



Securities Industry Association

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Philip Shaikun
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Dear Messrs. Van Weezel and Shaikun:

Over the past four years, the issue of research analyst objectivity has been the subject of vigorous rulemaking, in the form of National Association of Securities Dealers (“NASD”) Rule 2711 and New York Stock Exchange (“NYSE”) Rule 472, as well as the Securities and Exchange Commission’s (“SEC”) Regulation AC. These rules broke much new ground. The Securities Industry Association¹ (“SIA”), while seeking to offer constructive criticism of some aspects of the new rules in the notice and comment process, acknowledged and supported the need for regulatory action in this area. We

¹ The Securities Industry Association brings together the shared interests of approximately 600 securities firms to accomplish common goals. SIA’s primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated \$236.7 billion in domestic revenue and an estimated \$340 billion in global revenues. (More information about SIA is available at: www.sia.com.)

believe that these regulatory actions were, on the whole, necessary and salutary, and that investor confidence in the quality of “sell-side” research has improved as a result.²

As regulatory experience has accumulated in this area, it may now be appropriate to try to identify aspects of the new rules that require fine-tuning to address requirements that are ineffective, unduly vague or burdensome. This can be done through further interpretive guidance in some instances, or by revising the structure and scope of rules in some other instances. The Research Subcommittee of SIA’s Federal Regulation Committee has identified several areas where we would like to suggest some topics for regulatory refinement of the rules concerning research analysts. Specifically, as discussed below, we recommend that the self-regulatory organizations (“SROs”) consider dropping the requirement that analysts take the Series 7 examination in light of the successful implementation of the new Series 86 and 87 examinations specifically tailored for research analysts and research supervisors. We also request that the SROs consider modifications to their requirements concerning blackout periods. Finally, we have also identified several issues where interpretive guidance would be helpful with regard to recently adopted amendments to the research rules.

Discussion.

A. Analyst Qualification exams.

In light of the successful adoption of the Series 86 and 87 examinations, it no longer is necessary or desirable to require analysts to continue to take the Series 7 examination. The Series 7 examination covers many subjects that are not germane to an analyst’s job. Prior to adoption of the Series 86/87 examinations, this was the “default” test that analysts took in the absence of any examination that was specifically tailored to analysts’ duties. However, the Series 7 is designed to measure the critical functions of a registered representative rather than a research analyst. For example, the Series 7 examination tests the applicant’s knowledge of the following seven functions, most of which have little bearing on the role of analysts:

² See, e.g., “Stock Research Gets More Reliable,” Wall Street Journal, June 7, 2005, at D-1.

1. seeking business for the broker-dealer through customers and potential customers;
2. evaluating customers' financial needs and objectives;
3. providing current and prospective customers with information on investments and making suitable recommendations;
4. opening, transferring and closing customer accounts and maintaining appropriate account records;
5. explaining the organization, participants and functions of various securities markets and the principal factors that affect them;
6. obtaining and verifying customers' purchase and sale instructions, entering orders and following up on completion of transactions; and
7. monitoring customers' portfolio and making recommendations consistent with changes in economic and financial conditions as well as customer's needs and objectives.

With the exception of material relating to principal factors affecting securities markets and prices (e.g. the business cycle and principal economic theories) – which are already more intensively covered in the Series 86/87 – the material relating to functions (4), (5) and (6) of a Series 7 are not relevant to functions that are carried out by a Series 86/87. While some portion of the Series 7 functions (1), (2), (3) and (7) is germane to the activities of a Series 86/87, these elements are a small part of the Series 7 exam. These elements could be easily incorporated into future Series 86/87 examinations, eliminating any need for analyst to take both the Series 86/87 and the Series 7. This proposed change would streamline the registration process for research analysts, saving time and expense for the industry, without in any way weakening appropriate registration requirements. Therefore, SIA recommends that the SROs add to the series 86/87 examinations those elements of the Series 7 examination that are relevant to the analysts' functions and then drop the Series 7 examination requirement for analysts.

