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Via E-mail to: rule-comments@sec.gov

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-9303
Attention: Nancy M. Morris, Secretary

Re: File No. SR-NYSE-2006-78, SR-NASD-2006-113 - Amendments to Research Analyst Rules

Ladies and Gentlemen:

This letter is submitted on behalf of the Committee on Federal Regulation of Securities (the "Committee") of the Section of Business Law of the American Bar Association (the "ABA") in response to the request of the Securities and Exchange Commission ("SEC" or "Commission") for comments on amendments proposed by the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers, Inc. ("NASD") (together, the "SROs") to the research analyst rules contained in Exchange Act Release No. 55,072 (Jan. 9, 2007), 72 Fed. Reg. 2058 (Jan. 17, 2007) (the "Proposing Releases").

The comments expressed in this letter represent the views of the Committee only and have not been approved by the ABA's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, this letter does not represent the official position of the ABA Section of Business Law, nor does it necessarily reflect the views of all members of the Committee.

I. Introduction and General Comments

The Committee applauds the NYSE and NASD for their careful, thorough and thoughtful study of the research analyst rules, primarily NYSE Rule 472 and NASD Rule 2711, and for their willingness to propose modifications to improve the effectiveness of those rules.[1] The original research analyst rules, while highly prescriptive, may have been a necessary response to restore

[1] Exch. Act Rel. No. 55,072 (Jan. 9, 2007), 72 Fed. Reg. 2058 (Jan. 17, 2007).

public confidence in the integrity of broker-dealer research after the joint enforcement actions brought by the SEC, NYSE, NASD and states in 2002 against many leading broker-dealers. We believe that the process by which the NYSE and NASD worked together to produce joint memoranda interpreting their research analyst rules,[2] and conducted the joint report that led to these proposed rule changes,[3] is an important step towards SRO harmonization. As discussed in more detail below, we support most of the specific research analyst rule changes proposed by the NYSE and NASD.

These things being said, the Committee would encourage the SEC, the NYSE and the NASD to review the research area more broadly with a view to harmonizing research regulation further. We agree with the NYSE and NASD about the continuing importance of research by securities analysts to the effective functioning of the U.S. securities markets. As the NYSE/NASD Joint Report notes, research reports continue to have an effect on stock prices, indicating that the reports are bringing material information to the markets.[4] One of the critical factors the courts have used to determine whether the market for a security is efficient, for the purpose of applying the fraud-on-the-market presumption of reliance, is whether the security has sufficient research analyst coverage.[5] We also agree with the Joint Report that the overall amount of broker-dealer analyst research has declined since the adoption of the research analyst rules, although a portion of that decline may be due to market developments rather than the adoption of the rules themselves.[6] This decline is particularly notable in the case of smaller public companies, which are disproportionately harmed by the lack of such coverage. The lack of research coverage is a factor often cited by small public companies in deciding to go private (either through being acquired by larger public company, or through a private equity-led buyout), and by small private companies in declining to go public. The substantial burden and cost of compliance with the research analyst rules is a significant factor in this decline in research coverage.

Moreover, although not noted by the Joint Report, since the adoption of the research analyst rules there also has been a significant migration of research coverage away from broker-dealers

[2] *See* NASD Notice to Members 02-39 (July 2002) (First Joint Memorandum); NASD Notice to Members 04-18 (March 2004) (Second Joint Memorandum).

[3] Joint Report by NASD and the NYSE On the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules (Dec. 22, 2005) (hereinafter "Joint Report") (available at http://www.nasd.com/web/groups/rules_regs/documents/rules_regs/nasdw_015803.pdf).

[4] *Id.* at 22.

[5] *See, e.g. In re Xcelera.com Sec. Litig.*, 430 F.3d 503, 514 (1st Cir. 2005) ("the greater the number of securities analysts following and reporting on a company's stock, the greater the likelihood that information released by the company is being relied on by investors"); *In re Polymedica Corp. Sec. Litig.*, 432 F.3d 1, 9 (1st Cir. 2005) (existence of "market analysts" for a security is a factor in determining the efficiency of the market for that security); *Cammer v. Bloom*, 711 F. Supp. 1264, 1286 (D.N.J. 1989).

