Geraghty, Associated Vice President and Associate General Counsel, Office of the General Counsel, Nasdaq on July 9, 2003.

[10] 15 U.S.C. 78*o*–3.

[11] 15 U.S.C. 78*o*–3(6).

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.

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 NASD 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, including whether the proposal, as amended, is consistent with the 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, 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 file number SR–NASD–2003–98, and should be submitted by August 25, 2003.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[12]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 03–19724 Filed 8–1–03; 8:45 am]

BILLING CODE 8010–01–P

[12] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–48252; File No. SR–NASD–2002–154; SR–NYSE–2002–49]

Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc. Relating to Exchange Rules 344 (''Supervisory Analysts''), 345A (''Continuing Education for Registered Persons''), 351 (''Reporting Requirements'') and 472 (''Communications with the Public'') and by the National Association of Securities Dealers, Inc. Relating to Research Analyst Conflicts of Interest and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3 to the Proposed Rule Change by the New York Stock Exchange, Inc. and Amendment No. 3 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Research Analyst Conflicts of Interest

July 29, 2003.

I. Introduction

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the ''Exchange Act'' or ''Act''),[1] and Rule 19b–4 thereunder,[2] on October 9, 2002, the New York Stock Exchange, Inc. (''NYSE'' or ''Exchange''), and on October 25, 2002, the National Association of Securities Dealers (''NASD''), filed with the Securities and Exchange Commission (''SEC'' or ''Commission'') proposed rule changes relating to research analyst conflicts of interest.

On December 4, 2002, NYSE submitted Amendment No. 1 to its proposed rule change [3] and on December 18, 2002, NASD submitted Amendment No. 1 to its proposed rule change.[4] The proposed rule changes, as

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

[2] 17 CFR 240.19b–4.

[3] *See* Letter from Darla Stuckey, Corporate Secretary, NYSE, to James A. Brigagliano, Assistant Director, Division of Market Regulation (''Division''), Commission (''NYSE Amendment No. 1''). NYSE Amendment No. 1 conformed aspects of the proposed NYSE rules to those of NASD (*See* SR–NASD–2002–154), and proposed effective dates for the various rule provisions.

[4] *See* Letter from Philip Shaikun, Assistant General Counsel, NASD, to Katherine A. England, Assistant Director, Division, Commission (''NASD Amendment No. 1''). NASD Amendment No. 1 clarified that only research analysts who are directly responsible for the preparation of research reports would be required to register with NASD and pass a qualification examination (*See* proposed NASD Rule 1050). NASD Amendment No. 1 also conformed NASD's proposed research analyst compensation provisions to comparable NYSE provisions. NASD Amendment No. 1 also amended

Continued

amended, were published for comment in the **Federal Register** on January 7, 2003.[5] The comment period expired on March 10, 2003. The Commission received 19 comment letters on the proposed rule changes from 18 different commenters in response to the Original Notice.[6]

On May 16, 2003, NYSE filed with the Commission Amendment No. 2 to its proposed rule change (''NYSE Amendment No. 2''), and on May 20, 2003, the NASD filed Amendment No. 2 to its proposed rule change (''NASD Amendment No. 2''). NYSE Amendment No. 2 and NASD Amendment No. 2 were published together in the **Federal Register** on May 29, 2003.[7] The comment period expired on June 19, 2003. The Commission received seven comment letters in response to the notice.[8] On July 29, 2003, the NASD submitted a letter responding to comments.[9] On July 29, 2003, NYSE filed Amendment No. 3 to its proposed rule change (''NYSE Amendment No. 3''), which included its response to comments. On July 29, 2003, NASD filed Amendment No. 3 to its proposed rule change (''NASD Amendment No. 3''). This order approves the proposed rule changes, as amended by NASD Amendment Nos. 1, 2, and 3, and by NYSE Amendment Nos. 1, 2, and 3. The Commission also seeks comment from interested persons on NYSE Amendment No. 3 and NASD Amendment No. 3.

II. Background

On May 10, 2002, the Commission approved rule changes filed by the NYSE and NASD (the ''SROs'') governing research analyst conflicts of interest.[10] Those rules took considerable steps towards promoting greater independence of research analysts and significantly enhanced the disclosure of actual and potential conflicts of interest to investors. In the Original Notice, the Commission published for comment a second set of proposed rules filed by the SROs to further address research analyst conflicts of interest. In its May 10, 2002 approval order of the first round of new analyst rules, the Commission asked the SROs to report on the operation and effectiveness of those rules on or before November 1, 2003. In light of the approval of these additional rules and the Global Settlement,[11] the Commission believes that a report at that time may be premature. Thus, the Commission will request a report from the SROs when it deems such report warranted. On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (''SOA''), which requires, among other things, that the Commission, or upon authorization and direction of the Commission, a registered securities association or national securities exchange, [12] adopt rules governing analyst conflicts.[13]

Certain of the SOA's mandates were satisfied by NASD and NYSE rule provisions existing at the time of the enactment of the SOA. Other of the SOA's mandates necessitated amendments to the existing rules. The SOA requires rules governing analyst conflicts of interest, including rules: limiting the supervision and compensatory evaluation of securities analysts to certain officials; defining periods in which brokers or dealers engaged in a public offering of a security as an underwriter or dealer may not publish research on such security; and requiring securities analysts and brokers or dealers to disclose specified conflicts of interest. The primary purposes of NASD Amendment No. 2 and NYSE Amendment No. 2 were to satisfy the remaining SOA requirements.

In February 2003, the Commission approved Regulation Analyst Certification (''Regulation AC''), which requires that broker-dealers (and certain associated persons) include in research reports a statement by the research analyst certifying that the views expressed in the research report accurately reflect his or her personal views; and a statement by the research analyst certifying either that no part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report; or that part or all of his or her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.[14]

On April 28, 2003, the Commission, along with other regulators, announced a global settlement of enforcement actions against ten of the nation's largest investment firms that followed joint investigations by regulators of allegations of undue influence of investment banking interests on securities research at brokerage firms. [15]

A. Current NYSE and NASD Rules Governing Disclosure of Conflicts of Interest

In the May 2002 approval order, prior to the enactment of the SOA, the Commission approved rule changes filed by the SROs governing analyst conflicts of interest. Those rule changes were designed to address analyst conflicts of interest in connection with the preparation and publication of research reports and public appearances

---

the definition of ''research report'' to conform it to the definition in the Sarbanes-Oxley Act of 2002. NASD Amendment No. 1 also revised certain language that was contained in the discussion of the proposed amendment concerning print media interviews and articles.

[5] *See* Securities Exchange Act Release No. 47110 (December 31, 2002), 68 FR 826 (''Original Notice'').

[6] *See* Letters to Jonathan G. Katz, Secretary, Commission, from: Adams, Harkness & Hill, Inc., AG Edwards, Keefe, Bruyette & Woods, Inc., Pacific Growth Equities, LLC, RBC Capital Markets, Stephens Inc., Stifel Nicolaus & Company, and William Blair & Company, dated March 10, 2003 (''Adams et al''); The Advest Group, Inc., dated April 28, 2003 (''Advest''); Association for Investment Management and Research, dated March 6, 2003 (''AIMR March 6th''); Bloomberg News, dated February 19, 2003 (''Bloomberg''); Charles Schwab Corporation, dated March 20, 2003 (''Schwab March 20th''); Credit Suisse First Boston, dated April 16, 2003 (''CSFB''); Gibson, Dunn & Crutcher LLP, dated March 10, 2003 (''Gibson''); Investment Company Institute, dated March 10, 2003 (''ICI March 10th''); Investorside Research Association, dated March 10, 2003 (''Investorside''); Vahan Janjigian, dated February 27, 2003; Robert Lin, dated November 17, 2002; Newspaper Association of America, dated March 10, 2003 (''NAA''); North American Securities Administrators Association, Inc., dated March 10, 2003 (''NASAA''); Securities Industry Association, letters dated March 10, 2003 (''SIA March 10th'') and May 9, 2003 (''SIA May 9th''); Stifel, Nicolaus & Company, Incorporated, dated March 10, 2003 (''Stifel''); SunTrust Capital Markets, Inc., dated March 10, 2003 (''SunTrust''); Weiss Ratings, Inc., dated March 10, 2003 (''Weiss''); Wilmer Cutler & Pickering, dated March 11, 2003 (''Wilmer March 11th'').

[7] *See* Securities Exchange Act Release No. 47912 (May 22, 2003), 68 FR 103 (''May 29th Notice'').

[8] *See* Letters to Jonathan G. Katz, Secretary, Commission, from: Association for Investment Management and Research, dated July 15, 2003 (''AIMR July 15th''); Banc of America Securities LLC, dated June 26, 2003 (''BOA''); Charles Schwab Corporation, dated June 30, 2003 (''Schwab June 30th''); Investment Company Institute, dated June 19, 2003 (''ICI June 19th''); Investment Counsel Association of America, dated June 19, 2003 (''ICAA''); Securities Industry Association, dated June 26, 2003 (''SIA June 26th''); Sullivan & Cromwell LLP, dated June 19, 2003 (''Sullivan''); Wilmer Cutler & Pickering, dated June 25, 2003 (''Wilmer June 25th'').

[9] *See* Letter from Philip A. Shaikun, Associate General Counsel, NASD to James A. Brigagliano, Assistant Director, Division, Commission (July 29, 2003) (''NASD Response to Comments'').

[10] *See* Securities Exchange Act Release No. 45908, 67 FR 34968 (May 16, 2002) (''May 2002 approval order'').

[11] *See* note 15 *infra*.

[12] *See* Letter from Annette Nazareth, Director, Division of Market Regulation, Commission, to Mary Schapiro, Vice Chairman and President, Regulatory Policy and Oversight, NASD, and Richard Grasso, Chairman and Chief Executive Officer, NYSE (March 13, 2003).

[13] *See* Pub. L. 107–204, 116 Stat. 745 (2002). The SOA amends the Exchange Act by adding new Section 15D. *See* 15 U.S.C. 78a *et seq.*; 15 U.S.C. 78*o*–6.

[14] *See* Securities Exchange Act Release No. 47384 (February 20, 2003), 68 FR 9482 (February 27, 2003).

[15] The terms of the settlement are available at *http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf* (''Global Settlement'').

made on equity securities. The rules contain a number of elements, including:

- A prohibition on offering favorable research to induce investment banking business;
- Structural reforms to increase analyst independence, including a prohibition on investment banking personnel supervising analysts or approving research reports;
- A prohibition on tying analyst compensation to a specific investment banking services transaction;
- Increased disclosures of conflicts of interest in research reports and public appearances by analysts;
- Restrictions on personal trading by analysts; and
- Disclosure in research reports of data and price charts showing the firm's ratings track record.

