

SR nasd 2006 112 - 1

THE ALLIANCE IN SUPPORT OF INDEPENDENT RESEARCH

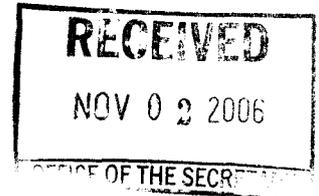
C/O PICKARD AND DJINIS LLP
ATTORNEYS AT LAW
1990 M STREET, N.W.
WASHINGTON, D.C. 20036

TELEPHONE
(202) 223-4418
By Hand

November 1, 2006

TELECOPIER
(202) 331-3813

Nancy M. Morris, Secretary
U.S. Securities and Exchange Commission
150 F Street, N.E.
Washington D.C. 20549



Re: SR-NASD-112; SR-NYSE-77

Dear Ms. Morris:

This letter is submitted on behalf of the Alliance in Support of Independent Research in response to the U.S. Securities and Exchange Commission's ("SEC" or "Commission") request for comments regarding the above-referenced rule amendments recently filed by the National Association of Securities Dealers, Inc. ("NASD") and the New York Stock Exchange ("NYSE") pursuant to Section 19(b)(3)(A) of the Securities Exchange Act of 1934 and Rule 19b-4(f)(1) thereunder regarding the rules applicable to research analysts and research reports (the "Rule Amendments").¹

As discussed in detail below, while the Rule Amendments purport to merely codify existing interpretive guidance, in at least one important area the Rule Amendments explicitly withdraw previous guidance that has been relied upon by NASD and NYSE members involved in the distribution of independent third-party research through client commission ("soft dollar") arrangements. The Rule Amendments also may be interpreted to impose new, unworkable obligations upon broker-dealers who distribute independent third-party research through client commission arrangements. Because the Rule Amendments contain newly articulated standards which could greatly impair the ability of broker-dealers to provide independent third-party research to their clients, we ask that the NASD and NYSE withdraw the offending provisions and resubmit them for public comment prior to any such provisions taking effect. In the alternative, we ask that the Commission abrogate the Rule Amendments on the grounds that they do not satisfy the standards of Section 19(b)(3)(A) of the Securities Exchange Act of 1934 and the rules thereunder as applied to self-regulatory rule changes which may take effect immediately upon filing with the Commission.

Members of the Alliance share a common interest in fostering a favorable regulatory environment in which research services and products may be furnished to the money management community, and in preserving the umbrella of protection Section 28(e) of the Securities Exchange Act of 1934 provides to fiduciaries who receive all forms of investment research.

¹ See SEC Rel. No. 34-54616 (October 17, 2006); SR-NASD-2006-112; SR-NYSE-2006-77. The rule filings are similar with at least one significant exception, as discussed infra.

The leading members of the Alliance in Support of Independent Research include the following broker-dealers:

Capital Institutional Services, Inc.
Kristi P. Wetherington, President and CEO

E*TRADE Capital Markets
Jennifer A. Connors, Head of Brokerage Compliance

The Interstate Group,
A Division of Morgan Keegan & Company, Inc.
Grady G. Thomas, Jr., President

Knight Equity Markets L.P.
Joanne Mascellino, President, Donaldson & Co. Division

Westminster Research Associates, Inc.
A BNY ConvergeEx Group Member
John D. Meserve, President

Our members are involved in a significant portion of the arrangements under which fiduciaries such as mutual funds, investment advisers, banks and other money managers are provided with independent research services and products for the benefit of their managed accounts.

Background

In 2002 the Securities and Exchange Commission approved rules by the NASD (Rule 2711) and NYSE (amendments to Rule 472) intended to improve the objectivity of research of broker-dealers (the "Research Analyst Rules").² These rules, which were adopted in light of issues raised regarding the independence of proprietary research distributed by broker-dealers who also engage in investment banking activities, impose a myriad of disclosure obligations on research reports distributed by NASD and NYSE member firms. In July of 2002, the NASD and NYSE published a Joint Interpretive Memorandum addressing interpretive issues raised by the Research Analyst Rules.³ One issue addressed in the Joint Interpretive Memorandum is the application of the rules to independent research distributed by broker-dealers through third-party soft dollar arrangements. In this regard, the Joint Interpretive Memorandum stated as follows:

When a member distributes research produced by an independent third party generated in accordance with a soft-dollar arrangement, the member's disclosure requirements do not apply. If the independent third-party source of the

² See SEC Rel. No. 34-45908 (May 10, 2002).

