

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-57279; File No. SR-FINRA-2007-011)

February 6, 2008

Self-Regulatory Organizations: Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of Proposed Rule Change as Modified by Amendment No. 1 to Amend NASD Rule 2711 (Research Analysts and Research Reports) and NYSE Rule 472 (Communications With The Public) Regarding a Member's Disclosure and Supervisory Review Obligations When it Distributes or Makes Available Third-Party Research Reports

I. Introduction

On September 12, 2007, the Financial Industry Regulatory Authority, Inc. ("FINRA") filed with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder.² Notice of the proposal was published for comment in the Federal Register on September 26, 2007.³ The Commission received five comment letters to the proposed rule change.⁴ On January 16, 2008, FINRA filed Amendment No. 1 to the proposed rule change to make certain modifications to the original rule filing. This order provides notice of the proposed rule

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 56480 (September 20, 2007), 72 FR 54698 (September 26, 2007).

⁴ See letters to Nancy M. Morris, Secretary, Commission, from Morris N. Simkin, Esq., Katten Muchin Rosenman LLP ("Katten"), dated October 12, 2007; Stephen R. Biggar, Global Director of Equity Research, Standard & Poor's Equity Research Services ("S&P"), dated October 16, 2007; Jill Ostergaard and Christopher J. Mahon, Co-Chairs, Self Regulation and Supervisory Practices Committee, Securities Industry and Financial Markets Association ("SIFMA"), dated October 17, 2007; Stephanie R. Nicholas, WilmerHale ("WilmerHale"), dated October 19, 2007; and William D. Lyons and Arkadiy Neyman, Westminster Securities Corporation ("Westminster") dated January 30, 2008.

change, as modified by Amendment No. 1, and approves the proposed rule change as amended on an accelerated basis.

II. Description

On September 12, 2007, FINRA filed with the Commission a proposed rule change to amend NASD Rule 2711 (“Research Analysts and Research Reports”) and NYSE Rule 472 (“Communications With The Public”) regarding a member’s disclosure and supervisory review obligations when it distributes or makes available third-party research reports.⁵ The Commission received four comment letters to the proposed rule change during the comment period.⁶ FINRA responded to those comments in a letter dated January 16, 2008.⁷ In accordance with that response to comments, FINRA amended the proposed rule change. The Commission then received a fifth comment letter on January 30, 2008.⁸

A. Current Rules

NASD Rule 2711(h)(13) and NYSE Rule 472(k)(4) set forth a member’s disclosure and supervisory review obligations when the member distributes – i.e., “pushes out” – or makes available a research report produced by a third party. A member that distributes a third-party research report must accompany the report with certain

⁵ See supra note 3.

⁶ Katten, S&P, SIFMA, and WilmerHale.

⁷ The comments and responses thereto are discussed in greater detail in FINRA’s Response to Comments. See letter from Philip Shaikun to Nancy M. Morris dated January 16, 2008.

⁸ Westminster. FINRA had already produced a response to comments dated January 16, 2008 by the time that the Commission received this letter. Per discussion with FINRA, FINRA does not believe that this letter changes its analysis.

current applicable disclosures (“third-party disclosures”), as they pertain to the member. The third-party disclosure requirements do not apply if a member makes available to its customers non-affiliate research either upon request or through a member-maintained web site.

NASD Rule 2711(h)(13) further requires that a registered principal (or supervisory analyst approved pursuant to Rule 344 of the New York Stock Exchange) review and approve by signature or initial any third-party research distributed by a member. Consistent with NASD Rule 2210(d)(1)(B), the member must review such research to ensure that the applicable disclosures discussed above are complete and accurate (“disclosure review”) and the content of the research reports contains no untrue statement of material fact or is otherwise not false or misleading (“content review”). Similarly, NYSE Rule 472(k)(4) requires a supervisory analyst approved pursuant to New York Stock Exchange Rule 344 to approve by signature or initial any third-party research distributed by a member organization. Additionally, NYSE Rule 472(k)(4) requires a supervisory analyst or qualified person, designated pursuant to NYSE Rule 342(b)(1), to conduct the same disclosure and content review as NASD Rule 2711(h)(13).

