Testimony
of
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Introduction

On behalf of the NASD, I want to thank the Committee for this opportunity to testify.

I am here today to tell you about the NASD's recently proposed rules governing analyst recommendations. In light of what we have heard today and in the weeks following the Enron revelations, I think you will agree that these rules will help American investors. Among other measures, the proposal will require increased disclosures of conflicts in research reports and public appearances, prohibit tying analyst compensation to specific investment banking transactions, and restrict an analyst's personal trading of securities. The proposal also will prohibit firms from offering favorable research to induce investment banking or other business.

NASD – A Private Sector Regulator

As the world's largest securities self-regulatory organization, NASD has been helping to bring integrity to the markets and confidence to investors for more than 60 years. Market integrity and investor confidence are at the core of NASD's mission and are the foundation of the success of U.S. financial markets.

Under federal law, virtually all securities firms doing business with the American public are members of the NASD, a private sector, not-for-profit organization. Roughly 5,500 brokerage firms, and almost 700,000 registered securities representatives come under our jurisdiction.

NASD writes rules that govern the behavior of securities firms, examines them for compliance with these rules, as well as the rules of the SEC and the federal securities laws, and disciplines members and their employees if they fail to comply. Our market integrity responsibilities include regulation; professional training; licensing and registration; investigation and enforcement; dispute resolution and investor education. We monitor all trading on The Nasdaq Stock Market -- the largest-volume market in the world. We are staffed by 1600 professional regulators and governed by a Board of Governors – at least half of whom are unaffiliated with the securities industry.

During the more than six decades since the NASD was established under a Congressional mandate for securities industry self-regulation, investors worldwide have flocked to our markets.

The co-existence of strong self-regulation and investor participation in the markets is no mere coincidence. Self-regulation brings to bear a keen practical understanding of the industry. It taps resources and perspectives not readily available to governments. It fosters investor protection and member involvement by promoting high standards that go beyond simply obeying the law. And it has helped to make our markets the most successful in the world.

Self-regulation works because the brokerage industry understands that market integrity leads to investor confidence, which is good for business. The overwhelming majority of NASD members comply fully with the word and the spirit of the rules and the law. They view their own reputation for fair dealing and high standards as a competitive necessity in a competitive industry.

Tough and even-handed enforcement is a fundamental part of NASD's mission. It not only ensures compliance and punishes wrongdoing, but also benefits the vast majority of our members who obey the rules and place investors first. Investors feel more confident using the markets when they know a tough cop is patrolling the beat.

On average, NASD files more than 1,000 new disciplinary actions annually, with sanctions ranging from censures to fines and suspensions to expulsion from the securities industry. We supplement our enforcement efforts with referrals to criminal authorities and the Securities and Exchange Commission. In one major 2002 settlement alone, reached jointly with the SEC, NASD imposed sanctions of $50 million against a major investment bank for violating SRO rules by extracting illegal paybacks from favored customers to whom it allocated "hot" initial public offerings (IPOs).

NASD Role In Regulating Analysts

The NASD's jurisdiction over analysts stems from the fact that most "sell-side" research analysts are employed by dealers that are required by law to belong to the NASD. These research analysts are considered to be "associated persons" of the broker/dealers that employ them, and this status subjects them to the NASD's rules.

The NASD has been using its existing rules effectively to investigate and bring enforcement actions against analysts whose behavior undermines investor confidence. For example, we successfully litigated a case where a firm touted an issuer's stock through a nationally distributed research report that contained numerous misrepresentations and omitted material information. The firm was expelled from the securities industry, and its president was fined and suspended.

Currently, we have several analyst investigations underway. We are examining whether firms adequately disclose risk factors. Certain reports, for example, fail to tell investors that issuers have no revenues or that they have received "going concern" audits. We are also looking at firms that made exceedingly bullish price predictions in the face of negative information and rapidly falling prices. In some instances, the issuers being promoted declared bankruptcy shortly after brokerage firms issued "Strong Buy" recommendations. Finally, with respect to certain recommendations, we are investigating whether firms had an adequate basis for price targets. The proposed new rules will greatly expand our enforcement capability in this important area.