B. Proposed Changes to NYSE and NASD Rules

The proposed SRO rule changes further address research analyst conflicts of interest in connection with equity research reports, and are designed to achieve full compliance with the mandates of the SOA. The Commission provides here a general overview of the proposed rule changes. The Commission notes, in particular, that while the NASD and NYSE rules may differ to some degree in their texts, the provisions are intended to operate in substantially the same way.[16]

First, the proposals further separate research analyst compensation from investment banking influence. Specifically, the proposals require that a compensation committee of the broker-dealer review and approve the compensation of its research analysts that are primarily responsible for the preparation of the substance of research reports. The committee would report to the Board of Directors and may not have representation from the firm's investment banking department. Among other things, the committee would consider the analyst's individual performance (*e.g.*, quality of research product); correlation between a research analyst's recommendations and stock prices; and overall ratings from various internal or external parties exclusive of the firm's investment banking personnel. The committee may not consider a research analyst's contribution to the firm's overall investment banking business. In addition, in order to comply with the SOA, the proposals prohibit investment banking personnel influence or control over the compensatory evaluation of research analysts.

Second, the proposed rules prohibit analysts from issuing positive research reports or reiterating a ''buy'' recommendation around the expiration of a lock-up agreement (sometimes called ''booster shot'' research reports). The proposals accomplish this by prohibiting the issuance of research reports by the manager or co-manager of a securities offering for fifteen days prior to and after the expiration of lock-up agreements.

Third, the amendments extend the current ten and forty-day quiet periods for the issuance of written research reports to communications in public appearances by managers and co-managers of initial and secondary offerings. The proposals also establish a 25-day quiet period during which broker-dealers who have agreed to participate (or who are participating) as underwriters or dealers (other than a manager or co-manager) of an issuer's initial public offering would be prohibited from publishing research reports and analysts would be prohibited from making public appearances regarding that issuer.

Fourth, the proposed rules further insulate research analysts from investment banking interests by prohibiting analysts from participating in ''pitches'' or other communications for the purpose of soliciting investment banking business.

Fifth, the proposed rules require that a member provide notice to customers that it is terminating research coverage of an issuer that is the subject of a research report (''subject company''). The final report must include a final recommendation or rating (unless it is impracticable to do so).

Sixth, the proposed SRO rule changes restrict the prepublication review and approval of research reports by persons not directly responsible for research. The rules also require that prepublication communications about the content of a research report between all non-research personnel and the research department be intermediated by legal or compliance staff.

Seventh, the proposals prohibit members engaged in investment banking activities from directly or indirectly retaliating, or threatening to retaliate, against a research analyst who publishes a research report or makes a public appearance that may adversely affect the member's present or prospective investment banking relationship. The SROs have clarified in the rules that the anti-retaliation provision would not preclude termination of a research analyst, in accordance with the member's policies and procedures, for causes unrelated to issuing or distributing such adverse research or for making an unfavorable public appearance regarding the member's current or potential investment-banking relationship with the issuer.

Eighth, the proposals expand on the current SRO compensation disclosure requirements by requiring disclosure by a member in research reports, to the extent the member knows or has reason to know, and by a research analyst in public appearances, to the extent the analyst knows or has reason to know, of whether the member, or any affiliate thereof (including the research analyst), received any compensation during the past twelve months from the issuer that is the subject of the report or public appearance. The rule changes further require disclosure of whether the subject company is, or has been during the previous year, a client of the member, and if so, the types of services provided to the issuer. The types of services provided to the subject company must be described as: (1) Investment banking services, (2) non-investment banking securities-related services, or (3) non-securities services. Both the compensation disclosure and the client services disclosure provisions provide for an exception in order to prevent the disclosure of material non-public information regarding specific potential future investment banking transactions of the issuer.

Ninth, the proposed SRO rule changes also create an exception from the existing ''gatekeeper'' provisions of the SRO rules for certain members that engage in limited underwriting activity.[17] The gatekeeper provisions prohibit a research analyst from being subject to the supervision or control of any employee of a member's investment banking department, and further require legal or compliance personnel to intermediate certain communications between research and investment banking personnel.

Tenth, the proposed rules require that legal or compliance personnel pre-approve all securities transactions of persons who oversee research analysts, including the members of a committee and certain others, that have direct influence or control with respect to the preparation of research reports or establishing or changing a rating or price target of a subject company's equity securities, to the extent that the transactions involve securities of subject

[16] *See* NASD Amendment No. 3 and NYSE Amendment No. 3.

[17] *See* NYSE Rule 472(b)(1) and (3), and NASD Rule 2711(b)(1) and (3) (''gatekeeper'' provisions).

companies covered by research analysts that they oversee.

Finally, the proposed rules impose additional registration, qualification, and continuing education requirements on research analysts. The proposed amendments would establish a new registration category and require a qualification examination for research analysts. The proposals would also impose requirements regarding the continuing education of certain registered persons consisting of a Regulatory Element and a Firm Element [18] to address applicable rules and regulations, ethics, and professional responsibility.

III. Discussion

The Commission received a total of 26 comment letters from 22 commenters on the proposed rule changes.[19] As discussed in detail below, although commenters generally supported the fundamental goals and objectives behind the proposed rule changes, many commenters also believed that certain of the initial proposals should be revised, and some suggested substantive changes. In response to various concerns and suggestions raised by commenters, the NYSE filed NYSE Amendment No. 3, and the NASD filed NASD Amendment No. 3, to their proposed rule changes.

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.[20] In particular, the Commission believes that the proposals are consistent with Sections 6(b)(5) and 6(b)(8) of the Exchange Act,[21] Sections 15A(b)(6) and 15A(b)(9) of the Exchange Act,[22] and Section 15D of the Exchange Act, which was enacted as part of the SOA.

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 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.

The Commission also believes that the rules, as amended, fulfill the mandates of the SOA [23] that require that rules be implemented that are reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances, and to improve the objectivity of research, provide investors with more useful and reliable information, and to require disclosure in public appearances and research reports of conflicts of interest that are known or should have been known by the securities analyst or the broker-dealer to exist at the time of the appearance or the date of distribution of the report.

Section 3(f) of the Exchange Act directs the Commission to consider, in addition to the protection of investors, whether approval of a rule change will promote efficiency, competition, and capital formation.[24] 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, promote the independence of research analysts and the objectivity of research. The rule proposals are reasonably designed to require analysts to disclose in public appearances, and broker-dealers to disclose in research reports, conflicts of interest of which they know or should know to exist at the time of the appearance or the date of the report. As such, the rules should provide investors with more useful and reliable information and promote greater public confidence in securities research.

A. Solicitation of Investment Banking Business [NYSE Rule 472(b)(5) and NASD Rule 2711(c)(4)]

Under the initial proposals, a research analyst would have been prohibited from issuing research reports or making public appearances concerning a company if the analyst engaged in any communication with the company in ''furtherance of obtaining investment banking business'' prior to the time the company entered into a letter of intent or other written agreement that designated the analyst's firm as underwriter of the company's initial public offering.

Commenters expressed substantial concern regarding this provision, largely arguing that the phrase ''in furtherance of obtaining investment banking business'' was overly broad and several suggested alternative language.[25] They also expressed concern that the vagueness of the proposals would discourage analysts from visiting and communicating with private companies because firms would be unsure of what communications would, especially in hindsight, be considered ''in furtherance of obtaining investment banking business.'' [26]

Commenters also requested clarification on whether the consequence of a research analyst's participation in a communication ''in furtherance of obtaining investment banking business'' would be a permanent ban on the analyst writing research reports on that issuer, even where the analyst was no longer employed by the same firm. Commenters argued for a time limit on the research ban, and against the retroactive application to communications made prior to the effective date of the rule or in cases

[18] The Firm Element requires broker-dealers to keep employee education current by means of a formal, ongoing training program. Broker-dealers must ensure that training is relevant to identified needs and that it is adequate to convey the desired information relating to products and job functions. The Regulatory Element requires that broker-dealers conduct an annual needs analysis and focuses on compliance, regulatory, ethical, and sales-practice standards. All registered persons must participate in a prescribed computer-based training session within 120 days of their second registration anniversary date, and every third year thereafter. *See generally Content Outline For The Regulatory Element*, Securities Industry/Regulatory Council on Continuing Education (December 2000).

[19] *See* notes 6 and 8 *supra*.

[20] *See* 15 U.S.C. 19(b)(2).

[21] 15 U.S.C. 78f(b)(5) and (8).

[22] 15 U.S.C. 78*o*–3(b)(6) and (9).

[23] *See* Exchange Act Section 15D, 15 U.S.C. 78*o*–6.

[24] 15 U.S.C. 78c(f).

[25] *See* Adams *et al.* letter; SIA March 10th letter; Stifel letter; SunTrust letter; and Wilmer March 11th letter.

[26] *See* SIA March 10th letter; Stifel letter; and SunTrust letter.

where the research analyst is no longer employed by the same firm.[27]

Commenters also noted that the proposed provisions referred to the signing of a letter of intent, or other written agreement, in determining the date the firm received an investment-banking mandate. They argued that letters of intent are not common industry practice and, therefore, should not be used as evidence of the receipt of a mandate.[28]

The proposals also provided that the prohibition would not apply to ''due diligence communications'' between the research analyst and the subject company, the sole purpose of which is to analyze the financial condition and business operations of the subject company. Commenters requested clarification as to the meaning of ''due diligence communications'' and several suggested specific language or parameters.[29]

After considering commenters' concerns, the SROs modified their proposals in Amendment No. 3 to provide for an outright prohibition on research analyst participation in ''pitches'' for investment banking business or other communications with companies ''for the purpose of soliciting investment banking business.'' [30] While the original proposals sought to provide a disincentive for analyst involvement in pitches by prohibiting an analyst from preparing research reports on issuers with whom the analyst engaged in a pitch, the amended proposals take the approach of prohibiting analyst involvement in pitches.

The NASD believes that this amendment will not only promote regulatory consistency, but will also further the goals of research objectivity and investor confidence by eliminating all participation by research analysts in solicitation efforts, which could suggest a promise of favorable research in exchange for underwriting business.[31] Because the SROs believe that the same potential conflicts exist with respect to solicitation of all investment banking business, the amendment is not limited to initial public offerings.[32]

The final amendments also address commenters' concerns regarding what communications are permissible for research analysts. The SROs note that certain activities are traditionally associated with research functions within a multi-service securities firm, and are separate from the solicitation activities of concern that analysts may have recently been called upon to engage in by their firms.[33] For example, the NASD notes that the proposed amendment would not curtail research analysts from performing activities traditionally associated with research functions that do not involve solicitation of investment banking business, such as helping to screen potential investment banking clients.[34] The NYSE also recognizes the need for critical financial analysis of a subject company, during the period after the receipt of an investment banking mandate by the member while an issuer is preparing to engage in a securities offering to the public.[35] By prohibiting analyst participation in pitches and other activities involving the solicitation of investment banking business, the final amendments also avoid the implementation issues associated with the initial proposals.