FINRA has interpreted that content review requirement to mean that a member’s supervisory obligation for review of third-party research extends to any untrue statement of material fact or any false or misleading information that (1) should be known from a reading of the report or (2) is known based on information otherwise possessed by the member.⁹ No supervisory review is required under either rule when a member makes

⁹ See Notice to Members 07-04. NYSE Information Memo 07-11, which has been incorporated by FINRA, sets out the same standard for NYSE Rule 472(k)(4).

available non-affiliate research either upon request or through a member-maintained web site.

B. Amended Proposal

The proposed rule change would define a “third-party research report” for the purposes of the rules as a research report that is produced by a person or entity other than a member. The proposal further would create the subcategory of “independent third-party research” and eliminate the content review requirement when a member distributes or makes available such research. The proposal, as amended, would define “independent third-party research” for the purposes of the rules to mean a third-party research report, in respect of which the person or entity producing the report: (1) has no affiliation or business or contractual relationship with the distributing member or that member’s affiliates that is reasonably likely to inform the content of its research reports; and (2) makes content determinations without any input from the distributing member or that member’s affiliates.

The proposed rule change would create an exception from the disclosure review requirement for independent-third party research reports made available by a member either (1) upon request, (2) through a member-maintained web site, or (3) where such report is made available by a member to a customer in connection with a solicited order in which the registered representative has informed the customer, during the course of the solicitation, of the availability of independent research on the solicited equity security and the customer requests such independent research.

The proposed rule change would require that current applicable third-party disclosures accompany any third-party research report that does not meet the definition of

“independent third-party research report,” irrespective of whether it is distributed or made available upon request, on a member-maintained web site or in connection with a solicitation, as described above. However, the proposed rule change would amend NASD Rule 2711(h)(13) and NYSE 472(k)(4) to allow a member to direct a customer to a web address where such applicable third-party disclosures could be found. As amended, the proposal would allow members to meet the disclosure review requirement for non-independent or pushed out independent third-party research if the member establishes written supervisory policies and procedures reasonably designed to ensure the completeness and accuracy of all applicable disclosures.

FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be the date of publication of the Regulatory Notice announcing Commission approval.

III. Comment Letters

The Commission received five comment letters to the proposed rule change.¹⁰ The commenters generally expressed support for the proposal,¹¹ but requested that FINRA consider certain modifications to it. As originally proposed, this rule change would define “independent third-party research” to mean a research report, in respect of which the person or entity producing the report: (1) has no affiliation or business or contractual relationship with the distributing member or that member’s affiliates that is reasonably likely to inform the content of its research reports; and (2) makes both

¹⁰ See supra note 4.

¹¹ Westminster did not specifically express general support for the proposal and suggested changes. See infra.

coverage and content determinations without any input from the distributing member or that member's affiliates.

One commenter¹² asserted that the prohibition on input into coverage determinations could significantly diminish a firm's ability to rely on the exception. The commenter noted that firms typically request coverage from independent research providers of particular sectors or market capitalization companies to supplement their own research or offer a second opinion of companies they cover. The commenter argued that a distributing firm's inability to control the content of a research report should suffice to establish independence and therefore the second prong of the definition is superfluous and should be eliminated.

FINRA agreed that input into coverage decisions does not necessarily compromise the independence of a third-party research report and thus amended the original proposed rule change to delete the prohibition on coverage determinations in Amendment No. 1. However, FINRA believed the remainder of the second prong of the definition (the requirement that the member have no input on the content of the report) went beyond the prohibition of a contractual or affiliate relationship prohibited by the first prong and therefore should remain. Therefore, FINRA will construe the amended second prong to mean that a distributing firm cannot have any input into the outcome of the research report. Thus, input into coverage determinations would be permissible, so long as the agreement to cover a company or sector does not carry with it an implicit understanding as to any particular conclusions or recommendations of the resultant research reports.

¹² WilmerHale.

FINRA also received comments regarding the proposed disclosure review requirement. NASD and NYSE rules currently require a member that distributes any third-party research report to accompany the report with certain current applicable disclosures as they pertain to the member. These rules further require that a registered principal or supervisory analyst review and approve by signature or initial any third-party research distributed by a member. That review must ensure that the applicable disclosures are complete and accurate. No disclosures or review is required when the third-party research report is made available upon request or through a member-maintained web site.