³ See NASD Notice to Members 02-39, Attachment B (July 2002).

research is also an NASD or NYSE member, the third-party member firm must comply with the applicable SRO Rules' provisions . . .⁴

Accordingly, based upon the Joint Interpretive Memorandum, a broker-dealer distributing the research of an independent third party through a client commission arrangement, whether or not the independent third party was also an NASD or NYSE member, was not required to make any disclosures under the Research Analyst Rules regarding the research report.

Recent NASD and NYSE Rule Amendments

There are two provisions of the Rule Amendments which could impair the ability of broker-dealers to distribute independent third-party research through client commission arrangements. First, the Rule Amendments have explicitly withdrawn the interpretation in the Joint Interpretive Memorandum which exempted broker-dealers who distribute third-party independent research from the disclosure requirements of the Research Analyst Rules, and replaced this interpretation with a provision which may or may not require such broker-dealers to accompany third-party research with certain disclosures. Second, the Rule Amendments can be read to have imposed a requirement upon broker-dealers who distribute research of an independent third party through a client commission arrangement to appoint a principal to review such research for compliance with the Research Analyst Rules and other rules governing communications with the public. This latter provision is particularly troublesome because in the vast majority of client commission arrangements where a broker-dealer provides third-party independent research to its institutional customers such research is delivered directly from the research preparer to the customer, without flowing through the broker-dealer. Furthermore, because broker-dealers who provide independent third-party research to their clients are not involved in the preparation of such research, they are not in a position to conduct a supervisory review of such research.⁵

Potential New Disclosure Requirements Applicable to Broker-Dealers Who Distribute Third-Party Research

NASD Rule 2711(h)(13)(A) and NYSE Rule 472(k)(4)(i) require members who distribute or make available any research report that is produced by another member, a non-member affiliate of the member or an independent third party to accompany the research report with the disclosures, as they pertain to the member, required by NASD Rule 2711(h)(1)(B), (h)(1)(C), (h)(2)(A)(ii) and (h)(8) and NYSE Rule 472(k)(1)(i)c, (k)(1)(i)a, (k)(1)(i)b and (k)(1)(iii)d, respectively.⁶ An exception to this disclosure obligation is

⁴ NASD Notice to Members 02-39, Attachment B at 368.

⁵ Broker-dealers who distribute independent third-party research through client commission arrangements that seek the protection of the Section 28(e) safe harbor do conduct general reviews of such research to confirm that it is susceptible to characterization as "brokerage and research services" under Section 28(e)(3), but such a review does not rise to the level that may be contemplated in the Rule Amendments.

⁶ These disclosures include: (1) if, as of the end of the month immediately preceding the date of publication of the research report the member or its affiliates beneficially own 1% or more of any class of common equity

available for research reports prepared by an independent third party that a member makes available to its customers either upon request or through a member-maintained web site.⁷

As discussed above, the distribution of independent third-party research through a soft dollar arrangement was unconditionally exempted from the disclosure requirements described above under the old Joint Interpretive Memorandum. As referenced in the following language, the Rule Amendments would specifically supersede the existing interpretation:

The joint interpretive memoranda indicate that distribution of independent third-party research through a soft-dollar arrangement is not encompassed by the disclosure requirements. The proposed rule change would supersede this interpretation. Thus, when a member organization distributes independent third-party research through a soft-dollar arrangement, the third-party disclosure requirements would apply, unless another exception is available (e.g. where such research is provided upon customer request).⁸

Although it may be argued that all research in a third-party client commission arrangement is provided upon customer request, and thus is eligible for this exemption, the Rule Amendments do not make this clear. Indeed, by specifically withdrawing the existing blanket exemption for independent third-party research distributed through soft dollar arrangements, the Rule Amendments imply that some arrangements would now not be exempt from the disclosure requirements. Thus, in this important respect, the Rule Amendments clearly represent a change to existing interpretations, and should have been submitted for public comment prior to becoming effective.