The amended proposals further insulate research analysts from investment banking interests, while addressing commenters' concerns regarding vagueness, by clarifying the parameters of the kind of activities the rule is designed to address. The SROs note that the prohibition on analysts' involvement in solicitations of investment banking business is intended to support the prohibition on promising favorable research as a marketing tool to prospective investment banking clients of members, and is designed to encourage issuers to choose an investment banking firm based on the merits of the firm's underwriting capabilities.[36]

In our view, it is appropriate for the SROs to prohibit analyst involvement in pitches or other communications by research analysts that are made for the purpose of soliciting investment banking business. The Commission believes that the rules address concerns regarding analyst objectivity and independence from investment banking interests while permitting research analysts to provide certain services to their firm that several commenters viewed as valuable. The Commission also finds that the rules relating to research analyst involvement in solicitations for investment banking business are consistent with the Exchange Act, particularly Sections 6(b)(5), 6(b)(8), 15A(b)(6), and 15A(b)(9).

B. Compensation of Research Analysts [NYSE Rule 472(h) and NASD Rule 2711(d)]

The rule proposals reinforce the separation of research analyst compensation from investment banking influence by requiring procedures for review and approval of a research analyst's compensation by a committee that reports to the Board of Directors or a senior executive of the broker-dealer. No employee of a member's investment banking department may participate in the committee. At a minimum, the committee must consider the following factors: the research analyst's individual performance (*e.g.*, quality of research product), the correlation between a research analyst's recommendations and stock prices, and overall ratings from various internal (other than investment banking) or external parties.

Further, in reviewing and approving an individual research analyst's compensation, the committee may not consider his or her direct contribution to the firm's overall investment banking business. The basis for a research analyst's compensation would have to be documented and the committee must provide an annual attestation to certify that the committee reviewed and approved the compensation of research analysts who are primarily responsible for the preparation of the substance of research reports [37] and documented the basis for such approval.

Several commenters expressed concern regarding the compensation committee provisions and suggested alternatives.[38] One commenter believed that the ban on consideration by a compensation review committee of contributions to the firm's investment banking business should not preclude considering contributions to the extent that they benefit investors.[39] Other commenters asked for clarification that a member's overall profitability may be considered in determining a research

[27] *See* Adams *et al.* letter; SIA March 10th letter; SunTrust letter; and Wilmer March 11th letter.

[28] *See* SIA March 10th letter and Wilmer March 11th letter.

[29] *See* Adams *et al.* letter; SIA March 10th letter; Stifel letter; and Wilmer March 11th letter.

[30] The Global Settlement also prohibits research analyst involvement in ''pitches.''

[31] *See* NASD Response to Comments.

[32] *See* NASD Response to Comments and NYSE Amendment No. 3.

[33] *Id.*

[34] *See* NASD response to Comments.

[35] *See* NYSE Amendment No. 3.

[36] Promising favorable research to companies as an inducement for business is currently explicitly prohibited by NASD Rule 2711(e) and NYSE Rule 472(g). In addition, according to the SROs, promising favorable research to companies as an inducement for business would constitute a violation of just and equitable principles of trade. *See* Securities Exchange Act Release No. 45526 (March 8, 2002), 67 FR 11526 at 11539 (March 14, 2002) (Notice of SRO rules approved by the Commission in May 2002 approval order).

[37] The research analyst who is primarily responsible for the preparation of the substance of a research report is often referred to as the ''lead'' analyst. The Commission notes that a research report may have more than one lead analyst.

[38] *See* SIA March 10th letter, Stifel letter, and Weiss letter.

[39] *See* SIA March 10th letter.

analyst's compensation.[40] Others requested confirmation that a research analyst's compensation could be based not only on a member's overall profitability, but also on the profitability of a firm's capital markets division, investment banking department, or an industry group within an investment banking department, and requested that the SROs explicitly acknowledge certain additional permissible compensation factors set forth in the Global Settlement.[41]

The SROs agree that the general financial success of a member may be considered in determining analyst compensation.[42] NASD does not believe that it would be appropriate for a member to determine a research analyst's compensation based upon the profitability of the member's capital markets division, investment banking department, or some subgroup of such a division or department.[43] NASD acknowledges that several other factors may be appropriate to consider when determining compensation, the rules do not attempt to list all possible permissible considerations, and the NASD does not think it necessary to do so.[44]

Several commenters argued that the SRO rules should adopt the Global Settlement approach by applying obligations concerning how to calculate compensation only for the ''lead analyst'' (those analysts that are required to provide certifications under Regulation AC).[45] As such, commenters argued that the compensation committee provision should apply only to the compensation of analysts who are primarily responsible for a research report's substance.[46]

Upon consideration of commenters' concerns, the SROs agree that such a limitation on the scope of this provision is reasonable, and filed amendments to apply the compensation restrictions only to those research analysts who are primarily responsible for the preparation of the substance of a research report.[47] Thus, research analysts who are not primarily responsible for a research report's substance, such as junior analysts who report to the lead analyst, would not be covered by the compensation committee provision.

Commenters requested clarification on the intended role of the compensation committee and asserted that the proposed language was unclear as to whether the appropriate role of the committee was to ''review and approve'' research analyst compensation or to ''determine'' research analyst compensation; the commenter argued that the appropriate role for the committee should be to serve a review and approval function.[48]

The SROs amended the proposals to require that research analyst compensation be reviewed and approved by the compensation committee.[49] The amendments clarify that the committee must review and approve a research analyst's compensation. With the exception of the prohibitions of NYSE Rule 472(b)(1) and NASD Rule 2711(b)(1) on research analysts being subject to compensatory evaluation by investment banking personnel, the rules do not address who may initially determine that compensation.

The SOA requires that the ''compensatory evaluation'' of research analysts be limited to ''officials employed by the broker or dealer who are not engaged in investment banking activities.''[50] In order to satisfy the mandates of the SOA, the SROs have filed amendments to prohibit employees of the member's investment banking department from evaluating the compensation of research analysts.[51] As such, investment banking department personnel may not have input in determining research analyst compensation. Unlike the compensation committee provisions, this prohibition applies to the compensatory evaluation of all research analysts, and is not limited to those research analysts that are primarily responsible for the preparation of the substance of a research report.

The Commission notes that neither the current nor proposed SRO rules prohibit the consideration of the revenues or results of the firm as a whole in determining research analyst compensation. [52] The NASD has recognized that a research analyst, as part of his or her professional duties, may advise his or her firm's investment banking department concerning certain matters, such as whether a potential underwriting client is prepared for an initial public offering.[53] Therefore, for example, NASD has stated that such activities may be considered in determining an analyst's compensation; however, it may not be given undue weight relative to evaluating the quality of other research work product.[54]

The Commission believes that the proposed compensation committee amendments are consistent with the SOA and promote the alignment of investor interests with those of research analysts who are primarily responsible for the preparation of the content of research reports by requiring that the committee, in reviewing and approving research analyst compensation, consider the quality of the research product and the correlation between the research analyst's recommendations and the stock price performance. The Commission also believes that the proposed prohibition on investment banking input regarding the compensatory evaluation of all research analysts is an important restriction in reducing the influence of investment banking interests on research analysts, and satisfies the mandates of Section 15D of the Exchange Act. The Commission also finds that the amendments relating to research analyst compensation are consistent with the Exchange Act, including Sections 6(b)(5), 6(b)(8), 15A(b)(6), and 15A(b)(9).

C. Definition of ''Research Report'' [NYSE Rule 472.10(2) and NASD Rule 2711(a)(8)]

Several commenters expressed concern regarding the proposals' amended definitions of ''research report.''[55] The proposals adopt the SOA definition of ''research report'' by eliminating the current definitional requirement that a research report contain a ''recommendation.'' The NASD Rule 2711 and NYSE Rule 472 contain substantially similar amended definitions of ''research report,'' defining the term as a written or electronic communication that includes an analysis of equity securities of individual companies or industries, and provides information reasonably

[40] *See* SIA May 9th letter and Sullivan letter.

[41] *Id.*

[42] *See* NYSE 472(h)(1) and NASD Response to Comments.

[43] *See* NASD Response to Comments.

[44] *Id.*

[45] *See* SIA May 9th letter and Sullivan letter.

[46] *See* SIA March 10th letter.

[47] *See* NASD Response to Comments and NYSE Amendment No. 3.

[48] *See* SIA March 10th letter.

[49] *See* NYSE Rule 472(h)(2) and NASD Rule 2711(d)(2).

[50] *See* 15 U.S.C. 78*o*–6(a)(1)(B).

[51] *See* Amendment No. 3.

[52] The SROs' rules permit consideration of firm revenues as a whole, so long as a research analyst's compensation is not based on a specific investment banking transaction, and so long as the member discloses in research reports if the research analyst received compensation that is based upon (among other factors) the member's investment banking revenues. *See* NYSE Rule 472(h)(1) and (2), and NASD Rule 2711(d)(2).

[53] *See* NASD Response to Comments.

[54] *Id.*

[55] *See* BOA letter, CSFB letter, Schwab March 20th letter, SIA March 10th letter, Stifel letter, Sullivan letter, and Wilmer March 11th letter.

sufficient upon which to base an investment decision.

While commenters acknowledge the SOA definition,[56] some nevertheless urge the SROs to interpret the SOA's definition to be a non-substantive change to the current NASD and NYSE definitions of ''research report.'' [57] One commenter, for example, believes that the SROs should interpret the SOA definition effectively to continue to require a recommendation or a ''subjective view or conclusion.''[58] Commenters argued that, otherwise, the proposed definition would be over-inclusive, encompassing many types of communications that traditionally have not been classified as research reports, including those by individuals who are not typically considered research analysts.[59] Consequently, these commenters argue that the scope of the modified definition would result in unnecessary regulation and could constrict the free flow of information to the investing public.[60]

The SROs do not believe that the commenters' suggestions are consistent with the requirements of the SOA.[61] The NASD notes that Congress adopted a definition of ''research report'' that is very similar to the current definitions of ''research report'' in NASD Rule 2711, except for the deletion of the requirement that there be a recommendation.[62] The NASD believes that they must therefore recognize the import of that distinction.[63] As such, the NASD declines to interpret the definition in a way that they would consider to be rendering a conscious Congressional act to be superfluous.[64] In this regard, the NASD notes that the Commission adopted the SOA definition of ''research report'' in Regulation AC, and declined to incorporate interpretations suggested by commenters that would continue to require a recommendation or subjective conclusion.[65]

Commenters also suggested several other measures to narrow the scope of the proposed ''research report'' definition, such as limiting the definition of ''research report'' to communications ''furnished by the firm to investors in the U.S.'' [66] The SROs believe that all research reports produced by members, irrespective of where or to whom they are distributed, should embody the same standards of integrity.[67] The NASD notes that some aspects of NASD 2711 may reflect a more restrictive policy than the terms agreed to by the many parties, including NASD, to the Global Settlement, because the purposes behind NASD Rule 2711 may differ from the objectives in seeking a resolution to an enforcement matter.[68] For this reason, the SROs decline to modify their proposals to apply only to research that relates either to a U.S. company or a non-U.S. company for which a U.S. market is the principal equity trading market as provided in the Global Settlement.[69]

Some commenters noted that Regulation AC applies only to ''covered persons,'' generally exempting from the rule, among others, those affiliates of a broker or dealer that have no officers or employees in common with the broker or dealer.[70] Commenters also requested that the SROs narrow the scope of their rules to carve out ''departments or divisions that have a sufficient level of independence from the member firm'' and are not subject to pressure from investment banking.[71]

The NASD does not believe it necessary or appropriate to adopt a ''covered persons'' definition.[72] The NASD also notes that the Commission's jurisdiction is broader than the NASD, whose jurisdiction extends only to their members.[73] As such, research produced by non-member affiliates is already excluded from the scope of SRO analyst rules, except in cases where members distribute research produced by non-member affiliates. To the extent that commenters' concerns are more specifically about the application of the rules to investment advisers, the SROs note that the Joint Memorandum, which provides members with guidance regarding the operation of the analyst rules, explains that those advisers are excluded from the definition of ''research analyst.'' [74]

Several commenters requested that the SROs restate their previous guidance set forth in their Joint Memorandum, which excluded certain communications from the definition of ''research report.'' [75] Commenters requested that the SROs exclude from the definition certain additional communications excepted by Regulation AC or the Global Settlement.