Enron Highlights Need for Transparency

Many individuals were seriously harmed by the collapse of Enron when they lost their jobs and their retirement savings. Also problematic is the potential loss of investor confidence in the markets as a result of Enron. While all the reasons behind the collapse of Enron have not been discerned, we can be fairly certain that at a minimum there was information withheld from the public and a situation that was fraught with conflicts of interest.

The conflicts of interest in the Enron saga range from the most obvious - a CFO involved on both sides of corporate transactions - to the revolving door of public accountants moving into the corporation. There was also a potential conflict when analysts who were recommending Enron stock were employed by investment banks engaged in multifaceted businesses with Enron including investment banking, lending and advisory work.

These potential conflicts of interest are troubling from many perspectives but most of all because they were not disclosed to the investing public so that they could be considered in evaluating the objectivity of the analysts' recommendations.

One of the jobs of the NASD is to help ensure that there is transparency for investors and that investors are aware of situations that may pose conflicts of interest. That is why we have proposed rules for analysts to disclose potential and actual conflicts of interest – so that the investing public is better able to evaluate the vast amounts of information on companies in which they may choose to invest.

Information

With stock market participation expanding from Wall Street to Main Street, the role of investment information has exploded as well. TV financial news, business magazines, newspapers, Internet websites and chat rooms, corporate filings and news releases, stock analyst reports -- there is a din of data for investors to sift through today. Unfortunately, quantity does not guarantee quality: It has never been harder for small investors to assess which information they should rely upon in making their investment decisions. As a result, some investors have depended too heavily on the summary recommendations of just a few securities analysts -- not understanding the particular context in which such recommendations often are generated, and the particular ways in which they often must be read.

Research analysts study companies and draw on a wealth of company, industry, economic and business trend information to help their clients make better investment decisions. Everyday retail investors may believe that most analysts work for them -- that their primary obligation is to the investing public. In fact, the full story is much more complicated.

"Sell-side" analysts typically work for large financial firms that underwrite securities. (An underwriter typically is an investment bank that acts as an intermediary between the securities issuer and investors in a public offering of securities.) "Buy-side" analysts typically work for institutional money managers -- such as mutual funds, hedge funds, or investment advisers. Both sell-side and buy-side analysts may provide research and advice for institutional clients, whose investment decisions often bear little relation to those faced by everyday investors. Analysts also can be unaffiliated with either the sell side or the buy side -- in which case they sell their independent research and findings to financial or investing institutions, banks, insurance companies or private investors on a project or subscription basis.

Proposed NASD Rules

Even before the tragedy of Enron, analysts were already under the scrutiny of Congress, the SEC and the self-regulatory organizations. When the Internet Bubble burst and stock prices fell dramatically in the second half of 2000, many people began to wonder why the analyst recommendations sounded strangely the same as during the bull market.

Under the leadership of the House Financial Services Committee and SEC Chairman Harvey Pitt, the NASD and the New York Stock Exchange began working with the SEC and securities industry representatives to develop uniform NASD/NYSE rules addressing conflicts of interest that arise when research analysts recommend securities in public communications. The rules that we developed were filed with the SEC on February 8, 2002, and we expect the Commission to publish them for comment shortly.

These comprehensive, tough rules, when adopted, will improve the objectivity of research and provide investors with more useful and reliable information when making investment decisions. To that end, the rules will minimize the influence that a member's investment banking department has over its research department and will restrict severely analysts' personal trading of securities. And the rules will require extensive disclosure of potential conflicts of interest facing firms and analysts.

Conflicts can arise when analysts work for firms that have investment banking or other business relationships with the issuers of the recommended securities, or when the analyst owns securities of the recommended issuer. The rules will require disclosure of financial interests held by the member firm, the analyst and his or her family members, and any other material conflict of interest associated with a recommendation of a security. The rules will require firms to clarify the meanings of their research ratings and provide historical price and ratings distribution data in research reports to better enable investors to evaluate and compare the quality of research.

Investment Banking Relationships

Providing investment banking services, such as underwriting an IPO or advising on a merger or acquisition, can generate substantial revenues for an analyst's firm. Thus, an analyst may have an incentive not to say or write things that could jeopardize client relation for their investment banking colleagues. Accordingly, our rules will limit the relationship between investment banking departments the research departments in firms. For example, research department personnel will not be subject to the supervision or control of th investment banking department. Similarly, the investment banking department could not review or approve research reports prior to distribution, but could check research reports prior to distribution as necessary only to verify the accuracy of information or to reviev any potential conflicts of interest that may exist. These communications between the two departments – written and oral – will have made through the firm's legal and compliance department and documented.

