In 1991, the New York Stock Exchange (''NYSE''), in NYSE Information Memo 91–8, issued a policy statement regarding stock accumulations by a NYSE member organization in advance of that member's issuance of research reports. NYSE Information Memo 91–8 stated that where an NYSE member organization intended to purposefully acquire a position in an NYSE-listed security in contemplation of its issuance of a favorable research report, the NYSE would find such conduct to be inconsistent with just and equitable principles of trade.

At that time, the NASD also considered the issue of trading activity in anticipation of the issuance of research reports but determined to address the issue on a case-by-case basis. Thus, in response to individual member firm requests for a position on the issue, the NASD staff informally had taken the position that trading based upon material, non-public market information could be considered a violation of just and equitable principals of trade. In 1994, however, the NASD solicited member comment in Notice To Members 94–40 (''NTM 94–40'') on the development of a formal policy that clearly would state that trading in anticipation of a research report would be deemed a violation of Article III, Section 1 of the Rules of Fair Practice. The NASD Board, in proposing this new Interpretation, also sought comment on a policy to recommend, but not require, that member firms develop and implement ''Chinese Wall'' restrictions that would isolate research and trading activities within individual departments of the firm.

(b) Comments Received

In response to its proposal on trading ahead of research reports, the NASD received eleven comments that were fairly evenly split between support of and opposition to the proposed policy. Three firms either fully supported the proposal or suggested very minor changes. These firms believed that the proposed Interpretation would: (1) Clarify a member firm's obligations in Nasdaq and third market securities; (2) promote consistency among self-regulatory organization rules; (3) ease the compliance burden on the firms; and (4) engender greater investor confidence that the investor will not be disadvantaged by the professional.[2] Two other firms[3] supported the proposed policy in part, but expressed certain reservation. For example, A.G. Edwards believed that it was important that an Interpretation be developed to address issues related to a firm's unfair trading in advance of a research report. The firm also believed that any Interpretation should be extended to third Market trading in advance of research report on NYSE-listed companies. However, Edwards was concerned that the proposal could harm small capitalized issues with limited liquidity and it could undercut a firm's interest in developing research reports, especially with low liquidity stocks. J.P. Morgan's letter raised similar concerns.

Finally, six comments[4] opposed the adoption of the proposed Interpretation. These comments expressed two principle concerns with the proposal: (1) It would adversely affect the liquidity and pricing of Nasdaq SmallCap stocks because firms would not be able to develop a readily available inventory in such stock to meet investor demand after the issuance of the report; and (2) member firms likely would diminish their research efforts because their own customers would not be able to benefit from securities that the firm had been able to secure at advantageous prices.

(c) Discussion

As noted above, the NASD has carefully examined its policies regarding the trading practices for member firms in anticipation of the issuance of a firm's research reports. The NASD believes that purposeful inventory adjustments made in anticipation of customer trading activity as a result of the firm's research report could appear to, and at times would, conflict with the firm's fiduciary duties toward its customers. The NASD, after weighing the issues related to the matter, has determined that in the interests of investor protection, it would be deemed a violation of just and equitable principles of trade if a member firm purposefully adjusts its inventory position in a Nasdaq security, in an exchange listed security that is traded in the third market, or in a derivative product of any such securities in anticipation of the issuance of a research report in that security. At the least, such purposeful activity creates an appearance of impropriety that harms the perception of the marketplace and could lead to a loss of investor confidence. The NASD notes that it is important that investors understand that they will not be disadvantaged by professionals, and accordingly, it seeks to further enhance its rules and policies that promote the fair treatment of investors and maintain the confidence of such investors. This new policy should enhance the overall perception of Nasdaq and the third market and encourage investors to participate in those markets, thereby promoting liquidity. In addition, because the NASD believes that the proposed Interpretation is consistent with the policy found in NYSE Information Memorandum 91–8, this clear statement of NASD policy will promote consistency among self-regulatory organizations and help to alleviate compliance burdens for member firms that operate in multiple markets.

After considering the comments on the proposal in NTM 94–40, the NASD Board determined to refine the proposal slightly to incorporate comments recommending that the proposed Interpretation address third market trading in listed securities that are the subject of a firm's research report. The NASD believes it important from an investor protection viewpoint to clearly state that it would be a violation of just and equitable principles of trade if a member firm trading in the third market in anticipation of the issuance of a research report were to establish, increase, or decrease a position in an exchange-listed security. Without the inclusion of exchange-listed securities traded in the third market, there could be a significant gap in customer protection rules on this issue. Similarly, the NASD has amended its policy as proposed in NTM 94–40 to clarify that it would also be a violation if the firm were to decrease or liquidate its position in a security because it was about to issue a negative research report. This amendment to the proposed policy also closed a potential gap in the policy and clarified the intent of the NASD.

Finally, the NASD, in reaction to a comment letter[5] decided to include in the proposed Interpretation a prohibition regarding a member firm's attempts to do indirectly what it is not permitted to do directly. Accordingly, the proposed Interpretation prohibits a member firm from purposefully establishing, increasing, decreasing or liquidating a derivative security position in anticipation of the firm's issuance of a research report on the security underlying the derivative position. The NASD's concern is, for example, that by trading in options on an underlying security that is to be the subject of a research report, the member

[2] See letters from Merrill Lynch; Lehman Bros.; and the Association for Investment Management and Research (''AIMR'').

[3] See letters from J.P. Morgan Securities and A.G. Edwards.

[4] See letters from Kemper Securities, Inc.; Brown & Wood; Pacific Growth Equities; Conning & Co.; First Albany; and Rauscher Pierce Refsnes, Inc.

[5] See Lehman Bros. letter.