The Commission understands that the SROs intend to review existing interpretive guidance for continued applicability, and note their belief that the guidance in the Joint Memorandum excluding certain communications from the definition of ''research report'' would remain effective.[76] Moreover, the SROs have indicated agreement that certain additional categories of communications, discussed in the release adopting Regulation AC, would not fall within the amended definition of ''research report.'' [77] The SROs determined that an analysis prepared for a specific person or a limited group of fewer than fifteen persons; and periodic reports or other communications prepared for investment company shareholders or discretionary investment account clients discussing past performance or the basis for previously made discretionary investment decisions, would not fall within the definition of ''research report.''[78] The NASD continues to note that whether a particular communication falls within the definition of ''research report'' depends on specific facts and circumstances.[79]

Some commenters asserted that all ''technical analysis'' and ''quantitative'' research should be excluded from the definition of ''research report.'' [80] However, the NASD does not agree that such exclusions are appropriate beyond current interpretations.[81] Neither NASD or NYSE modified their proposals in response to this comment. The NYSE did not further elaborate on its reasoning for this determination. The Joint Memorandum excludes from the definition of ''research report''

[56] *See* 15 U.S.C. 78*o*–6(c)(2).

[57] *See* SIA March 10th letter.

[58] *See* Wilmer March 11th letter.

[59] For example, Wilmer's June 25th comment letter, Wilmer suggested that communications such as prospectuses, trading commentary or company profiles could be deemed research reports under the proposed definition.

[60] *See* ICI March 10th letter and Wilmer March 11th letter.

[61] *See* NASD Response to Comments and NYSE Amendment No. 3.

[62] *See* NASD Response to Comments.

[63] *Id.*

[64] *Id.*

[65] *Id.* Regulation AC defines ''research report'' as ''a written communication (including an electronic communication) that includes an analysis of a security or an issuer and provides information reasonably sufficient upon which to base an investment decision.'' *See* Regulation AC.

[66] *See* Sullivan letter.

[67] *See* NASD Response to Comments and NYSE Amendment No. 3.

[68] *See* NASD Response to Comments.

[69] *See* NASD Response to Comments and NYSE Amendment No. 3.

[70] *See* Sullivan letter.

[71] *Id.*

[72] *See* NASD Response to Comments.

[73] *Id.*

[74] *See* NYSE Information Memorandum. No. 02–26 (June 26, 2002) and NASD Notice to Members 02–39 (July 2002) (''Joint Memorandum'').

[75] *See* BOA letter, Schwab June 30th letter, SIA June 26th letter, and Sullivan letter (*e.g.*, research reports commenting on trading conditions).

[76] *See* NASD Response to Comments and NYSE Amendment No. 3.

[77] *Id.; See* note 14 *supra.*

[78] *See* NASD Response to Comments and NYSE Amendment No. 3.

[79] *See* NASD Response to Comments.

[80] *See* CSFB letter, Schwab March 20th letter, and SIA March 10th letter.

[81] *See* NASD Response to Comments.

communications of ''technical analysis concerning the demand and supply for a sector, index or industry based on trading volume and price.'' The NASD does not believe it is consistent with the purposes of the rules to extend the exclusion to technical analysis of individual securities.[82] The NASD also notes that the Commission similarly excluded from the definition of ''research report'' in Regulation AC only sector, index, and industry technical analysis.[83] The Commission believes that the SROs' determination not to apply the exception to individual securities is reasonable.

Commenters argue that ''quantitative'' reports are based on objective criteria, such as mathematical models, and are therefore not subject to influence by virtue of a member's conflicts.[84] The NASD believes the term ''quantitative,'' as applied to research, may be vague and open to many interpretations.[85] In fact, the NASD observes that many research reports typically labeled ''quantitative'' by members have raised conflicts concerns.[86] Further, the NASD does not agree that all mathematical models are inherently ''objective.'' [87] Many such models are based on subjective formulas where a person or persons selects the inputs; for example, a particular performance ratio or consensus earnings estimates. The NASD believes that such mathematical models can be manipulated to produce a particular desired result, depending on, for example, the ratios or other criteria selected, the universe of securities, and the formula employed.[88]

Consequently, the NASD does not believe it appropriate or practicable to provide for a blanket exclusion of ''quantitative research.'' [89] The NASD acknowledges the possibility that certain ''quantitative models'' devised by members may effectively eliminate the role of a ''research analyst'' and sufficiently guard against any potential conflicts of interest to render them outside the definition of a ''research report;'' however, the NASD believes that such facts and circumstances are best considered on a case-by-case basis.[90]

The Commission notes that the SROs have tailored their definitions of ''research report'' to the definition of ''research report'' in the SOA and have indicated that they intend to review the exceptions to the definition provided in the Global Settlement, in order to provide additional guidance on the rules' application where appropriate.[91]

The Commission believes that the SRO amendments to the definition of the term ''research report'' are consistent with Section 15D of the Exchange Act in that they do not require that there be a ''recommendation.'' The Commission also finds that the rules relating to research analyst involvement in solicitations for investment banking business are consistent with the Exchange Act, particularly Sections 6(b)(5), 6(b)(8), 15A(b)(6), and 15A(b)(9).

D. Definition of ''Public Appearance'' [NYSE Rule 472.50 and NASD Rule 2711(a)(4)]

The SROs amended their definitions of ''public appearance'' to include print media appearances. Several commenters were critical of this provision in light of the SROs' guidance in the Joint Memorandum, which stated that research analysts should decline subsequent appearances with media outlets that previously edited out required analyst disclosures, absent assurances that the disclosures will no longer be edited out.[92] Commenters expressed concern that the rules infringed upon the editorial discretion of the media by directing analysts to decline appearances with media outlets that previously have not included the analyst disclosures.[93]

Commenters argued that the Joint Memorandum should be revised to reflect the NASD's updated guidance in the Original Notice that an analyst would not violate the rule if he or she makes the required disclosures to the print, radio or television media in good faith, even if the media outlet does not print or broadcast the information.[94] A commenter also recommended that the proposed rules be clarified to make explicit that print journalists may, in their editorial discretion, and without penalty to their publications or imposing restrictions upon access to a research analyst, decline to publish the conflict disclosures provided by the analyst.[95]

The SROs recognized that it is important that media audiences, as well as readers of research reports, receive disclosures of potential conflicts of interests.[96] In response to commenters' concerns, however, the SROs modified their guidance to state that an analyst would not violate the rule if the analyst continues to make appearances with a media outlet that has, in the past, not printed or broadcast the disclosures, so long as the analyst makes the required disclosures in good faith.[97]

In NYSE Amendment No. 2, the Exchange would require a research analyst that recommends securities in a print media interview, article prepared under his or her name, or broadcast, to prepare a record of such interview, article, or broadcast before the close of the next business day. Such record must contain pertinent information regarding the event and the required disclosures provided the media source. Further, such record must be made regardless of whether the media outlet publishes or broadcasts the required disclosures. In addition, the SROs require that the records of such interviews, articles, or broadcasts and the requisite disclosures must be maintained in a manner consistent with Rule 17a–4 of the Exchange Act.[98]

While commenters supported the NYSE's proposed interpretation, they were concerned that the new recordkeeping requirements for public appearances were impractical and failed to take into account the realties of research analysts' business and travel schedules.[99] According to the commenters, the difficulty in requiring that research analysts themselves make the required records before the close of the next business day, would result in a reduction in the number of public appearances.[100]

In response to commenters' concerns, the NYSE amended its proposal to require that the record be made within 48 hours of such interview, article or broadcast, and would permit such record to be prepared by the research analyst, legal or compliance personnel, or research department management.[101]

In Amendment No. 3, the NASD also amended its rule proposal to explicitly

[82] *Id.*

[83] *Id.*

[84] *See* CSFB letter, Schwab March 20th letter, and SIA March 10th letter.

[85] *See* NASD Response to Comments.

[86] *Id.*

[87] *Id.*

[88] *Id.*

[89] *Id.*

[90] *Id.*

[91] *See* NASD Response to Comments and NYSE Amendment No. 3.

[92] *See* Gibson letter, NAA letter, and SIA March 10th letter.

[93] *See* Bloomberg letter, Gibson letter, NAA letter, and SIA March 10th letter.

[94] *See* Gibson letter, Schwab March 20th letter, and SIA March 10th letter. *See also* Original Notice at 836.

[95] *See* Bloomberg letter.

[96] *See* NASD Rule 2711(a)(4) and NYSE Rule 472.50.

[97] *See* NASD Amendment No. 1 and NYSE Amendment No. 2.

[98] Rule 17a–4 requires that records be preserved for a period of not less than three years, the first two in an easily accessible place. 17 CFR 240.17a–4.

[99] *See* Schwab June 30th letter, SIA June 26th letter, and Wilmer June 25th letter.

[100] *See* Wilmer June 25th letter.

[101] *See* NYSE Rule 472(k)(1)/01.

require that research analysts prepare a record of the disclosures made by the research analyst in a print or broadcast media interview, newspaper article, or other public appearance.[102] These records must be made regardless of whether the media source published or broadcast the disclosures and the record must be maintained for three years. NASD has not expressly included a required period of time regarding when the record must be made.

The Commission finds that the amendments to the definition of ''public appearance'' will provide media audiences, including the print media, with useful information to better evaluate the nature and extent of a firm's relationship with a subject company. The proposed amendments to the definition of ''public appearance,'' along with the proposed recordkeeping requirements and the SROs' guidance regarding media appearances, strike an appropriate balance between addressing commenters' concerns and providing investors with important disclosure information.[103] The Commission believes that the proposed recordkeeping requirements will serve as a useful tool in promoting and monitoring the disclosure of potential conflicts of interests to investors. Therefore, the Commission finds that the proposed amendments are consistent with the Exchange Act, including Sections 6(b)(5), 6(b)(8), 15A(b)(6), and 15A(b)(9).

E. Supervisory Analyst Personal Trading Restrictions [NYSE Rule 472(e)(5) and NASD Rule 2711(g)(6)]

The original proposals would have extended the existing personal trading restrictions to include other persons: the director of research, supervisory analyst, or member of a committee who have direct influence or control with respect to the preparation of research reports or establishing or changing a rating or price target of a subject company's equity securities.