B. *Blackout Restrictions.*

Experience has shown that, at a minimum, reconsideration of the blackout restrictions of NASD Rule 2711(f)(1) to (4) and NYSE Rule 472(f)(1) to (4) may be appropriate. Since the effect of blackout restrictions is, by definition, to limit the amount of information available to investors, we believe that they should be applied cautiously, and that regulators should periodically reassess their continued utility.³

The SEC's recently-adopted changes to the securities offering process includes provisions for substantial expansion of Rule 139 to permit a much broader range of research concerning Form S-3 or F-3 eligible issuers. In connection with these changes, it might be appropriate for the SROs to broadly re-examine the scope of the rule against publishing during blackout periods. With regard to the restrictions on publishing research within 15 days prior to or following expiration, waiver or termination of a lock-up or similar agreement, there has never been a substantial public record to support of abuse to warrant imposing blackout restrictions around "research booster shots."⁴ We believe that experience has shown the success of the SEC's Regulation AC, which was newly adopted at the time the NASD and NYSE proposed this ban. Regulation AC should be sufficient to address any concerns in this area, without reducing the amount of available information.

If the SROs are disinclined to conduct a full-scale review at this time, we have suggestions for more limited modifications. One specific difficulty that our members

³ We have noted previously that restrictions on publication of research following offerings should be applied with caution, since such restrictions "will operate to the potential disadvantage of retail investors. Institutional investors will still have other means, such as through foreign broker-dealers involved in the offering or buy-side research, to obtain current research on the subject company. . . . This will exacerbate any perceived or actual advantage of institutional investors in obtaining information about a company." Letter to Jonathan G. Katz from Stuart J. Kaswell, April 11, 2002, at 22, available at http://www.sia.com/2002_comment_letters/other/final_letter.pdf. This concern is as valid today as it was three years ago.

⁴ The release proposing the ban on research around lock-up expirations was silent on any actual instances of abuse in this area. The most that was said by way of a factual basis for the proposal was this statement by the NYSE: "This provision is intended to address situations where research analysts *may* issue positive research reports or reiterated 'buy' recommendations shortly before or just after the expiration of a lock-up agreement. Through issuance or reiteration of 'buy' recommendations, shareholders of the subject company which were precluded from selling shares in the immediate aftermarket for specified periods of time, *may* be able to shell their shares at higher prices." 68 Fed. Register 826, at 833-34 (January 7, 2003) (emphasis added).

have encountered with the current SRO blackout restrictions occurs if, during the blackout period, analyst wants to downgrade an issuer's securities but there is no new release of public material information to justify it. In this circumstance, the analyst can only pull his or her recommendation, but cannot explain to readers the reasons for this action. This result is undesirable from a policy perspective – it suppresses analysts' actual views, and creates distortions in available information since the issuer dominates control of information about itself while the syndicate is silenced. Therefore, it would be helpful if the SROs could change their guidance to allow analysts to publish if their view of the company has become more negative since the last published report, regardless of whether there is any material news about the company or the market that would justify a downgrade.

Another area of difficulty concerns existing guidance that generally excludes earnings announcements from the exception under the rules from quiet periods and blackout periods for significant news or significant events. The SROs stated in their March, 2004 Joint Guidance that “news or events that have a material impact on, or cause a material change to, a company's operations, earnings or financial condition, and that generally would trigger the filing requirements of SEC Form 8-K” would fall within the exception. However, the Guidance goes on to say that the SROs “would not regard an announcement about earnings to fall within the exception because an earnings announcement itself generally is not a causal event or news item that materially affects a company's operations, earnings or financial condition.”⁵

This statement is at odds with the SEC's view of the materiality of earnings announcements. At about the same time that this Joint Guidance was issued, the SEC issued new rules concerning items that are reportable under Form 8-K, with the intention of substantially expanding reportable events “by increasing the number of unquestionably or presumptively material events that must be disclosed currently” so as to “provide

⁵ NASD Notice to Members 04-18 (March 2004), at 234-35.

investors with better and more timely disclosure of important corporate events.”⁶ The SEC continues to take an expansive view toward 8-K disclosure in general, and earnings guidance in particular as a category of information that is effectively *per se* material.⁷ The statement in the Joint Guidance that “an earnings announcement itself generally is not a causal event or news item that materially affects a company’s operations, earnings or financial condition” seems squarely contrary to the SEC’s expansive view of the materiality of earnings announcements, and we request that the SROs remove this restriction in their guidance.