[6] Joint Report at 25-26. The Joint Report cites one press article that questioned the extent of the decline in broker-dealer research since the adoption of the research analyst rules.

to investment advisers - who are not subject to the SRO rules. Research coverage also has migrated to unregistered entities relying on the publisher's exemption to investment adviser regulation[7]- research which is not subject to any securities regulation beyond the federal and state anti-fraud provisions. The Commission and the SROs should be concerned both by the decline in broker-dealer analyst research, and by the migration of research to less-regulated environments.

As a result, the Committee urges the Commission, the NYSE and NASD to engage in a more searching reconsideration of the research analyst rules. . In particular the Committee believes that a disclosure-based approach to regulation of research analysts,[8] with fewer prescriptive features such as highly technical regulation of day-to-day contacts between research analysts and other brokerage firm personnel, the personal trading of individual research analysts, and the structure of compensation decisions for research analysts, would provide more efficient and effective regulation. Although such highly prescriptive regulation may have appeared necessary in the immediate wake of the research analyst enforcement cases, we believe that it has contributed substantially to the cost of providing broker-dealer research, and thus to some of the decline in the availability of such research, with limited incremental benefit in terms of the effectiveness of that regulation. Disclosure-based rules for broker-dealer research could achieve equivalent regulatory protection for investors in a more cost-efficient and less arbitrary manner than the current SRO research analyst rules, even with the amendments proposed here.

Further, we suggest that the Commission (together with the SROs) consider conducting an empirical study of both institutional and retail investors' use of broker-dealer research and of the factors investors consider important in evaluating that research. The Commission is currently conducting just such an empirical review of the marketing, sale, and delivery of financial products, accounts and services offered to individual investors by broker-dealers and investment advisers, with a view towards determining the most effective methods of regulating broker-dealers and investment advisers.[9] Similarly, the Commission conducted "focus-group" testing of its proposed mutual fund point-of-sale disclosure rules, and as a result learned that investors found many of its original proposed disclosures confusing or of limited relevance.[10] We believe a similar review would help the Commission and the SROs determine whether (as we believe

[7] Investment Advisers Act Section 202(a)(11)(D).

[8] The Committee strongly supports the SROs' proposal that disclosure of potential conflicts of interest involving research analysts be web-based rather than requiring those disclosure to be provided in paper-based format on every research report. Moving towards web-based disclosure is consistent with Commission's initiatives in a variety of areas from issuer proxy disclosure to broker-dealer financial statement disclosure and investment adviser proxy voting disclosure, and we encourage the Commission and the SROs to continue to explore additional areas in which web-based disclosure is appropriate.

[9] *See* Exch. Act Rel. No. 54,077 (June 30, 2006) (announcing Request for Information and Draft Solicitation for empirical study).

[10] *See* Sec. Act Rel. No. 8377 (Mar. 9, 2005) (reopening comment period in light of investor focus group reaction to original proposed mutual fund point-of-sale disclosure rules).

likely) some portions of the existing research analyst rules are excessively burdensome in light of their limited relevance to the actual investors who read and use research reports.

II. Uniformity

As discussed above, we applaud the NYSE and NASD for their efforts to harmonize their research analyst rules and to issue joint interpretations of those rules. Since the SROs began reconsidering the research analyst rules, on November 28, 2006, the NASD and NYSE jointly announced their plan to consolidate their member regulation operations into a new, single SRO for all securities firms conducting a public business in the United States. The research analyst rule filing, although published after this announcement, contains a number of inconsistencies between the NASD and NYSE proposals.[11] We urge the Commission to eliminate these inconsistencies and fully harmonize the NYSE and NASD research analyst rules.

The Committee believes there is no public benefit, and a potential for significant harm to investors, in having substantively different research analyst rules depending on whether a particular broker-dealer is an NYSE member or only an NASD member. The investing public does not (and cannot be expected to) understand the differences in regulation governing NYSE and NASD member firms, and customers rightfully expect the same level of substantive investor protection at whatever brokerage firm they choose to open an account. However the Commission chooses to harmonize the NYSE and NASD proposals (and our suggestions follow), we believe the most important issue is that they be harmonized in some way.[12]

As part of harmonizing the proposed amendments, the Committee urges the NYSE and NASD to make the language of their respective rules identical. Although we appreciate the efforts of the NYSE and NASD to interpret their rules consistently, the fact remains that their language is quite different - and differences in wording do matter. Especially for broker-dealers and their counsel who have not been intimately involved in the application of these rules over the past four years, the differences in rule language present potential traps for the unwary. As the NYSE and NASD move forward with the harmonization of their rulebooks, we suggest that the research analyst rules are a prime candidate for eliminating unnecessary differences in rule language.