Commenters were generally critical of this proposal.[104] Commenters argued that many persons who supervise or oversee research analysts review a wide range of research reports, including, in some cases, reports on all of the subject companies covered by the member.[105] They argued that expansion of the personal trading restrictions to supervisory personnel would effectively prevent these persons from owning any equity securities except diversified investment companies. This, commenters argued, would discourage many qualified persons from acting in supervisory capacities because of the trading blackout provisions and the prohibitions on trading against current recommendations. Commenters recommended that the SROs adopt less restrictive provisions regarding supervisory personnel, such as having legal or compliance personnel review their securities holdings or pre-approve trades to ensure that there is no conflict of interest.[106] Commenters recommended that the proposals be replaced by a requirement that firms implement policies and procedures reasonably designed to ensure that the trading transactions of supervisory personnel, committee members, and others, do not create a conflict of interest between their professional responsibilities and personal trading activities.[107]

In response to commenters' concerns, the SROs modified their proposals in several respects. Rather than applying the same trading restrictions to supervisory personnel that apply to research analysts, the amended proposals would require a member's legal or compliance personnel to pre-approve all securities transactions of persons who supervise research analysts and other persons, such as the director of research or member of a committee who has direct influence or control with respect to the preparation of research reports or establishing or changing a rating or price target of a subject company's equity securities, to the extent that the transactions involve securities of subject companies covered by research analysts.[108]

The Commission believes it is appropriate for the SROs to require pre-approval of securities transactions by supervisory research analysts and certain others where the securities traded are those of companies covered by the research analysts that they supervise. The Commission believes that this approach addresses the concerns regarding a possible disincentive from holding supervisory analyst positions, while still providing for a means of monitoring the trading activity of those who have direct influence or control with respect to the preparation of the substance of research reports or the establishment or changing of a rating or price target of a company's equity securities. Therefore, the Commission finds that the proposed rules are consistent with the Exchange Act, particularly Sections 6(b)(5), 6(b)(8), 15A(b)(6), and 15A(b)(9).

F. Research Analyst Ownership Disclosure and Personal Trading Restrictions [NYSE Rule 472(k)(1)(iii)(b) and (k)(2)(i)(b) and 472(e) and NASD Rule 2711(h)(1)(A) and 2711(g)]

Commenters recommended that managed accounts not controlled by the account owner should be excepted from the trading restrictions placed on research analysts.[109] One commenter believed that NYSE Rule 472(e)(4)(v) currently seems to exempt such accounts from the trading restrictions for research analysts, while NASD Rule 2711(g)(5) does not.[110]

In several instances, both NASD and NYSE have interpreted these provisions to exclude from the personal trading restrictions so-called ''blind trusts'' of research analysts or their household members where the account owner is unaware of the account's holdings or transactions.[111] The SROs have proposed modifications to the rules in Amendment No. 3 to exclude ''blind trust'' accounts that are controlled by a person other than the research analyst or member of the research analyst's household and where neither the research analyst nor member of the research analyst's household knows of the account's investments or investment transactions.

Several commenters argued that research analysts who prepare technical and quantitative research should be treated differently under the rules because those models do not present the same conflicts concerns.[112] These commenters also asserted that the personal trading restrictions effectively bar many of these ''technical'' and ''quantitative'' research analysts from owning any stocks because the broad universe of securities they cover makes ownership impractical. As such, commenters suggested that the SROs either interpret the definition of ''research report'' to exclude ''technical analysis'' and ''quantitative research,'' or amend the research analyst trading restriction provisions to require only

[102] *See* NASD Rule 2711(h)(12).

[103] The Commission notes that Rule 17a–4(b)(4) requires that a broker-dealer shall preserve originals of all communications by the broker-dealer, including those subject to the rules of an SRO of which the broker-dealer is a member regarding communications with the public.

[104] *See* Schwab March 20th letter, SIA March 10th letter, Stifel letter, and Wilmer March 11th letter.

[105] *Id.*

[106] *See* SIA March 10th letter.

[107] *See* Schwab March 20th letter and SIA March 10th letter.

[108] *See* NYSE Rule 472(e)(5) and NASD Rule 2711(g)(6).

[109] *See* Schwab March 20th letter and SIA March 10th letter.

[110] *See* SIA March 10th letter.

[111] *See* NYSE Rule 472.40 and NASD Rule 2711(a)(6).

[112] *See* Schwab March 20th letter and SIA March 10th letter.

pre-approval and disclosure requirements for such research analysts.[113]

The SROs do not believe that it is appropriate to provide exemptions from the trading limitations for a certain class of individuals who meet the definition of ''research analyst.'' [114] The SROs further note that the current rules provide for exceptions to the trading restrictions for certain investment funds, including investments in registered diversified investment companies as defined in Section 5(b)(1) of the Investment Company Act of 1940.[115]

The SOA requires disclosure of the extent to which a research analyst has debt or equity investments in the issuer that is the subject of the research report or public appearance.[116] Current NASD Rule 2711(h)(1)(A) requires disclosure of whether 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).'' [117] The Commission believes that NASD Rule 2711(h)(2), and NYSE Rule 472(k)(1) and (2), as amended, satisfy the requirements of Exchange Act 15D(b)(1).[118]

The Commission believes that the modified rule proposals reflect an appropriate compromise between addressing commenters' concerns and mitigating conflicts of interest that can arise when an analyst invests in the securities of companies the analyst covers. The Commission finds that the proposals are consistent with the Exchange Act, particularly Sections 6(b)(5), 6(b)(8), 15A(b)(6), and 15A(b)(9).

G. Termination of Coverage [NYSE Rule 472(f)(5) and NASD Rule 2711(f)(6)]

The original proposals require notification to customers when a firm withdraws research coverage of a subject company, and distributions of a final research report that includes a final recommendation or rating. The proposed rules also would require that notice of this withdrawal must be made in the same manner as the initial research coverage provided by the broker-dealer.

Several commenters expressed support for requiring firms to publish notice of withdrawal of research coverage of a company.[119] However, commenters requested clarification with respect to the meaning of the term ''withdrawal,'' and requested guidance regarding the requirement that notice of withdrawal must be made ''in the same manner as when research coverage was first initiated by the member.'' [120]

After considering commenters' concerns, the SROs filed amendments to require notice of ''termination'' of research coverage, rather than withdrawal or discontinuation. The NASD intends to provide general guidance as to what constitutes ''termination,'' and will also consider such scenarios on a case-by-case basis.[121]

The SROs also filed amendments to respond to commenters' concerns regarding the meaning of the requirement that the final notice must be ''made in the same manner'' as when research coverage was ''first initiated by the member.'' [122] After considering comments, the SROs modified the proposals to require that the member make the final research report on the subject company available using means of dissemination equivalent to those it ordinarily uses to provide the customer with its research reports on that subject company. The SROs also require that the final report must be comparable in scope and detail to prior research reports.

The rule proposals continue to require that the final report include a final recommendation or rating. However, the SROs have specified that a final recommendation or rating will not be required in cases where it is impracticable for the member to produce a comparable report (*e.g.,* if the research analyst covering the subject company has left the member, or where the member has terminated coverage on an industry or sector). In such cases, the rationale for termination will be required.

The Commission finds that the proposed amendments requiring notice of termination of coverage will provide investors with important information to better evaluate the usefulness of research, including whether the firm is no longer covering the issuer. The public may not be fully informed where a firm terminates coverage of a company without disclosing the termination to customers, and without providing customers with a final rating or recommendation, even in cases where a ratings change may have been warranted. The Commission believes that the amendments requiring notice of ''termination'' respond to commenters' concerns regarding what would constitute ''withdrawal,'' while providing investors with important information. Therefore, the Commission believes these proposals are consistent with the Exchange Act, including sections 6(b)(5), 6(b)(8), 15A(b)(6) and 15A(b)(9).

H. Quiet Periods on the Issuance of Research Reports [NYSE Rule 472(f) and NASD Rule 2711(f)]

The SOA requires establishment of periods during which brokers or dealers who have participated or are to participate in a securities offering as underwriters or dealers may not publish or otherwise distribute research reports related to such securities. [123] Current SRO rules impose quiet periods on underwriting managers and co-managers for 40 calendar days following an initial public offering and 10 calendar days following a secondary offering, but do not impose these restrictions on other members of the underwriting syndicate or selling group. In order to comply with the SOA, the SRO proposals establish a 25 calendar-day period after the ''date of the offering'' during which a member that has agreed to participate or is participating as an underwriter or dealer (other than as manager or co-manager) of an issuer's initial public offering may not publish or otherwise distribute a research report or make a public appearance regarding that issuer.[124]

Most commenters did not object to this proposed provision. One commenter, however, argued that the SOA does not require the SROs to apply the research blackout to every dealer that participates in the offering in any manner, including where the dealer has no agreement with the issuer or any underwriter to distribute the securities or to provide research about the issuer.[125]

The SROs have not modified this proposal. The NYSE notes that the 25-day prohibition effectively codifies quiet periods that exist because of the

[113] *See* CSFB letter and Schwab March 20th letter.

[114] *See* NASD Response to Comments and NYSE Amendment No. 3.

[115] *See* NYSE Rule 472(e)(4)(v) and (vi), and NASD Rule 2711(g)(5)(A) and (B); 15 U.S.C. 80a–5(b)(1).

[116] *See* 15 U.S.C. 78*o*–6(b)(1).

[117] In NYSE Amendment No. 3, the Exchange proposed to amend NYSE Rule 472(k)(1)(iii)(b) in order to require disclosure of the nature of the analyst's financial interest.

[118] 15 U.S.C. 78*o*–6(b)(1).

[119] *See* AIMR March 6th letter; NASAA letter; and SIA March 10th letter.

[120] *See* Schwab March 20th letter and SIA March 10th letter.

[121] *See* NASD Response to Comments.

[122] *See* SIA March 10th letter.

[123] *See* 15 U.S.C. 78*o*–6(a)(2).

[124] *See* NYSE 472(f)(3) and NASD 2711(f)(2). The Commission notes that the SROs have not proposed to impose a quiet period on non-managers that participate in secondary offerings.

[125] *See* Sullivan letter.

prospectus delivery requirements under Rule 174 under the Securities Act [126] pursuant to which brokers or dealers refrain from issuing research on exchange-listed or National Market System securities for 25 days after a registration statement becomes effective or bona fide public trading begins, to avoid the risk that such communications may be deemed prospectuses that do not meet the requirements of Section 10 of the Securities Act.[127]

The SRO proposals would amend the quiet period provisions in two other ways. First, the proposals would prohibit a member that has acted as a manager or co-manager of a securities offering from distributing a research report or making a public appearance concerning a subject company 15 days prior to and after the expiration, waiver, or termination of a lock-up agreement that restricts the sale of securities held by the subject company or its shareholders after the completion of a securities offering.

