

research and provide investors with more useful and reliable information when making investment decisions. Most of the new rules' provisions became effective on July 9, 2002, although some provisions took effect on September 9, 2002, and one provision took effect on November 6, 2002. Additionally, in July 2002, the SEC approved an NASD rule proposal to delay until November 6, 2002 the effectiveness of certain provisions for certain members with foreign affiliates, certain research analysts that are divesting the securities of all subject companies that they cover, and certain defined small firms.¹⁴

In June 2002, NASD and the NYSE issued a joint memorandum that provided members with the new rule language, as well as interpretive guidance on a number of Rule 2711's provisions.¹⁵ NASD and the NYSE also have been examining members' research practices to determine compliance with the new research analyst rules.

According to NASD, as a result of the examinations and further discussions with the SEC staff, NASD and NYSE agreed that additional rules governing members' research activities are necessary to protect investors. This rule change proposal would effectuate those additional safeguards. Generally, the proposed amendments would further separate analyst compensation from investment banking influence, prohibit analysts from issuing "booster shot" research reports, prohibit analysts from participating in "bake-off" meetings with prospective investment banking clients, require members to publish a final research report when they terminate coverage of a subject company, impose registration, qualification and continuing education requirements on research analysts, and make certain other changes.

NASD believes that these amendments do not implement all of the changes that may be required pursuant to the research analyst provisions of the SOA. NASD anticipates filing additional proposed amendments to Rule 2711 in the future to meet the requirements of SOA after further discussions with NYSE and SEC staff.

A more detailed discussion of the proposed rule change follows.

1. Analyst Compensation

The proposed amendments would require members to further separate analyst compensation from investment

banking influence by imposing new restrictions on the manner in which research analysts may be compensated. The rule proposal would require members to employ a compensation committee that reports to the member's board of directors (or if the member does not have a board of directors, a senior executive officer of the member) responsible for reviewing and approving analyst compensation at least annually. The committee could not have representation from the member's investment banking department. In determining an analyst's compensation, the committee would have to consider, if applicable, the research analyst's individual performance, including the analyst's productivity and research quality, the correlation between the analyst's recommendations and stock price performance, and overall ratings of clients, sales force, and peers independent of the member's investment banking department. The committee could not consider the analyst's contributions to the member's investment banking business.

The committee would be required to document the basis for establishing the analyst's compensation. The member also would have to attest annually to NASD that the committee reviewed and approved each analyst's compensation and documented the basis upon which the compensation was established.

2. Restrictions on Publishing Research Reports and Public Appearances

The proposed amendments would make several changes to current Rule 2711(f), which imposes "quiet periods" on members during which members may not publish research reports following an initial or secondary public offering of securities. First, the proposed amendments would extend the quiet period prohibitions to public appearances by research analysts as well as to the issuance of research reports.

Second, the proposed amendments would prohibit "booster shot" research reports or public appearances around the time of the expiration, waiver or termination of a "lock-up" agreement. Members often enter into lock-up agreements with subject companies or their shareholders that restrict or prohibit the sale of a subject company's or its shareholder's securities for a defined period after the completion of a securities offering. This provision would prohibit members from publishing a research report or making a public appearance concerning a subject company for 15 days prior to or after the expiration, waiver or termination of a lock-up agreement, thus helping prevent members from

publishing favorable research that is intended to benefit the shareholders whose lock-up agreement is no longer in effect by driving up the price of the issuer's shares. However, the rule proposal includes an exception that would allow members to publish research reports during this quiet period to comment on the effect of significant news or a significant event on the subject company, provided that the legal and compliance department authorizes the publication of the report before it is issued. A similar exception exists with respect to quiet periods in the current rule.

Third, the proposed amendments would require a member that decides to terminate coverage of a subject company to publish a notice of this termination, and to publish its final rating or recommendation of the subject company's securities (assuming the member had issued a prior rating or recommendation). This provision is intended to eliminate the practice of dropping coverage of a subject company rather than lowering a rating or recommendation.

3. Bake-Offs

The proposed amendments would prohibit a research analyst from issuing a research report or making a public appearance concerning a subject company if the research analyst communicated with the subject company in furtherance of obtaining investment banking business before the subject company had entered into a letter of intent or other written agreement designating the member as an underwriter of an initial public offering of the subject company. This provision would not apply to due diligence communications between an analyst and a subject company where the sole purpose is to analyze the financial condition and business operations of the subject company. The purpose of this provision is to prevent research analysts from attending "bake-off" meetings or otherwise communicating with a subject company where the intention is to pitch the member's investment banking services.

4. Registration, Qualification and Continuing Education of Research Analysts

The proposed amendments would create new NASD Rule 1050, which would require all persons associated with a member that function as research analysts to register with NASD. For purposes of Rule 1050, "research analyst" would be defined as any associated person who is directly responsible for the preparation of

¹⁴ See Securities Exchange Act Release No. 46165 (July 3, 2002), 67 FR 46555 (July 15, 2002).

¹⁵ See Notice to Members 02-39 (July 2002).