

may submit sections of the research report to the company to verify factual accuracy and may notify the subject company of a ratings change after the "close of trading" on the business day preceding the announcement of the ratings change. Submissions to the subject company may not include the research summary, the rating or the price target, and a complete draft of the report must be provided beforehand to legal or compliance personnel. Finally, any change to a rating or price target after review by the subject company must first receive written authorization from legal or compliance.

As the Commission noted in the May 10th order, several commenters argued that the gatekeeper provisions would impose significant costs, especially for smaller firms that would have to hire additional personnel. Commenters also noted that personnel often wear multiple hats in smaller firms, thereby causing a greater burden to comply with the restriction on supervision and control by investment banking personnel over research analysts. NASD received similar comments in response to *Notice to Members* 02-44, which sought comment on whether certain members should be exempted from certain provisions of the Rule and what criteria should be employed to fashion such an exemption.

NASD received 10 comments in response to the *Notice to Members*.⁷ Generally, the comments emphasized the financial and administrative burdens imposed by NASD Rule 2711 to implement the gatekeeper provisions and to structure firms so that research personnel are not subject to supervision by investment banking personnel. Commenters argued that the conflicts addressed by NASD Rule 2711 are less pronounced with respect to smaller firms and that the burdens of compliance could force firms to discontinue their research business.

In response to the comments, NASD has been developing a proposed permanent exemption to preserve the role of smaller firms in the capital

raising process and to ensure research coverage for smaller or regional companies.

NASD believes that compliance with both NASD Rules 2711(b) and (c) continues to pose financial and administrative challenges for certain smaller firms. As such, NASD believes it appropriate to extend the effective date of those provisions for members that over the previous three years, on average per year, have participated in 10 or fewer investment banking transactions as manager or co-manager and generated \$5 million or less in gross investment banking revenues from those transactions. NASD proposes to delay the effective date of NASD Rules 2711(b) and (c) until July 30, 2003, or until the date a superseding permanent exemption is approved by the SEC and becomes effective.

As a further condition for the delayed implementation date, those firms that meet the eligibility requirements outlined above would be required to maintain records of communications that would otherwise be subject to the gatekeeper provisions of NASD Rules 2711(b) and (c).

2. NASD's Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of section 15A(b)(6) of the Act,⁸ which requires, among other things, that NASD's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that this proposed rule change would reduce or expose conflicts of interest and thereby significantly curtail the potential for fraudulent and manipulative acts. NASD further believes that the proposed rule change will provide investors with better and more reliable information with which to make investment decisions.

3. NYSE's Purpose

The Exchange is filing the proposed rule change to establish July 30, 2003, or until such date as a permanent exemption is approved by the SEC and becomes effective, as the effective date for NYSE Rule 472(b)(1), (2) and (3), subject to certain conditions, for members and member organizations that over the previous three years, on average per year, have participated in ten or fewer investment banking services transactions as manager or co-manager and generated \$5 million or less in gross investment banking

revenues from those transactions (hereinafter referred to as "small firms").

In the May 10th order, the Commission approved amendments to NYSE Rules 351 ("Reporting Requirements") and 472, which place prohibitions and/or restrictions on Investment Banking Department, Research Department, and Subject Company relationships and communications and impose new disclosure requirements on members and member organizations and their associated persons. At the same time, the Commission also approved a staggered implementation period for the rules. Most provisions of the rules became effective on July 9, 2002, including those that restrict supervision and control of associated persons by the investment banking department and those that require disclosure of investment banking compensation received from a subject company. The "gatekeeper" provisions, described below, became effective on September 9, 2002.

On July 9, 2002, the Exchange filed, for immediate effectiveness, SR-NYSE-2002-23⁹ that extended the effective date to November 6, 2002 for NYSE Rule 472(b)(1), (2) and (3) ("gatekeeper" provisions) for small firms.

On November 7, 2002, the Exchange filed, for immediate effectiveness, SR-NYSE-2002-60,¹⁰ which extended the delayed effective date of the gatekeeper provisions for small firms until May 5, 2003.

Small Firm Relief

NYSE Rule 472 contains provisions that generally restrict the relationship between the research and investment banking departments, including "gatekeeper" provisions that require a legal or compliance person to intermediate certain communications between the research and investment banking departments. NYSE Rule 472(b)(1) prohibits an associated person (also referred to throughout this filing as a "research analyst") from being under the control or supervision of any employee of the investment banking department.

NYSE Rule 472(b)(1) also prohibits the investment banking department from reviewing or approving any research reports prior to distribution. NYSE Rule 472(b)(2) creates an exception to the prohibition of (b)(1) to allow investment banking personnel to review a research report prior to

⁷ Letter from David Amster, CRT Capital Group, dated August 19, 2002; Letter from Peter V.B. Unger, Fulbright & Jaworski, LLP, dated August 30, 2002; Letter from First Analysis Securities Corp., dated August 30, 2002; Letter from Scott Cleland and John Eade, Investors' Research Association, dated August 29, 2002; Letter from W. Gray Medlin, The Carson Medlin Co., dated August 29, 2002; Letter from Cathryn Streeter, BioScience Securities, Inc., dated August 28, 2002; E-mail from James Nelson, Minnesota Valley Investments, dated July 31, 2002; E-mail from Joe B. Kercheville, Kercheville & Company, dated August 28, 2002; E-mail from Ray Chin, DBS Vickers Securities (USA) Inc., dated July 29, 2002; Letter from Stuart J. Kaswell, Securities Industry Association, dated August 30, 2002.

⁸ 15 U.S.C. 78o-3(b)(6).

⁹ See Securities Exchange Act Release No. 46182 (July 11, 2002), 67 FR 47013 (July 17, 2002).

¹⁰ See note 5 *supra*.