Commenters argued that this provision would raise difficult compliance issues, since co-managing underwriters often have no knowledge of a lead manager's waiver of a lock-up agreement.[128] Commenters also expressed concern that this provision could dissuade issuance of lock-up waivers prior to their normal expiration time.[129] One commenter suggested, as an alternative, that the SROs bar firms and their analysts from issuing research reports ''for the purpose, in whole or in part, of affecting the price of the issuer's securities for the benefit of a selling shareholder.'' [130]

The SROs determined not to modify the proposals in this regard. The SROs believe that the concern regarding a co-managing underwriter's lack of knowledge of a lead manager's waiver of a lock-up agreement can be addressed through a provision in an underwriting agreement to require a lead or co-managing underwriter to notify the other managers or co-managers of its intention to grant such a waiver a specified number of days prior to doing so.[131] The SROs believe that such a notification would avoid the inadvertent issuance of research reports or making of public appearances within the blackout periods surrounding waivers of lock-up agreements.[132]

Several commenters requested that the blackout period regarding lock-up agreements not apply to the publication of research reports pursuant to Securities Act Rule 139 [133] regarding a subject company with ''actively traded securities,'' as defined in SEC Regulation M,[134] or to public appearances regarding such companies.[135] These commenters noted that, because the quiet period following secondary offerings does not apply to these types of companies, the quiet period surrounding waivers or expirations of a lock-up agreement also should not apply.

After consideration of commenters' concerns, the SROs modified their proposals to apply the exception for actively traded securities to the provisions prohibiting ''booster shot'' research reports. The SROs note that such an exception would not be appropriate in the context of an IPO, where there is not a developed secondary trading market or widespread research coverage.[136] The SROs agree that, for certain seasoned issuers and actively traded securities, the proposed blackout surrounding the expiration of lock-up agreements is not necessary.[137] Accordingly, the SROs have amended this provision to provide for such an exception.

Second, the SRO proposals also extend the current 40 and 10-day quiet period provisions to public appearances by research analysts regarding securities that are covered by a research report blackout during the same period of time.[138] Commenters did not oppose this proposal. The SRO amendments define ''date of the offering'' for all quiet period provisions to mean the later of the effective date of the registration statement or the first date on which the security was bona fide offered to public.[139]

The Commission believes that the SRO rules relating to quiet periods will encourage market forces to determine the price of the security in the aftermarket following an offering unaffected by research reports and public appearances by firms with the most substantial interest in the offering—those firms that are a part of the underwriting syndicate. The Commission believes that the SROs' proposals to extend the current quiet period provisions to cover public appearances is a reasonable extension of the prohibition on research reports during the same period of time.

The Commission believes that the proposed 25-day quiet period provisions satisfy the requirements of Section 15D(a)(2) of the Exchange Act because they are reasonably designed to ''define periods during which brokers or dealers who have participated, or are to participate, in a public offering of securities as underwriters or dealers should not publish or otherwise distribute research reports relating to such securities or to the issuer of such securities.'' The Commission finds that the quiet period provisions are consistent with the Exchange Act, particularly Sections 6(b)(5), 6(b)(8), 15A(b)(6) and 15A(b)(9).

I. Disclosure of Compensation and Client Arrangements [NYSE Rule 472(k) and NASD Rule 2711(h)]

The SOA requires that rules be adopted reasonably designed to require that firms disclose in research reports and public appearances any compensation received by the broker-dealer or its affiliates from the subject company that is known or should have been known by the research analyst or broker-dealer at the time the research report is issued and at the time the public appearance is made.[140]

Current SRO rules require firms to disclose investment banking compensation received from a subject company or its affiliates in the past 12 months.[141] The SROs have not proposed to change this provision. However, in NASD Amendment No. 2 and in NYSE Amendment No. 2, the SROs proposed amendments to expand the required compensation disclosures to mandate disclosure in research reports and public appearances of any non-investment banking compensation received by a member or its affiliates from the subject company. In addition, the SRO amendments would require separate disclosure of investment banking compensation and non-investment banking compensation received from the subject company or its affiliates in research report disclosures.[142]

While the SOA does not specify a look-back period for the compensation disclosure provision, the SROs

[126] 17 CFR 230.174.

[127] 15 U.S.C. 77j.

[128] *See* SIA March 10th letter.

[129] *Id.*

[130] *Id.*

[131] *See* NASD Response to Comments and NYSE Amendment No. 3.

[132] *Id.*

[133] 17 CFR 230.139.

[134] 17 CFR 242.101(c)(1)

[135] *See* Sullivan letter.

[136] *See* NASD Response to Comments and NYSE Amendment No. 3.

[137] *Id.*

[138] *See* NYSE Rule 472(f)(1) and (2), and NASD Rule 2711(f)(1)(A) and (B).

[139] *See* NYSE Rule 472.120 and NASD Rule 2711(f)(3).

[140] *See* 15 U.S.C. 78*o*–6(b)(2).

[141] *See* NYSE Rule 472(k)(1)(i)(a)(2) and NASD Rule 2711(h)(2)(A)(ii)(b).

[142] *See* NYSE Rule 472(k)(1)(i)(a)(2) and (K)(1)(i)(d)(2), and NASD Rule 2711(h)(2)(A)(ii)(b) and (iii)(a).

period [143] to be consistent with the SOA's client disclosure provision,[144] which imposes this timeframe for disclosure of a client relationship with the subject company. In addition, the current requirement in the SRO rules for disclosure of investment banking compensation is also based on this timeframe.[145]

Several commenters were strongly critical of this proposed amendment.[146] In particular, these commenters asserted that requiring disclosure of non-investment banking compensation received by a member and its affiliates from the subject company would be extremely burdensome and complex, and therefore not in the public interest. Commenters expressed heightened concerns regarding the difficulties of tracking affiliate compensation received from the subject company. [147] They argued that real-time tracking of such compensation would be unduly burdensome and asserted that firms would be unable to implement a real-time tracking system capable of 100% accuracy with regard to disclosure of affiliate compensation.[148] Commenters argued that the SRO proposals did not give effect to the SOA requirements that the mandated rules be ''reasonably designed to address conflicts of interest,'' and would provide little useful information to investors.[149] Commenters recommended that the SROs adopt a narrower version of this proposal that would tie disclosure of the receipt of compensation by a member or its affiliates from a subject company to the research analyst's knowledge of such compensation.[150]

As noted by commenters, the SOA mandates disclosure of conflicts of interests that are ''known or should have been known'' [151] by the analyst or broker or dealer, and the SROs agree that the proposals should be modified to reflect this qualification.[152] Accordingly, the SROs revised their proposals in several respects regarding the disclosure of non-investment banking compensation received by the member or affiliates from the subject company.

While the original proposals implied that ''real-time'' disclosure was required, the modified proposals provide for periodic disclosure in certain circumstances. For example, if the member received any non-investment banking compensation from the subject company, the proposals require disclosure as of the end of the month immediately preceding the date of publication of the research report. Real time disclosure would only be required if the analyst or an employee of the member with the ability to influence the substance of the research report (''influential employee'') possesses actual knowledge of such member non investment banking compensation.[153]

The SROs revised their proposals to require disclosure in research reports of affiliate non-investment banking compensation of which the analyst or influential employee knows,[154] or of which the analyst or member or has reason to know.[155]

The modified SRO proposals respond to commenters' concerns by requiring disclosure in research reports of affiliate non-investment banking compensation of which the analyst or member ''has reason to know.''[156] The proposals create two mechanisms by which analysts and members may satisfy the disclosure requirements relating to what the analyst or member would have reason to know about affiliate non-investment banking compensation.[157]

The rules provide that this disclosure requirement will be deemed satisfied if the member has taken steps reasonably designed to identify affiliate non-investment banking compensation during that calendar quarter and discloses such in research reports within 30 days after completion of the last calendar quarter.[158] In the alternative, the proposals provide that a member and analyst would be presumed not to have a reason to know of affiliate non-investment banking compensation from the subject company, if the member maintains and enforces policies and procedures reasonably designed to prevent the analyst and any influential employee from, directly or indirectly, receiving information from the affiliate concerning whether the affiliate received such compensation.[159] If such procedures are maintained and enforced by the member, then the member and analyst would be presumed not to have reason to know of affiliate non-investment banking compensation. However, because this is a presumption of a lack of knowledge, to the extent that the research analyst or an employee of the member with the ability to influence the substance of a research report obtains actual knowledge of affiliate non-investment banking compensation, disclosure would be required under NASD Rule 2711(h)(2)(A)(iv) and NYSE Rule 472(k)(1)(ii)(b)(2).

Unlike the original proposals, which required absolute disclosure of any compensation received by the member and its affiliates, the revised proposals would limit certain of the disclosure requirements to the actual knowledge of research analysts and influential employees, and in cases where the analyst or member has reason to know. Thus, real-time tracking by the member non-investment banking compensation may not be necessary.

Commenters have argued that all of the compensation disclosure requirements should be tied to the knowledge of the research analyst or supervisor.[160] However, the SROs do not agree.[161] Certain of the disclosure requirements, such as the receipt of investment banking compensation to the member or its affiliates from the subject company, are not tied to the knowledge of specific individuals, but require that the firm track the receipt of such compensation sufficient to make affirmative disclosures where warranted.[162] The SOA also requires that disclosure of firm and affiliate compensation be made by research analysts in public appearances.[163] Therefore, the SRO proposals require the disclosure of any compensation

[143] *See* NYSE Rule 472(k)(1)(i)(d)(2) and NASD Rule 2711(h)(2)(A)(iii)(a).

[144] *See* 15 U.S.C. 78*o*–6(b)(3).

[145] *See* NYSE Rule 472(k)(1)(i)(a)(2) and NASD Rule 2711(h)(2)(A)(ii)(b).

[146] *See* BOA letter, Schwab June 30th letter, SIA June 26th letter, and Wilmer June 25th letter.

[147] *See* BOA letter and Wilmer June 25th letter.

[148] The Commission notes that, in requiring disclosure of any compensation, the SOA did not mandate, and the SRO proposals do not require, that broker-dealers disclose how much compensation was received, but rather requires affirmative disclosure (if such is the case) of whether any compensation has been received.

[149] *See* SIA June 26th letter and Wilmer June 25th letter.

[150] *Id.*

[151] The SROs use ''have reason to know'' in their proposals, because that language appears in other related rules. However, the SROs interpret ''have reason to know'' as having the same meaning as ''should have been known'' as used in the Section 501(b) of the SOA. 17 U.S.C. 78*o*–6(b). *See* NASD Response to Comments and NYSE Amendment No. 3.

[152] *See* NASD Response to Comments and NYSE Amendment No. 3.

[153] *See* NYSE Rule 472(k)(1)(i)(d)(2) and (k)(1)(ii)(b)(2), and NASD Rule 2711(h)(2)(A)(iii)(a).

[154] *See* NYSE Rule 472(k)(1)(ii)(b)(2) and NASD Rule 2711(h)(2)(A)(iv).

[155] *See* NYSE Rule 472(k)(1)(iii)(a) and NASD Rule 2711(h)(2)(A)(v).

[156] *See* NYSE Rule 472(k)(1)(ii)(b)(2) and NASD Rule 2711(h)(2)(A)(v).

[157] *See* NYSE Rule 472(k)(1)(iii)(a)(1) and (2), and NASD Rule 2711(h)(2)(a)(v)(a) and (b).