Another area in which the Commission, the NYSE and the NASD should attempt to achieve greater uniformity concerns the Global Settlement of the research analyst enforcement actions. Broker-dealers subject to the Global Settlement are subject to a number of additional regulatory

[11] As discussed further below, for example, NYSE Rule 472(f)(2) would prohibit publication or distribution of research by any member firm who had acted as a manager, co-manager, underwriter or dealer of a securities offering within five days of expiration, waiver or termination of a lock-up agreement, whereas NASD Rule 2711(f)(3) would impose such ban for 15 days on any member firm who had acted as an underwriter or dealer. In addition, the NASD specifically struck "manager and co-manager" from its rule. *See* 72 Fed. Reg. at 2060 and 72 Fed. Reg. at 2064, respectively.

[12] The Committee also suggests that the Commission consider whether Regulation AC can be harmonized with the SRO research analyst rules - currently Regulation AC defines the term "research report" more broadly than do the SRO research analyst rules and this disparity creates the potential for inadvertent violations.

requirements (such as disclosures on confirmations and account statements) beyond those applicable generally to broker-dealers. There is no sound public policy rationale for such an unlevel playing field - inconsistent regulatory requirements for broker-dealers engaging in the same lines of business only serve to confuse investors. We recognize that achieving uniformity in this area would require the agreement of state securities regulators, and most of those additional requirements expire on the fifth anniversary of the Global Settlement. Nonetheless, the Committee believes that these sorts of regulatory requirements should be imposed, if at all, only on a uniform basis throughout the broker-dealer industry. We also urge the Commission, the NYSE and the NASD to learn from this experience, and to resist the urge to use "bad facts" as an excuse to regulate through the enforcement process.

Subsequent to the SEC's publication of this rule filing, the NASD requested comments on proposed amendments to its Rules 3010(g) and 2711 related to the definitions of "Office of Supervisory Jurisdiction" and "Initial Public Offering," respectively, in connection with the NASD and NYSE Rule Harmonization Project. The Committee believes this harmonization process is a positive step towards the goal of eliminating duplicative rules and streamlining regulation.[13] Although (without commenting on the specifics of those proposals) we see such initiative as a positive step forward, we encourage the NASD and NYSE to approach every rule filing between now and the completion of the consolidated rulebook with this goal in mind. It is at best inefficient for the NASD and NYSE to continue to propose (and for the Commission to continue to approve) inconsistent SRO rules knowing that they will have to be revisited as part of the process of consolidating the two rulebooks.

As the NASD and NYSE proceed with their Rule Harmonization Project, the Committee encourages them to look beyond harmonizing their own rules toward global harmonization. Numerous jurisdictions outside the U.S. have adopted research analyst rules, and those rules often differ in important respects from the SRO research analyst rules. Especially for broker-dealers with affiliates providing research in multiple jurisdictions and attempting to ensure a level of consistency for all of their research, these cross-border differences in regulation add to the cost and burden of providing research, without any corresponding investor benefits.[14] For these reasons, we believe the NYSE and NASD should work with the major foreign jurisdictions to attempt to harmonize research analyst rules on a global basis.

[13] *See* NASD Notice to Members 07-12, *Rule Harmonization* (Feb. 2007).

[14] The proposed amendments do not clarify the concept of "globally branded research," see NASD Notice to Members 05-24 (April 2005) or the interplay between the Series 86/87 research analyst registration requirements and the concept of "associated persons" who are eligible for U.S. registration - issues as to which we believe there remains substantial confusion.

III. Quiet Periods

The Committee supports the SROs' proposal to apply a uniform 25-day IPO quiet period for all underwriters and dealers (including managers and co-managers) participating in an IPO offering, as well as the proposal to eliminate the quiet period following secondary offerings. The Committee believes that these changes will benefit investors by increasing the flow of important information, without sacrificing the reliability or integrity of the research.