Another important issue raised by the Rule Amendments which must be clarified is the treatment of arrangements pursuant to which a member distributes the research of another, independent, NYSE or NASD member firm as opposed to research of a non-member third-party research producer. This is so because, absent an exemption, the Rule Amendments would apply the disclosure requirements to an NYSE or NASD member who distributes research reports produced by another member, a non-member affiliate of the

security of the subject company; (2) if the member or any affiliate managed or co-managed a public offering of securities for the subject company in the past 12 months, received compensation for investment banking services from the subject company in the past 12 months or expects to receive or intends to seek compensation for investment banking services from the subject company in the next 3 months; (3) if the member was making a market in the subject company's securities at the time the report was published; and, (4) any other actual, material conflict of interest.

⁷ NASD Rule 2711(h)(13)(B); NYSE Rule 472(k)(4)(ii).

⁸ SR-NASD-2006-112 at 38. Similar language may be found in SR-NYSE-2006-77 at 10 and in SEC Rel. No. 34-54616 at 23-24. The NYSE's discussion of its Rule Amendment indicates that an additional exception to the disclosure requirements would apply if research reports are "furnished directly by the research provider to the customer." We note, however, that the NASD's discussion of its Rule Amendment does not indicate that the NASD will recognize a similar exemption. While the NYSE's interpretation mitigates some of the issues caused by the SRO's apparent repeal of the blanket exemption applicable to independent third-party research distributed through client commission arrangements, it still leaves uncertainty where there was once a bright line test.

member or an independent third party, while the exemption for research reports requested by clients only applies to research reports of independent third parties, and does not mention research reports of other members. To the extent that the Rule Amendments can be read to subject a broker-dealer who distributes the research reports of another independent broker-dealer through a client commission arrangement to the disclosure requirements, such interpretation is contrary to the interpretation in the Joint Interpretive Memorandum, which indicated that the disclosure requirements did not apply to a member who distributes the research report of an independent third party, regardless of whether the third party is also a NYSE or NASD member. The imposition of additional disclosure obligations on the distribution of research reports of other broker-dealers through client commission arrangements would contradict the policy objectives set forth by the Commission in its July interpretive release regarding client commission arrangements under Section 28(e). This release indicated that the Commission's goal was to "permit the industry to flexibly structure [commission sharing] arrangements that are consistent with the statute and best serve investors."⁹

New Potential Requirements to Review and Approve Third-Party Research Distributed Through a Client Commission Arrangement

Of potentially greater significance is another provision of the Rule Amendments that would require broker-dealers who distribute third-party research to appoint a principal to review and approve such research.¹⁰ In this regard, NASD Rule 2711(h)(13)(C) provides:

A registered principal (or supervisory analyst approved pursuant to Rule 344 of the New York Stock Exchange) must approve by signature or initial any third-party research distributed by a member. All third-party research distributed by a member must be reviewed by the designated principal . . . to determine that the applicable disclosures required by Rule 2711 are complete and accurate, and the content of the research report is consistent with all applicable standards regarding communications with the public.¹¹

It appears that this provision may be intended to apply to third-party research provided through Section 28(e) arrangements.¹² In this regard, we note that the aforementioned provision, which exempts independent third-party research reports provided upon customer request from the disclosure obligations, does not appear to apply to the NASD's new requirement that a registered principal review and approve such research.

⁹ SEC Rel. No. 34-54165, 71 Fed. Reg. 41978, 41992 (July 24, 2006).

¹⁰ We note that the Rule Amendments use the term "research" and "research reports," in a somewhat haphazard fashion, which would in some cases broaden the impact of this provision.

¹¹ A similar provision is found in NYSE Rule 472(k)(4)(i)a and b.

¹² We note that the Joint Interpretive Memorandum indicated that "a member will not be considered to have distributed independent third party research to a customer where a customer independently requests or accesses such research from the member . . ." NASD Notice to Members 02-39, Attachment B at 369. Because the Rule Amendments purport to "supersede" the Joint Interpretive Memorandum, it is unclear whether the NASD and NYSE intend to continue to apply this interpretation to the Rule Amendments.