[158] *See* NYSE Rule 472(k)(1)(iii)(a)(1) and NASD Rule 2711(h)(2)(a)(v)(a).

[159] *See* NYSE Rule 472(k)(1)(iii)(a)(2) and NASD Rule 2711(h)(2)(a)(v)(b).

[160] *See* SIA June 26th letter and Wilmer June 25th letter.

[161] *See* NASD Response to Comments and NYSE Amendment No. 3.

[162] This requirement is part of the original amendments. *See* NYSE Rule 472(k)(1)(i)(a)(2) and (3), and NASD Rule 2711(h)(2)(A)(ii)(b) and (c).

[163] *See* 15 U.S.C. 78*o*–6(b).

received by the member and affiliates to be disclosed in public appearances, to the extent that the analyst knows or has reason to know of such compensation in the past 12 months.[164] This requirement, unlike current SRO rules, mandates disclosure of investment banking compensation in public appearances.[165]

The SOA mandates the establishment of rules that require disclosure of whether a subject company currently is, or was, a client of the broker or dealer during the 1-year period preceding the appearance or date of distribution of the research report, and if so, a statement of the type of services provided to the client.[166] This is broader than the current SRO rules which require a research analyst to disclose during a public appearance (when such research analyst knows or has reason to know) if the subject company is an investment banking services client of the member.[167]

In order to meet the mandates of the SOA, the proposed SRO amendments would provide for disclosure by a member in research reports, and by a research analyst during a public appearance (if the analyst knows or has reason to know), of whether a subject company is a client of the member and the types of services provided to the client.[168] The types of services have been categorized into: Investment banking services (which are required to be disclosed under current SRO rules); non-investment banking securities-related services; and non-securities services.[169]

Commenters expressed concerns regarding the client disclosure provisions that were similar to those noted above regarding the compensation disclosure provisions.[170] Commenters suggested that the client disclosure provision should be amended to require broker-dealers to disclose only those services most likely to present an actual or potential conflict of interest.[171]

Commenters also requested guidance as to what would constitute a client relationship.[172] In response to commenters' concerns, the SROs have clarified that a subject company is a client of the member if they have received compensation from the subject company, or if the member has entered into an agreement to provide services.[173]

Commenters argued that the proposals should be modified to require broker-dealers to provide disclosures regarding services provided to subject companies on an annual basis, and should be linked to the receipt of compensation for non-investment banking, securities-related, or non-securities services.[174]

NYSE believes that requiring disclosure of whether a subject company is a client and the types of services provided, including non-investment banking services, should provide investors with potentially more meaningful insight into the nature of the relationship between the subject company and the member and the potential conflicts attendant to such relationships.[175] NYSE, for example, observes that it might be more beneficial for an investor, in determining whether a firm has real conflicts of interest inherent in conducting investment banking on behalf of a subject company, to know that a member is also providing non-investment banking securities-related services to a subject company.[176]

While there is some overlap between disclosure of the receipt of compensation from a subject company and a client relationship, the SROs have declined to modify their proposals to link or merge the receipt of compensation provision to the client disclosure provision.

The SROs also modified their proposals to require disclosure of client relationships and types of services provided to the issuer, as of the end of the month immediately preceding the date of publication of the research report, or sooner, if the analyst or influential employee possess actual knowledge of such member non investment banking compensation.[177] The Commission believes this would provide firms with additional time to identify and aggregate the required information, while providing investors with relevant disclosure information and complying with the requirements of Section 15D of the Act.[178]

In requiring that firms and their research analysts identify the types of services provided to subject companies, the SROs recognize that there is a possibility that this could result in the dissemination of material non-public information.[179] This issue was raised when the Commission considered amendments to the NASD and NYSE's analyst rules in 2002.[180] The rules, approved by the Commission, require disclosure of prospective investment banking compensation.[181] In light of this concern, the SROs had structured the disclosure of information related to investment banking services to mitigate the possibility of disclosing material non-public information by requiring a general disclosure of investment banking compensation received from the subject company in the past 12 months, along with a three-month forward-looking investment banking compensation disclosure if the member ''expects to receive or intends to seek'' compensation for investment banking services from the subject company in the next three months.[182]

The SROs believe that they have also addressed concerns regarding the disclosure of material non-public information with the proposed new disclosure requirements.[183] The amendments provide for an exemption from the proposed compensation and client disclosure provisions to the extent that such disclosure would reveal material non-public information regarding specific potential future investment banking services transactions of the subject company.[184] The SOA explicitly authorized us to permit an exception for material non-public information regarding specific potential future investment banking services transactions of the subject company in the compensation disclosure provision.[185] The Commission notes that this exception applies only to *specific* potential *future* transactions of an *investment banking* nature and that relate to a particular issuer. The SROs have determined that such an exception should also apply to the client disclosure provision.[186] The Commission finds that providing for such an exception in the client disclosure provision is consistent with the SOA's compensation disclosure provision. Further, the exception as to

[164] *See* NYSE Rule 472(k)(2)(i)(c)(2) and NASD Rule 2711(h)(2)(B)(i).

[165] *Id.*

[166] *See* 15 U.S.C. 78*o*–6(b)(3).

[167] *See* NYSE Rule 472(k)(2)(i)(c)(1) and NASD Rule 2711(h)(2)(B)(iii).

[168] *See* NYSE Rule 472(k)(1)(i)(d)(1) and NASD Rule 2711(h)(2)(A)(iii)(b).

[169] *Id.*

[170] *See* SIA June 26th letter and Wilmer June 25th letter.

[171] *Id.*

[172] *See* Schwab June 30th letter and SIA June 26th letter.

[173] *See* NASD Response to Comments and NYSE Amendment No. 3.

[174] *Id.*

[175] *See* NYSE Amendment No. 3.

[176] *Id.*

[177] *See* NYSE Rule 472(k)(1)(i)(d)(1) and NASD Rule 2711(h)(2)(A)(iii)(b).

[178] *See* 15 U.S.C. 78*o*–6(b)(3).

[179] *See* NASD Response to Comments and NYSE Amendment No. 3.

[180] *See* May 2002 approval order.

[181] *Id.* at 34972.

[182] *See* NYSE Rule 472(k)(1)(i)(a)(2) and (3), and NASD Rule 2711(h)(2)(A)(ii)(b) and (c); *See also* May 2002 approval order.

[183] *See* NASD Response to Comments and NYSE Amendment No. 3.

[184] *See* NYSE Rule 472(k)(3)(i) and NASD Rule 2711(h)(2)(c).

[185] *See* 15 U.S.C. 78*o*–6(b)(2).

[186] *See* NASD Response to Comments and NYSE Amendment No. 3.

compensation is appropriate to address concerns regarding the dissemination of material non-public information regarding specific potential future investment banking services transactions of the subject company. Finally, the Commission believes that the SRO rules, by providing an exemption in the client disclosure provision fulfill the SOA mandate to adopt rules reasonably designed to provide disclosure of broker-dealers' clients and client services, while appropriately addressing concerns related to the potential dissemination of material non-public information.

In the Joint Memorandum, the SROs provided guidance that ''knows or has reason to know'' requires disclosure of such information of which the analyst has actual knowledge, as well as such information that should be reasonably discovered in the ordinary course of business. The SROs note that they expect that a research analyst would have reason to know of disclosures made in prior research reports.[187] In addition, a research analyst would have reason to know of such information by virtue of the steps taken by the member or member organization to identify compensation received by a client pursuant to proposed NYSE Rule 472(k)(1)(iii)(a)(1) and NASD Rule 2711(h)(2)(A)(v)(a).[188]

The SOA also mandates rules requiring disclosure of compensation received by a research analyst from the subject company.[189] Current SRO rules do not expressly require such disclosure. To the extent that receipt of such compensation constitutes an actual, material conflict of interest, the SROs believe that disclosure would be required under NASD Rule 2711(h)(1)(C) and NYSE Rule 472(k)(1)(iii)(d). The SROs proposed amendments specifically require disclosure of any compensation received by an analyst from the subject company in the past 12 months.[190]

The Commission believes that the proposed SRO compensation disclosure amendments are appropriate and satisfy the mandates of the SOA. Several commenters expressed concern regarding the difficulty of tracking non-investment banking compensation, especially that of member affiliates.[191] The Commission believes that the SROs have significantly modified the rule amendments from proposal in a manner that addresses commenters' concerns regarding the difficulties presented by real-time tracking of non-investment banking compensation, while meeting the requirements of the SOA. In summary, the Commission finds that the SRO rules relating to disclosure by the broker-dealer and research analyst in research reports and public appearances of broker-dealer, research analyst, and affiliate compensation from subject companies satisfy the requirements of Section 15D(b)(2) of the Exchange Act[192] in that they are reasonably designed to require each securities analyst to disclose in public appearances, and each registered broker or dealer to disclose in each research report whether any compensation has been received by the registered broker or dealer, or any affiliate thereof, including the analyst, from the issuer that is the subject of the appearance or research report, that are known or should have been known by the securities analyst or the broker or dealer, to exist at the time of the appearance or the date of distribution of the report.

The Commission also believes that the proposed provisions regarding disclosure of whether the subject company is a client of the broker-dealer and the services provided satisfy the requirements of the SOA. The Commission also finds that the proposals are consistent with the Exchange Act, including Sections 6(b)(5), 6(b)(8), 15A(b)(6) and 15A(b)(9).

J. Registration and Continuing Education Requirements [NYSE 344 and 345A; NASD 1050 and 1120]

The proposed amendments would mandate certain registration requirements for research analysts who are primarily responsible for the preparation of the substance of research reports. The proposals would impose both the regulatory element and the firm element of the continuing education requirements on research analysts.[193]

Commenters expressed several concerns with this proposal. First, commenters requested clarification that the registration and qualification requirements apply only to research analysts who are primarily responsible for the substance of a research report.[194] Second, commenters recommended that research analysts who have a certain level of industry experience, or who have already attained a commonly used industry qualification, be exempt from the qualification examinations.[195] Commenters also argued that research analysts who work for members that are not engaged in investment banking activities should be exempt from the proposed requirements.[196]

In response to these comments, the SROs modified their proposals so that the registration and qualification requirements apply only to research analysts who are primarily responsible for the preparation of the substance of research reports or whose name appears on research reports; therefore, junior analysts would not be required to register. The SROs are also considering whether there are certain classes of research analysts, who otherwise would be required to comply, that should be exempted from portions of the qualification requirements.[197] However, because the qualification examination will cover, in part, the provisions of NASD Rule 2711 and the research analyst provisions of NYSE Rule 472, the NASD has indicated that it is unlikely that any current research analysts will be wholly exempt from all parts of the qualification examination.[198] The SROs are also considering whether they will accept, as a substitute, other industry qualification exams in place of the new research analyst qualification exam.[199]

Commenters also noted that the NASD and the NYSE proposals differed as to whether the regulatory element component of their continuing education requirements applies to research analysts.[200] After further consideration, the SROs have agreed that research analysts should be required to complete both the regulatory element and the firm element of the continuing education requirements.[201] The NYSE has modified its proposals accordingly.