The Committee has concerns about the other quiet period proposals. As discussed above, the Committee considers uniformity of application of the SRO analyst conflict rules to be of critical importance. In that regard, the Committee generally prefers the NASD's proposal to eliminate the existing quiet period surrounding lock-up waivers and terminations over the NYSE's proposal to reduce that quiet period to five days. The Committee agrees with the NASD's observation that the general requirements of fairness, balance and full disclosure of potential conflicts in research reports are sufficient to prevent abuses with respect to research reports issued in the period surrounding lock-up waivers and terminations, and believes that the lock-up quiet period should be eliminated in favor of not interrupting the flow of important information to investors. In their thorough examinations of broker-dealer compliance with the current rules, the NYSE and NASD did not find significant abuses in connection with lock-up periods. The Committee believes strongly, however, that the elimination of the lock-up quiet period should not be coupled with a new certification requirement, as proposed by the NASD (*i.e.*, the proposal to require a certification that the member firm has a bona fide reason for issuing the report within fifteen days before and after the lock-up waiver/expiration and is not otherwise issued for any reason pertaining to conditioning the market price of the security that is the subject of the report).

The Committee does not believe that an additional certification requirement is necessary to protect against the risk that a report accurately reflecting an analyst's views would nevertheless be timed so as to inappropriately condition the market for a security. Regulation AC already serves to ensure that the views expressed in a research report, whether positive or negative, accurately reflect the analyst's views at the time the report is issued, and the general anti-manipulation and anti-fraud provisions of the securities laws address activities aimed at inappropriately conditioning the market for a security. For these reasons, the imposition of the certification requirement would impose additional burdens on broker-dealers while providing little practical benefit to investors in terms of improving either the reliability of the research report's content or the integrity of the timing of its dissemination.

Moreover, compliance with the lock-up expiration quiet period requirements has proven logistically difficult, requiring that firms develop a complex addendum to the standard lock-up that extends the lock-up period in the event that the company issues an earnings release within the last 16 or 17 days of the lock-up period in order for firms to issue a research report outside of the 15-day pre-termination date quiet period. Such extended lock-ups have sometimes proven to be difficult to enforce with respect to the individual shareholders subject to the lock-up as such shareholders have the ability to sell without the knowledge of the underwriters. Moreover, lock-up waivers may be granted subjectively and tracking the waivers thus cannot be fully automated; accurate tracking depends on intervention by fallible humans. As to lock-up waivers, the burdens of compliance with the rule are excessive and the rule does not serve any significant

investor protection purpose: allowing an individual shareholder to sell a small amount of securities could not possibly impact the public market nor be an incentive for a firm to issue a research report. The NASD's certification requirement would require firms to continue to track the lock-up periods (and thus incur all the costs and potential human errors inherent in the current rules), with no additional investor benefit beyond that already provided by Regulation AC. Some members of the Committee believe the NYSE's five-day lock-up expiration quiet period without a certification requirement would be superior to the NASD's certification requirement (although as discussed above the Committee's consensus favors no lock-up expiration quiet period, with no additional certification beyond Regulation AC).

Finally, the Committee supports the NYSE's proposal to interpret the "significant news" exception to the quiet period restrictions (including the lock-up quiet periods, if such quiet periods are retained in any form) as including a report issued in response to a company's earnings announcements. Earnings announcements constitute important information upon which investors regularly rely and getting the information into the hands of customers in a timely manner is critical. We are not aware of any other circumstances in which earnings announcements would not be considered presumptively "material" for the purposes of federal securities regulation. Indeed, we would argue that the current prohibition on the ability of a research analyst to issue an update to previously-issued research as a result of an earnings release is contrary to the analyst's obligation, as expressed in SEC enforcement actions, to update a stale research report. Even announcements only confirming existing earnings guidance are likely to be material, and investors expect research analysts to be able to comment on earnings guidance (whatever that guidance may be), so that they can have assistance in determining whether it was material. The Committee therefore believes that it is appropriate to include earnings releases within the exception for significant news and developments.