The rule change, as originally proposed, would maintain the disclosure review requirements when a member distributes independent third-party research reports, but would expand the exception to the requirement where independent third-party research is made available by a member to a customer in connection with a solicited order in which the registered representative has informed the customer, during the course of the solicitation, of the availability of such research and the customer requests it. The disclosure review requirement would still pertain where a member “pushes out” independent third-party research.

One commenter¹³ suggested that the disclosure review requirement be more principles-based, such that firms can discharge their obligations with policies and procedures reasonably designed to ensure that the disclosures are complete and accurate. The commenter asserted that many firms have systems to populate the disclosures, where applicable, and that those disclosures are updated frequently through automated processes

¹³ SIFMA.

that derive their information from areas outside of the research department. The commenter further noted that many firms distribute thousands of third-party research reports, making it difficult or impractical to review and approve each one.

In view of the volume of third-party research reports distributed by many firms, FINRA agreed that the disclosure review requirement should be satisfied with written supervisory policies and procedures reasonably designed to ensure the completeness and accuracy of all applicable disclosures and amended its proposal accordingly in Amendment No. 1.

One commenter¹⁴ wanted clarification that the disclosure review requirement does not apply where no disclosures are required, such as when independent third-party research is made available to a customer upon their request. FINRA agreed that no disclosure review is required under such circumstances but noted that members must have policies and procedures in place to verify that disclosures are not required in the first instance.

One commenter¹⁵ suggested that FINRA create an exception from the disclosure requirements altogether for independent third-party research that is distributed to institutional investors. FINRA responded that it is considering providing exceptions for the application of certain of the rules under its jurisdiction for institutional investors in its efforts in developing a single consolidated NASD and NYSE rulebook.

¹⁴ S&P.

¹⁵ Katten.

One commenter¹⁶ suggested that the proposal be amended to “include language that reflects the fact that a principal or supervisory analyst assigned by a member firm to carry out the review of third party research may not be aware of all information his or her member firm employer possesses regarding a specific company, industry, etc.” The commenter also requested that the rule text be amended to “refer to such reviews being performed based on information that can reasonably be expected to be in the possession of the reviewer (rather than the corporate knowledge of the reviewer’s entire firm).” Per discussion with FINRA, this comment did not change their analysis.

IV. Discussion

The Commission has carefully reviewed the proposed rule change and finds that it is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.¹⁷ In particular, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Act,¹⁸ which requires, among other things, that FINRA rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The Commission believes that the proposed rule change will promote the availability of independent third party research reports, thereby resulting in more fully informed decisions by investors.

¹⁶ Westminster.

¹⁷ In approving the proposed rule change, the Commission considered the proposal’s impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹⁸ 15 U.S.C. 78o-3(b)(6).

The Commission also finds good cause to approve Amendment No. 1 to the proposed rule change prior to the thirtieth day after the date of publication of notice of filing of the amendment in the Federal Register. The proposed rule change was published in the Federal Register on September 26, 2007.¹⁹ FINRA submitted Amendment No. 1 in response to the four comments received on the proposed rule change prior to FINRA's response to those comments.²⁰ The Commission believes that Amendment No. 1 simplifies the obligations of FINRA member firms but not at the expense of investor protection. Amendment No. 1 does not contain major modifications that are more restrictive than the scope of the proposed rule change as published in the Federal Register. The Commission believes that approving Amendment No. 1 will simplify compliance and is consistent with the public interest and the investor protection goals of the Act. Finally, the Commission finds that it is in the public interest to approve the proposed rule change as soon as possible to expedite its implementation.

Accordingly, the Commission believes good cause exists, consistent with Sections 15A(b)(6) and 19(b) of the Act,²¹ to approve Amendment No. 1 to the proposed rule change on an accelerated basis.

V. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule changes are consistent with the Act. Comments may be submitted by any of the following methods:

¹⁹ See supra note 3.

²⁰ As discussed above, FINRA believes that no change is necessary based on the fifth comment (Westminster) because that comment did not change their analysis.

²¹ 15 U.S.C. 78o-3(b)(6), and 78s(b).

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2007-011 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2007-011. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You

should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2007-011 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VI. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act and in particular Section 15A of the Act and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²² that the proposed rule change (File No. SR-FINRA-2007-011), as modified by Amendment No. 1, be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²³

Florence E. Harmon
Deputy Secretary

²² 15 U.S.C. 78s(b)(2).

²³ 17 CFR 200.30-3(a)(12).