The Commission finds that these proposals are consistent with the Exchange Act, particularly Sections 6(b)(5), 6(b)(8), 15A(b)(6) and 15A(b)(9).

K. Retaliation [NYSE Rule 472(g)(2) and NASD Rule 2711(j)]

The SOA mandates the establishment of rules that prohibit broker-dealers engaged in investment banking activities from directly or indirectly

[187] *Id.*

[188] *Id.*

[189] *See* 15 U.S.C. 78*o*–6(b)(2).

[190] *See* NYSE Rule 472(k)(2)(ii)(a)(1) and NASD Rule 2711(h)(2)(A)(i)(b).

[191] *See* BOA letter, SIA June 26th letter, and Wilmer June 25th letter.

[192] 15 U.S.C. 78*o*–6(b)(2).

[193] *See* note 15 supra.

[194] *See* SIA March 10th letter.

[195] *See* AIMR March 6th letter, Schwab March 20th letter, and SIA March 10th letter.

[196] *See* Investorside letter.

[197] *See* NASD Response to Comments and NYSE Amendment No. 3.

[198] *See* NASD Response to Comments.

[199] *See* NASD Response to Comments and NYSE Amendment No. 3.

[200] *See* SIA March 10th letter.

[201] *See* NASD Response to Comments and NYSE Amendment No. 3.

retaliating, or threatening to retaliate, against a research analyst who publishes an adverse, negative, or otherwise unfavorable research report research report that may adversely affect the broker-dealer's present or prospective investment banking relationship.[202] The SOA specifies that the rules may not limit the authority of a broker-dealer to discipline an analyst for causes other than such research report in accordance with the policies and procedures of the firm. The SROs have extended the anti-retaliation provisions to cover public appearances and have clarified that the rule would not preclude termination of a research analyst for causes unrelated to issuing or distributing adverse research or for making an unfavorable public appearance regarding a current or potential investment-banking relationship.

Commenters did not oppose this provision. The Commission believes that the SRO proposals are designed to protect the objectivity and independence of research analysts, and meet the requirements of Section 15D of the Exchange Act, which requires that a rule be adopted that prohibits broker-dealers engaged in investment banking activities from, directly or indirectly retaliating or threatening to retaliate, against a research analyst who publishes a negative, adverse, or otherwise unfavorable research report that may adversely affect the broker-dealer's present or prospective investment banking relationship with an issuer. The Commission further believes that the SROs' determination to apply the retaliation provision to cover adverse statements made in public appearances is consistent with Sections 6(b)(5), 6(b)(8), 15A(b)(6) and 15A(b)(9).

L. Small Firm Exemption [NYSE Rule 472(m) and NASD Rule 2711(k)]

The SROs have proposed an exemption from certain of the requirements that legal or compliance personnel must act as intermediaries regarding communications for firms that engage in limited underwriting activity.[203] Current NASD Rule 2711(b)(1) and (3) and current NYSE Rule 472(b)(1) and (3), the gatekeeper provisions, prohibit a research analyst from being subject to the supervision or control of any employee of a member's investment banking department, and further require legal or compliance personnel to intermediate certain communications between the research department and non-research personnel.

As the Commission noted in the May 2002 approval order when the Commission approved these gatekeeper provisions, several commenters argued that they would impose significant costs, especially for smaller firms that would have to hire additional personnel. Commenters said that personnel in smaller firms often perform multiple functions, and therefore the separation rules impose a greater burden on these firms. These comments raised the prospect that the rules might force some firms to curtail their research, potentially reducing research coverage for smaller companies and companies of regional or local interest.

To temporarily address those concerns while the SROs considered whether an exemption was appropriate, the effectiveness of the gatekeeper provisions was delayed until July 30, 2003, or until a superseding permanent exemption is approved and becomes effective, for those members that over the previous three years, on average per year, have participated in 10 or fewer investment banking transactions or underwritings as manager or co-manager and generated $5 million or less in gross investment banking services revenues from those transactions (''small firms'').[204] The rules approved today create a permanent exemption from the gatekeeper provisions for small firms, and supersede the temporary exemption filed by the SROs in May 2003.[205]

However, the permanent exemptions for small firms, unlike the temporary exemptions, do not apply to NASD Rule 2711(c) and NYSE Rule 472(b)(4), which restrict communications between the research department and the issuer, because the SROs do not believe that it would be appropriate to provide for a permanent exception from the gatekeeper provisions for the voluntary submission of sections of a draft research report to a subject company for the purpose of checking the factual accuracy of the draft report.[206] In addition, for the purposes of the small firm exception computations, the SROs have determined that ''investment banking services'' shall not include municipal securities transactions.[207]

The SRO proposals also require members that qualify for this exemption to maintain records for three years of any communication that otherwise would be subject to the review and monitoring provisions of NASD Rule 2711(b)(3) and NYSE Rule 472(b)(1), (2), and (3).

The Commission finds that the exceptions for small firms from certain of the rules addressing the relationships between research, investment banking, and companies that are the subject of research reports, are appropriate to address concerns unique to smaller firms who may share supervisory personnel across different offices or departments. The Commission finds that the proposals are consistent with the Exchange Act, particularly Sections 6(b)(5), 6(b)(8), 15A(b)(6), and 15A(b)(9).

M. Implementation

Commenters requested that the SROs coordinate the effective dates of their proposed changes and ensure that firms have adequate time to implement new rules.[208] In response to 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:

NYSE suggests the following effective dates for the provisions contained in SR–NYSE–2002–49:

Firm and Affiliate Compensation Disclosure Provisions—(NYSE Rules 472(k)(1)(i)d.2. and (k)(1)(iii)a.)—180 days, except upon written request to the Exchange for an extension of up to an additional 90 days thereafter.

Analyst and Firm Compensation Disclosure Provisions—(NYSE Rules 472(k)(1)(ii)a., (k)(1)(iii)a., (k)(2)(i)c.2. and f.)—180 days, except upon written request to the Exchange for an extension of up to an additional 90 days thereafter.

Client Disclosure Provisions—(NYSE Rules 472(k)(1)(i)d.1, (k)(1)(ii)b.1. and (K)(2)(1)c.1)—180 days, except upon written request to the Exchange for an extension of up to an additional 90 days thereafter.

Exceptions to Disclosures Required In Rule 472(k)(1) and (2)—(NYSE Rule 472(k)(3)(1)):

As applied to disclosures under Rule 472(k)(1)((i)a.,2., and 3.; effective immediately.[209]

[202] *See* 15 U.S.C. 78*o*–6(1)(C).

[203] *See* NYSE Rule 472(b) and NASD Rule 2711(b).

[204] *See* Securities Exchange Act Release No. 47876 (May 15, 2003); *see also* Securities Exchange Act Release No. 46165 (July 3, 2002), 67 FR 46555 (July 15, 2002).

[205] *See* NYSE Rule 472(m) and NASD Rule 2711(k).

[206] *Id.*

[207] NYSE notes its belief that municipal securities underwritings are not subject to the same potential conflicts of interest as equity securities. *See* NYSE Amendment No. 3.

[208] *See* SIA March 10th letter.

[209] NYSE notes the disclosures required pursuant to Rule 472(k)(1) and (2), approved as part of the original amendments have been renumbered as part of Amendment No. 3 and remain in effect. *See* NYSE Amendment No. 3.

As applied to disclosures under Rules 472(k)(1)(i)d.1., (k)(1)(ii)b.1., and (k)(2)(i)c.—180 days.

Qualification, Examination, and Registration Requirement for Research Analysts (NYSE Rule 344)—365 days after the completion of Qualification Examination (180 days after approval to develop and implement examination).

Continuing Education Requirement for Research Analyst—(Exchange Rule 345A)—Firm Element—180 days. Regulatory Element—In accordance with industry rules and regulations upon registration/qualification of research analysts.

Compensation Committee Review/Procedures (NYSE Rule 472(h)(2)—90 days.

Anti-Retaliation and Small Firm Exemption Provisions—(NYSE Rules 472(g)(2) and 472(m))—effective immediately upon approval.

All other Rule provisions—60 days.

NASD suggests the following effective dates for the provisions contained in SR–NASD–2002–154:

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

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

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

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

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

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

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

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

All other proposed rule changes: 60 days.

The Commission believes that the above implementation schedule suggested by the SROs is reasonable.

IV. Accelerated Approval of Amendments; Solicitation of Comments

The Commission find good cause to approve NYSE Amendment No. 3 and NASD Amendment No. 3 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 proposed rule changes and NASD Amendment No. 1 and Amendment No. 2 and NYSE Amendment No. 1 and Amendment No. 2 were published in the **Federal Register**.[210] The Commission believes that NYSE Amendment No. 3 and NASD Amendment No. 3 clarify the obligations of SRO members under the rules, refine the rules and make the NASD and NYSE proposals consistent with each other. 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. 3 and NASD Amendment No. 3 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,[211] to approve NYSE Amendment No. 3 and NASD Amendment No. 3 to the proposed rule changes on an accelerated basis.

Interested persons are invited to submit written data, views, and arguments concerning NYSE Amendment No. 3 and NASD Amendment No. 3, 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, 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–2002–154 and SR–NYSE–2002–49 and should be submitted by September 3, 2003.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Exchange Act,[212] that the proposed rule changes (SR–NASD–2002–154; SR–NYSE–2002–49), as amended, are approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[213]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 03–19730 Filed 8–1–03; 8:45 am]

BILLING CODE 8010–01–P

SMALL BUSINESS ADMINISTRATION

[Declaration of Disaster #3520]

Commonwealth of Kentucky; Amendment #2

In accordance with the notice received from the Department of Homeland Security—Federal Emergency Management Agency, effective July 25, 2003, the above numbered declaration is hereby amended to include Knox County in the Commonwealth of Kentucky as a disaster area due to damages caused by severe storms, flooding, mud and rock slides, and tornadoes beginning on June 14, 2003 and continuing through June 27, 2003.

In addition, applications for economic injury loans from small businesses located in the contiguous county of Whitley in the Commonwealth of Kentucky may be filed until the specified date at the previously designated location. All other counties contiguous to the above named primary counties have been previously declared.

All other information remains the same, *i.e.*, the deadline for filing applications for physical damage is September 2, 2003, and for economic injury the deadline is April 2, 2004.

(Catalog of Federal Domestic Assistance Program Nos. 59002 and 59008)

Dated: July 29, 2003.

Herbert L. Mitchell,

Associate Administrator for Disaster Assistance.

[FR Doc. 03–19734 Filed 8–1–03; 8:45 am]

BILLING CODE 8025–01–P

SMALL BUSINESS ADMINISTRATION

[Declaration of Disaster #3508]

Commonwealth of Kentucky; Amendment #3

In accordance with the notice received from the Department of

---

[210] *See* notes 5 and 7 *supra.*

[211] 15 U.S.C. 78f(b)(5), 78*o*–3(b)(6), and 78s(b).

[212] 15 U.S.C. 78s(b)(2).

[213] 17 CFR 200.30–3(a)(12).