With respect to the exception for significant news and developments, the SROs have advised that any research report issued in response to such an event "must be limited to discussing the effects of the news or event that triggered the exception. However, the report may contain or update a price target, rating or recommendation concerning the subject company's securities."[15] The Committee believes that this restriction, which prohibits the analyst from fully updating some aspects of prior research reports, operates in a manner that is contrary to the research analyst's obligation under Regulation AC to ensure that <u>every</u> research report accurately reflects the analyst's views <u>at that time</u> of that report.

IV. Personal Trading

Both the NASD and NYSE propose amending the personal trading rules to allow broker-dealers to adopt a requirement that research analysts divest themselves of securities they are responsible for covering. Today, a broker-dealer may not be able to impose such a requirement - an analyst is not permitted to divest a holding on which the firm has a "buy" or "hold" rating. The Committee believes this amendment is a positive step and will allow broker-dealers to adopt

[15] NASD Notice to Members 04-18 (March 2004), at 235.

what many firms believe to be a "best practice" that may avoid many conflicts of interest (although we also strongly believe it should be up to firms whether to mandate such divestment).

However, another inconsistency in the proposed amendments is the treatment of research analyst personal trading in investment funds. The NASD is proposing to allow a research analyst and his or her household members to own investment funds investing in securities covered by the analyst in situations where the analyst owns no more than 1% of the assets of the fund, so long as the analyst does not have any investment discretion over the fund. The NYSE, however, has declined to make this amendment and is retaining a 20% asset diversification requirement. *See* 72 Fed. Reg. at 2071. As between the two positions, the Committee believes the NASD's is more sound - we do not believe the NASD's approach offers any significant potential for abuse. The NYSE's proposal is a disincentive for qualified individuals to become research analysts, and tracking which funds are eligible for the NYSE's exception is a compliance burden without corresponding investor benefits.

More generally, the Committee believes the Commission, the NYSE and NASD should revisit the efficacy of the current research analyst personal trading rules, and consider replacing them with a disclosure-based approach. The current rules are highly prescriptive, and some highly qualified former research analysts have cited these rules as a primary reason for moving out of the research area.[16] Some broker-dealers, and some investors, believe that it is affirmatively beneficial for research analysts to "eat their own cooking" and invest in the securities they cover. Moreover, there are many personal circumstances (e.g. buying a home, or children's tuition) which are not unforeseeable but which justify trading contrary to an analyst's recommendation. A web-based disclosure system, in which research analyst disclosed proposed personal trades prior to placing those trades, would adequately apprise investors of potential conflicts of interest while allowing research analysts substantially more flexibility in their investment options. We believe broker-dealers should be given flexibility to adopt their own approaches to research analyst personal trading conflicts of interests, so long as those approaches are adequately disclosed and enforced. In our view, such a step would encourage more and better research without compromising investor protection.

V. Third Party Research

The Committee would also like to take this opportunity to provide certain comments regarding the rule amendments filed by the NYSE and NASD (collectively, the "SROs") on September 27, 2006 (collectively, the "Rule Amendments").[17] These amendments, which were filed for immediate effectiveness pursuant to Section 19(b)(3)(A) of the Exchange Act and Rule 19b-

[16] Another area in which the Committee believes a more principles-based, less prescriptive approach should be examined is the current extremely detailed regulation of when research analysts may communicate with other individuals (such as investment bankers) within the same firm. The current "chaperoning" requirement for such communications is regulatory overkill.

[17] *See* Exch. Act Rel. No. 54,616 (October 17, 2006).

4(f)(1) thereunder, purported to merely codify existing SRO interpretive guidance.[18] However, the Committee believes that at least in one significant area, the Rule Amendments represent a departure from previous guidance that NYSE and NASD members who provide independent third-party research to customers through client commission ("soft dollar") arrangements have relied upon. Accordingly, the Committee believes that at least that portion of the Rule Amendments that depart from such previous guidance should not have been filed for immediate effectiveness, but should rather have been subject to notice and public comment.

Under previous SRO guidance, certain disclosure requirements ordinarily applicable to third-party research distributed by a member[19] did not apply to independent third-party research distributed through a soft dollar arrangement. In a 2002 joint interpretive memorandum regarding the SRO research analyst rules (the "2002 Joint Interpretive Memorandum"),[20] the SROs indicated that:

> In general, the SRO Rules are intended to address conflicts of interest that can arise when a member produces its own research. 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.