C. Interpretive Conflicts With the Global Settlement. In addition to the suggestions above, we have identified other issues where further clarification through interpretive guidance would be very helpful, either to resolve inconsistencies between the NASD’s and NYSE’s respective rules, or to address situations where one or both of those rules appears to set requirements that are inconsistent with, and more stringent than, the terms of the Global Research Settlement entered into by the SROs, the SEC and state regulators with a number of major broker-dealers.⁸ We have identified several such issues in recently adopted NYSE and NASD rule changes restricting communications between Research and these groups.

1. Communications with internal personnel. Section I 10.d. of the Global Settlement permits communications between Research and Equity Capital Markets (“ECM”) so that Research can communicate its views, or those of customers, to ECM regarding the pricing and structuring of a proposed transaction. NYSE Rule 472(b)(6)(iii) and NASD Rule 2711(c)(7) bar any communication between a research analyst and any “internal

⁶ 69 Fed. Register 15594, at 15595 (March 16, 2004).

⁷ Item 2.02 under Form 8-K provides for mandatory 8-K disclosure of public information regarding public announcements or releases of material nonpublic information regarding a company’s results of operations or financial condition. Regarding the SEC’s view that earnings announcements are presumptively material, see, e.g., *SEC v. Flowserve Corporation*, Litig. Rel. 19154 (March 24, 2005) (available at www.sec.gov/litigation/litreleases/lr19154.htm), in which the SEC charged a Flowserve official with a violation of Regulation FD in connection with the official’s reaffirmation of previously announced earnings guidance.

⁸ The terms of the settlement are available at <http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf>.

personnel” unless the communication is “fair, balanced and not misleading, taking into consideration the overall context in which the communication is made.” On its face, with regard to Research-ECM communications this appears to be more restrictive than the Global Settlement. More significantly, this restriction impedes the role of research analysts in the due diligence process. In order to assist due diligence on potential transactions, research analysts must communicate with investment banking and ECM personnel, as well as with internal commitment committees and other internal risk management committees. We believe that public policy should not create unnecessary obstacles to research analysts performing this function in as effective and candid a manner as possible. The “fair and balanced” requirement creates uncertainty regarding analysts’ role in the due diligence process, and therefore deters analysts from participating fully in that process.

The NASD’s discussion of the rule when it was proposed gave some recognition to the need for flexibility for due diligence, stating that “the proposed rule change preserves the ability of the research analyst to give candid assessment of a transaction or sale of securities – including investment risks – in settings where the influences of investment banking and client pressure are minimized.”⁹ It would be helpful if the NASD and NYSE could state that, consistent with the Global Settlement, communications with ECM regarding pricing and structuring of a proposed transaction is one such “setting.” More importantly, since due diligence generally is a “setting” where such risks are minimized, and communications between research analysts and other personnel involved in the due diligence process serve both valid business objectives and the interests of investor protection, it would be helpful if the SROs’ guidance could give greater flexibility for analysts to participate in the due diligence process without having to consider whether their candid statements to other internal personnel involved in due diligence meet the “fair and balanced” requirement. Alternatively, the SROs could reconsider the need to restrict communications between research analysts and internal personnel other than sales personnel.

⁹ NASD Notice To Members 05-34 at 2 (May 3, 2005).

2. Communications with customers. While I 10d. (iii) 2) and I 11.c.2) of the Global Settlement require only that oral communications with a group of 10 or more investors regarding a transaction must comply with the “fair and balanced” standard, the SRO “fair and balanced” rules apply to *any* oral communication between Research and current or prospective customers, “taking into consideration the overall context in which the communication is made.”

In light of the standard set in the Global Settlement, it would be helpful if the SROs could give explicit guidance that the size of the group of investors is relevant to whether the “fair and balanced” requirement has been met, and specifically that an oral communication by Research to a group of fewer than 10 investors is presumptively fair and balanced if it has a reasonable basis.

3. Attendance at Road Shows. The SEC has given interpretive guidance under the Global Settlement that research analysts can passively listen from a remote location to a road show or investor presentation made by Investment Banking.¹⁰ The SROs should clarify that their rules likewise permit this.

Conclusion.

Thank you for considering these suggested modifications and clarifications to NYSE Rule 472 and NASD Rule 2711. If you have any questions about the suggestions in this letter, please do not hesitate to contact me at 202-216-2000, or gkramer@sia.com.

Sincerely,

George R. Kramer

¹⁰ Letter to Dana G. Fleischman from James A. Brigagliano, November 2, 2004, at 3 (available at <http://www.sec.gov/divisions/marketreg/mr-noaction/grs110204.htm>).

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