If the review and approval requirement found in NASD Rule 2711(h)(13)(C) is deemed to apply to independent third-party research provided through client commission arrangements (particularly arrangements where such research is furnished directly by the research preparer to the customer) it would impose a new regulatory obligation which goes far beyond current industry practice. Indeed, in most client commission arrangements, the independent third-party producer delivers its research product directly to the client, leaving no opportunity for such research to be reviewed and initialed by the providing broker. Furthermore, as the providing broker is not involved in the preparation of such research, it is not in any position to conduct a supervisory review of the research. Accordingly, to impose an obligation on a providing broker to review, approve and initial such research would severely curtail the ability of broker-dealers to supply independent research to their institutional clients under the Section 28(e) safe harbor.

We note that the NYSE has apparently taken a different approach than the NASD with respect to the review and approval of third-party research. In this regard, the NYSE rule amendment would specifically exempt third-party research made available to customers upon request from both the disclosure obligations relevant to third-party research reports as well as the review and approval requirements applicable to third-party research.¹³ As such, dual NYSE/NASD members would be subjected to two different regulatory standards, increasing the uncertainty of the application of the Rule Amendments.

Filing of the NYSE and NASD Rule Amendments For Immediate Effectiveness

The NASD and NYSE each filed the Rule Amendments in purported reliance on Section 19(b)(3) of the 1934 Act, which provides for the immediate effectiveness, upon filing with the Commission, of a proposed self-regulatory organization ("SRO") rule change "constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the self-regulatory organization." Although such a rule change is exempt from the procedural safeguards established by Section 19(b)(1) and (2), the Commission may, within sixty days of the filing of such change, summarily abrogate the change and require that the Section 19(b)(1) and (2) procedures be followed. The Commission may take such action whenever the Commission determines that it is necessary and appropriate in the public interest for the protection of investors or otherwise in furtherance of the purposes of the 1934 Act.¹⁴

As explained above, the Rule Amendments do not merely codify stated policies or interpretations of the NYSE and NASD, but in several important respects impose new obligations upon members. Indeed, the Rule Amendments expressly supersede an important exemption relied upon by broker-dealers who distribute third-party independent

¹³ See NYSE Rule 472(k)(4)(ii). This provision exempts independent third-party research made available upon customer request from NYSE Rule 472(k)(4)(i), which contains both the disclosure requirements as well as the requirements that a supervisory analyst approve, by signature or initial, third party research distributed by a member organization. In contrast, NASD Rule 2711(h)(13)(B) would only exempt independent third-party research requested by a customer from the disclosure requirements of Rule 2711(h)(13)(A) and not from the review and approval requirements of Rule 2711(h)(13)(C).

¹⁴ Section 19(b)(3)(C).

Ms. Nancy M. Morris

November 1, 2006

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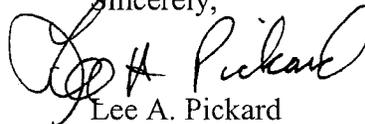
research through client commission arrangements, and replace it with an interpretation whose effect is uncertain.

* * *

Because, on their face, the Rule Amendments change existing, recognized and relied upon interpretations, they constitute rule changes subject to the prior notice, comment and Commission review procedures of Section 19(b)(1) and (2). We therefore respectfully request that the NASD and NYSE withdraw the Rule Amendments insofar as necessary to address the issues raised above including but not limited to incorporating the exemption which has been relied upon by broker-dealers who distribute independent third-party research through client commission arrangements. In the alternative, we respectfully request that the Commission summarily abrogate the Rule Amendments and require that they be refiled and processed in accordance with Section 19(b)(1) and (2).

The Alliance in Support of Independent Research appreciates the opportunity to comment on these rule changes. If you have any questions, please do not hesitate to contact Lee A. Pickard or William D. Edick at 202-223-4418.

Sincerely,



Lee A. Pickard

William D. Edick

Pickard and Djinis LLP

Counsel to the Alliance in Support of
Independent Research

cc: The Honorable Christopher Cox, Chairman
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
The Honorable Annette L. Nazareth, Commissioner
The Honorable Kathleen L. Casey, Commissioner

Erik R. Sirri, Director
Jo Anne Swindler, Assistant Director
Racquel L. Russell, Branch Chief
Division of Market Regulation

Patrice Gliniecki, Senior Vice President and Deputy General Counsel
Philip Shaikun, Associate Vice President and Associate General Counsel
National Association of Securities Dealers, Inc.

William Jannace, Director, Rule and Interpretive Standards
New York Stock Exchange LLC