This position was reiterated in a second joint interpretive memorandum released by the SROs in 2004 (collectively with the 2002 Joint Memorandum, the "joint interpretive memoranda").[21]

The Rule Amendments "supersede" this guidance and replace the general exemption from the third party research disclosure requirements for independent third-party research distributed through soft dollar arrangements with a narrower exemption. In that regard, the NASD's filing with the SEC provides that:

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[18] The Committee notes that in this regard, the SROs have asserted that, for example, the Rule Amendments merely "reflect interpretations with respect to the meaning, administration, or enforcement of existing SRO rules" and "[do] not deviate from the existing interpretation." *See* letter dated November 29, 2006 from Philip A. Shaikun, NASD Associate Vice President and Associate General Counsel and Mary C. Yeager, NYSE Assistant Corporate Secretary to James A. Brigagliano, Esq., Acting Associate Director, SEC Division of Market Regulation ("Joint Response to Comments") at 7. As illustrated above, however, the Committee believes that at least one aspect of the Rule Amendments constitutes a substantive change and is therefore inappropriate for filing for immediate effectiveness under Section 19(b)(3)(A) and Rule 19b-4(f)(1) thereunder.

[19] Under NASD Rule 2711(h)(13)(A) and NYSE Rule 472(k)(4)(i), members that distribute or make available third-party research must accompany the research with the disclosures 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 (the "Third Party Research Disclosures"), as such disclosures pertain to the member.

[20] *See* NASD Notice to Members 02-39 and NYSE Information Memorandum 02-26 (July 2002).

[21] *See* NASD Notice to Members 04-18 and NYSE Information Memorandum 04-10 (March 2004).

> 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 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).[22]

Accordingly, the Rule Amendments do not merely constitute a stated policy, practice or interpretation with respect to the meaning, administration or enforcement of an existing rule, but rather constitute a substantive change to the SROs' research analyst rules and previous interpretations thereto.[23] Because of this, the Committee believes that at least that portion of the Rule Amendments which effects these changes should not have been filed for immediate effectiveness, but should rather have been subject to notice and public comment. The Committee would therefore like to take this opportunity to provide its comments regarding the Rule Amendments.

The Committee's first comment regarding the substance of the amended rules concerns the structure of amended NASD Rule 2711 and NYSE Rule 472. Specifically, the Committee agrees with the SROs that independent third-party research made available to customers upon request or through a member-maintained website should be exempt from both the Third Party Research Disclosure requirements and the registered principal review and approval requirements. The Committee notes, however, that while the amended NYSE Rule 472 explicitly carves such research out from both of these requirements,[24] the amended NASD Rule 2711 on its face only exempts such materials from the Third Party Research Disclosure requirements.[25] It is apparent that the NASD intended for Rule 2711 to apply this exemption to both these requirements.[26] Because NASD Rule 2711 in its current form does not accurately

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[22] *See* File No. SR-NASD-2006-112.

[23] The Committee believes that recent SRO guidance regarding the Rule Amendments confirms the substantive nature of this change. In this regard, NASD Notice to Members 07-04 specifies that "the rule change does not incorporate language from previous interpretive guidance that exempted independent third-party research provided through a soft dollar arrangement from the third-party research analyst rules. The new rule language treats such soft dollar research the same as any other third-party research." We note that NYSE Information Memorandum 07-11 (January 24, 2007) contains similar language, as the NYSE states therein that "the applicable disclosure and supervisory requirements apply equally to all third-party research distributed by a member organization, including soft dollar arrangements."

[24] *See* NYSE Rule 472(k)(4)(ii).

[25] *See* NASD Rule 2711(h)(13)(A), (h)(13)(B) and (h)(13)(C).

[26] The Committee notes that the SROs asserted in the Joint Response to Comments that "neither the third-party disclosures nor the supervisory review requirements apply unless the research is 'distributed' by a member. In this regard, NASD's rule operates the same as the NYSE rule: if a member does not 'distribute' third-party

convey the NASD's intention, the Committee respectfully submits that NASD Rule 2711 should be amended so as to explicitly apply this exception to both the Third Party Research Disclosure requirements and the registered principal review and approval requirements.