Similarly, the subject company could not approve research reports prior to distribution, but could review sections of a draft research as necessary to verify facts in those sections, so long as the firm doesn't share the research rating, the research summary or the price Any changes to the analyst's rating or price target for the subject company made after the company completes its factual review will be justified in writing and submitted to the firm's legal or compliance department for approval.

Our rules will allow firms to notify a subject company whose rating will be changed but only after the close of trading in its principa market the evening prior to a morning announcement of the change.

Compensation of Analysts and Firms

Sell-side analysts serve a very important role in our securities market's capital raising process. As part of their job responsibilities, research analysts advise investment banking departments concerning such matters as whether a potential underwriting client is financially or operationally prepared for an initial public offering. Nevertheless, there are inherent conflicts of interest related to analyst compensation for these activities. In this regard, brokerage firms' compensation arrangements can put pressure on analysts to issue positive research reports and recommendations by tying analyst compensation to specific investment banking services.

To address those concerns, our proposed rules will prohibit a firm from tying analyst compensation to specific investment banking services transactions. Thus, for example, an analyst may not receive a bonus that is based on the analyst's contributions to a specific investment banking deal. However, a firm will not be prohibited from compensating an analyst based upon the analyst's overall performance, including services provided to the investment banking department. If the analyst received compensation based upon (among other factors) the firm's investment banking revenues, this must be disclosed in the report.

Our rules will also provide that a firm must disclose in research reports if the firm or its affiliates received compensation from the co that is the subject of the research report within the last 12 months prior to the date of the research report. A firm also will have to dis the firm or its affiliates reasonably expects to receive compensation from the company within the next three months following the da the research report. When a research analyst in a public appearance recommends securities, the analyst will have to disclose if the cc is a client of the firm or its affiliates, provided that the research analyst knows or has reason to know of this fact.

Our rules will prohibit promises of favorable research or specific price targets in return for investment banking or other business. W rules already prohibit this type of fraudulent conduct, this provision will make this prohibition more explicit. We will also require q periods during which a firm could not publish a research report regarding an issuer for which the firm acted as manager or co-manag an initial public offering within 40 calendar days following the effective date of the offering. A firm could not issue a research repor regarding an issuer for which the firm acted as manager or co-manager of a secondary offering within 10 calendar days following the effective date of the offering. A firm could permit exceptions to these prohibitions (consistent with other securities laws and rules) f research material that is issued due to significant news or events.

Analyst Trading of Securities

There has been much public discussion about analysts' personal trading. Our rules will provide that no analyst or member of the ana household could purchase or receive an issuer's securities prior to its initial public offering (*e.g.*, so-called pre-IPO shares), if the issu principally engaged in the same types of business as companies that the analyst issues research reports about.

Under the rule, no analyst or household member could trade securities issued by companies the analyst follows for a period beginnin calendar days prior to the issuance of a research report and ending five business days after the issuance of such a research report. Th prohibition will also apply to a period beginning 30 calendar days before and ending five calendar days after the analyst changes a ra price target of a subject company's securities. And no analyst or household member could make trades contrary to the analyst's mos current recommendations (*i.e.,* sell securities while maintaining a "buy" or "hold" recommendation or buy securities while maintaini "sell" recommendation).

Very limited exceptions to these prohibitions will be permitted under circumstances of significant personal hardship and only where s trades are pre-cleared by the firm's legal and compliance department.

Analyst and Firm Ownership of Securities

Many members of the public want to know whether analysts own stocks in the company they recommend. An analyst and the firm itself may own significant positions in the companies an analyst covers, either directly, or through employee stock-purchase pools that invest in companies they cover. Our proposed rules will require that a firm disclose in research reports and an analyst disclose in public appearances if the analyst or a household member has a financial interest in the securities of the subject company. The firm and analyst will have to disclose any other actual, material conflict of interest of which the firm or analyst knows or has reason to know at the time of the research report's issuance or the public appearance.

Likewise, a firm will have to disclose in research reports and an analyst will have to disclose in public appearances if, as of 5 busines before the publication or appearance, the firm or its affiliates beneficially own 1% or more of any class of common equity securities subject company. Firms will compute beneficial ownership of securities based upon the same standards used to compute ownership purposes of the reporting requirements under Section 13(d) of the Securities Exchange Act of 1934.