In addition, the Committee would like to address the treatment under the rules of independent third-party research furnished directly to a customer by a third-party research provider pursuant to a soft dollar or client-commission arrangement. Typically, a broker-dealer who enters into a soft dollar or client commission arrangement with an institutional customer does not directly furnish such independent third-party research to the customer. Rather, the third-party research provider sends its research directly to the customer, without the research flowing through the broker-dealer.[27]

The NYSE has indicated that an exception from the Third Party Research Disclosure requirements is available under the amended Rule 472 where independent third party research is furnished directly by the research provider to the customer.[28] The Committee agrees with the NYSE's position that such an exception should apply. While the NASD does not appear to have expressly articulated this position, the SROs have described their respective Rule Amendments as "substantially similar" and rejected suggestions that the SROs' respective versions of the Amended Rules contain inconsistencies.[29] The Committee notes, however, that neither the amended Rule 2711 nor the amended Rule 472 explicitly includes this exception from the Third Party Research Disclosure requirements for third-party research that does not "flow through" the member firm. To promote a clear understanding of the application of Rule 2711 and Rule 472, the Committee believes that both Rule 2711 and Rule 472 should be revised to expressly exclude from the Third Party Research Disclosure requirements all independent third-party research furnished directly to customers by the research provider pursuant to a soft-dollar or client commission arrangement.[30]

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research, then the supervision requirements do not attach." *See* Joint Response to Comments, p. 4, note 7 and accompanying text.

[27] The Commission's recent interpretive release regarding Section 28(e) describes a review process applicable to broker-dealers who make independent third-party research available to customers through soft dollar arrangements. As described by this release, this process entails a review of the *description* of the services to be paid for with client commissions for red flags that indicate the services are not within Section 28(e). *See* Exch. Act Rel. No. 54165, 71 Fed. Reg. 41978, 41994-95 (July 24, 2006). We note that such a review does not rise to the level that would be required for compliance with the principal review and approval requirements under the amended SRO rules.

[28] *See* File No. SR-NYSE-2006-77 at p. 10.

[29] *See, e.g.*, File No. SR-NYSE-2006-77; File No. SR-NASD-2006-112; Joint Response to Comments. *See also* Joint Report by NASD and the NYSE On the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules (December 2005) at p. 4 ("The NASD and NYSE rules and interpretations are virtually identical and are intended to operate uniformly.") This is another example of why it would be beneficial to have the NYSE and NASD adopt exactly the same rule text for its research analyst rules.

[30] For example, NYSE Rule 472(k)(4)(ii) could be amended to provide that, incorporating the Committee's other recommendations described above, "the requirements in paragraph (k)(4)(ii) shall not apply to research reports

The Committee also believes that an exemption from the supervisory review and approval requirements of Rule 472 and Rule 2711 should apply where independent third party research is furnished directly by the research provider to the customer without "flowing through" a member. The Committee notes that the supervisory review and approval requirements of these rules appear to apply only where a member firm "distributes" independent third party research, and not to apply where such research is merely "made available."[31] Nevertheless, to ensure that the applicability of the supervisory review requirements is consistent with that of the Third Party Research Disclosure requirements, the Committee believes that the SRO rules should explicitly provide for an exemption from the review and approval requirements for research furnished directly to a customer by a research provider. The Committee notes that a contrary position would slow the ability of investors to receive time-sensitive research reports, and would impose a substantial compliance burden on broker-dealer firms.

VI. Definition of "Research Report"

The SROs propose to amend the definition of "research report" to exclude written and electronic communications relating to open-end registered investment companies that are not listed or traded on an exchange or public direct participation programs ("DPPs"). The SROs previously codified an interpretation that communications that constitute statutory prospectuses that are filed as part of a registration statement are not considered "research reports," because "prospectuses serve different purposes than research reports."[32] As a result of the proposed amendment and the rule change previously adopted, the SRO rules would, for the first time, contain language that clarifies the position of the SROs that the research analyst rules extend to:

- any private placement memorandum for equity securities; and

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prepared by an independent third party that the member organization makes available to customers either upon request or through a member organization-maintained website, *or that are furnished directly by the independent third party to customers*." NASD Rule 2711(h)(13) could be amended by renumbering current Rule 2711(h)(13)(C) as new Rule 2711(h)(13)(B), amending current Rule 2711(h)(13)(B) to provide that "the requirements of paragraphs (h)(13)(A) *and (h)(13)(B)* shall not apply to research reports prepared by an independent third party that the member makes available to its customers either upon request or through a member-maintained web site, *or that are furnished directly by the independent third party to customers*."