The firm will have to disclose any other actual, material conflict of interest that it has with respect to the subject company, and the re analyst must disclose in public appearances any such conflict of interest of which the analyst knows or has reason to know at the tim public appearance.

Other Disclosures

Under our rule, the front page of research reports will have to contain disclosures or else refer the reader to the page on which disclos are found. Disclosures must be clear, comprehensive and prominent. These disclosures include the valuation methods used, and any objectives will have to have a reasonable basis and include a discussion of risks.

A firm will have to disclose in research reports if it was making a market in the subject company's securities at the time the research was issued.

A firm will have to disclose in research reports and analysts will have to disclose in public appearances if they or a household memb officer, director or advisory board member of the subject company.

The rules will require that firms disclose in research reports the meanings of all ratings used by the firm in its ratings system. For ex a firm might disclose that a "strong buy" rating means that the rated security's price is expected to appreciate at least 10% faster than securities in its sector over the next 12-month period. Definitions of ratings terms also will be required to be consistent with their pla meaning. Thus, for example, a "hold" rating may not mean that an investor should sell a security. Firms will *not be* required to adop same ratings system.

Regardless of the ratings system employed, a firm will have to disclose in research reports the percentage of all securities that the fir recommends an investor "buy," "hold," or "sell." A firm should determine, based on its own ratings system, into which of these thre categories a particular securities rating falls. This information will have to be current as of the end of the most recent calendar quarte the second most recent calendar quarter if the publication date is less than 15 calendar days after the most recent calendar quarter). F example, a research report might disclose that the firm has assigned a "buy" rating to 58% of the securities that it follows (which wou include both "buy" and "strong buy" ratings), a "hold" rating to 15%, and a "sell" rating to 27% (which would include both "reduce" "sell" ratings). Within each of the three categories, a firm must also disclose the percentage of subject companies that are investmen banking clients of the firm. Thus, for example, if 20 of the 25 companies to which a firm has assigned a "buy" rating are investment banking clients of the firm, the firm will have to disclose that 80% of the companies that received a "buy" rating are its investment ba clients. These disclosures will demonstrate how the firm distributes its ratings among different ratings categories. They will also inc whether the firm tends to assign positive ratings to the securities it follows and to its investment banking clients.

A firm must include in research reports a price chart that maps the price of a stock over time and indicates points at which an analyst assigned or changed a rating or price target. An example of this price chart is attached. This chart will enable investors to compare t ratings and price targets that a firm has assigned to a particular security with the stock performance of the security itself. This provis will apply only to securities that have been assigned a rating for at least one year, in recognition of the long-term nature of many ratir Moreover, the price chart will not have to extend more than three years before the date of the research report. The information in the chart will have to be current as of the end of the most recent calendar quarter (or the second most recent calendar quarter if the public date is less than 15 calendar days after the most recent calendar quarter).

Supervisory Procedures/Reporting Requirements

Our proposed rules require firms to adopt written supervisory procedures reasonably designed to ensure that the firm and its employe comply with the rules. A firm's senior officer will have to attest annually to its SRO that it has established and implemented procedu reasonably designed to comply with these rules.

This new rules is a matter of private sector self-regulation. And not self-regulation in name, but self-regulation in fact. It will strengthen the industry's own business practices and ethical standards. And it will be enforced by the NASD with a full range of disciplinary options -- which include stiff fines and the potential for expulsion from the industry.

Conclusion

The NASD mission is clear: to bring integrity to the markets and confidence to investors by employing industry expertise and resources. As Congress recognized over 60 years ago, self regulation properly implemented has an important role in securities market regulation. Enron hasn't changed that. These proposed rules will have teeth because self-regulation in the securities industry has teeth.

Thank you for the opportunity to highlight one area where self regulation has been a resounding success, in no small part due to the support of Congress. While our proposed rules do not solve all the problems revealed in the wake of Enron, it is an important step in restoring investor confidence in the markets. The work of your Committee and the Congress will be vital in addressing the myriad other issues that Enron highlights. I look forward to working with you as Congress examines the range of suitable remedies to address these issues.

Power Point Presentation

Sample Price Chart