[31] In this regard, NYSE Rule 472(k)(4)(i) applies both the Third Party Research Disclosure and principal review and approval requirements to research reports that a member "*distributes or makes available*." Rule 472(k)(4)(ii) provides an exemption from these requirements for any research reports that the member "*makes available* . . . upon request or through a member organization-maintained website." NASD Rule 2711(h)(13)(A) imposes the Third Party Research Disclosure Requirements on any research report that a member "*distributes or makes available*." Rule 2711(h)(13)(B) provides an exemption from this requirement for any research report that a member "*makes available* . . . upon request or through a member-maintained website." Rule 2711(h)(13)(C) imposes the principal review and approval requirements only upon "any third-party research *distributed* by a member."

[32] Exch. Act Rel. No. 54,616 (October 17, 2006); 71 Fed. Reg. 62331 (October 24, 2006), at 62333.

- sales literature used in connection with public and private offerings of privately placed funds, public and privately-offered closed-end funds, exchange-traded funds ("ETFs") and private and publicly-offered real estate investment trusts ("REITs").

The SROs' apparent theory for this result is that the purpose of a private placement memorandum and sales literature accompanying a public or private securities offering is to "provide information reasonably sufficient upon which to base an investment decision."

The Committee does not believe that either SEC Regulation AC or the SRO research analyst rules should apply to private placement memoranda, nor should either set of rules apply to sales materials for private placements and public offerings of equity securities. Such communications also "serve a different purpose than research reports." In the case of such sales materials, such materials are related to the offering and are used as part of the marketing effort along with a private placement memorandum or SEC registration statement. Such materials are easily distinguished from third-party communications that may be considered "research reports" when they are issued by a non-participating broker-dealer with respect to a public offering, for example, of an ETF or REIT. We note that NASD Rule 2210 has historically excluded offering circulars that are exempt from SEC registration from the NASD's advertising rules. Further, sales literature concerning, for example, SEC-registered REITs, is reviewed by SEC staff in connection with the review of the registration statement. Although REIT sales material is not required to be filed for review under NASD Rule 2210, in practice such materials are generally filed because many broker-dealers will not use such sales literature unless it has been reviewed by NASD staff under Rule 2210. As a practical matter, the research analyst registration requirements, the separation of research analysts from banking, the research disclosure requirements, and other provisions of the SRO research analyst rules (as well as compliance with SEC Regulation AC) would be extremely difficult and problematic if applied to those associated persons of broker-dealers who may participate in the preparation of a private placement memoranda and sales literature. For the foregoing reasons, the Committee recommends that the SROs, instead, clarify that the research analyst rules do not apply to any offering document or sales material related to an offering of securities, when that sales material is distributed by a broker-dealer participating in the offering of securities.

VII. Conclusion

Securities industry research continues to be vitally important to investors and serves a critical role in the effective functioning of the U.S. securities markets. Generally we believe the proposed NYSE and NASD research analyst rule amendments will make a positive contribution to the provision of high-quality research. The Committee believes the Commission and the SROs should consider a broader disclosure approach to the research analyst rules, rather than micro-management of broker-dealer internal procedures. We believe such a change can limit the burden and expense of research analyst regulation, and thus encourage more and better research, in a way that will benefit both small public companies and the individuals who invest in those companies. Such an approach would be consistent with the statutory mandate that the Commission, when evaluating SRO rules, consider efficiency and capital formation along with

investor protection. The Committee appreciates the opportunity to submit comments on this important initiative. Members of the Committee are available to meet and discuss these matters with the Commission and its staff and to respond to any questions.

Respectfully submitted,

/s/ Keith F. Higgins

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