



Securities Industry Association

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August 22, 2001

Barbara Z. Sweeney, Secretary,
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, NW
Washington, D.C. 20006-1500

Re: Proposed Amendment to Rule 2210, NTM 01-45

Dear Ms. Sweeney:

The Federal Regulation Committee and the Legal and Compliance Division of the Securities Industry Association (“SIA”)¹ are pleased to submit this response to NASD-Regulation Inc.’s (“NASD-Regulation”) proposed amendment to Rule 2210, as set out in Notice to Members 01-45. SIA supports enhanced disclosure to investors of information relating to potential conflicts of interest that securities analysts may face. As part of SIA’s commitment to strengthening public confidence in the securities industry, SIA recently issued recommended best practices for research analysts. SIA commends NASD-Regulation for addressing these issues. We also commend Congressman Richard Baker, chairman of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Entities of the House Committee on Financial Services, for his leadership in seeking improvements in this area, as well as the SEC for its report, “Analyzing Analyst

¹ The Securities Industry Association brings together the shared interests of nearly 700 securities firms to accomplish common goals. SIA member-firms (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. The U.S. securities industry manages the accounts of nearly 80 million investors directly and indirectly through corporate, thrift, and pension plans. In the year 2000, the industry generated \$314 billion of revenue directly in the U.S. economy and an additional \$110 billion overseas. Securities firms employ approximately 770,000 individuals in the U.S. (More information about SIA is available on its home page: <http://www.sia.com>.)



Recommendations,”² which as discussed below provides an important perspective on this issue.

As discussed below, we think that, with respect to disclosure, the proposed amendment could be extended in some respects to better accomplish NASD-Regulation’s policy objectives. We also believe that some aspects of the proposals should be adjusted to avoid unnecessary problems. We are concerned that without some refinements, some of the proposals might exacerbate potential conflicts rather than remediate them, or might lead to customer confusion rather than awareness. With the changes that we suggest, we think that NASD-Regulation’s proposal will stand a better chance of strengthening public trust and confidence in the quality of securities research.

Executive Summary.

SIA recommends enhancing the rule by

- ❖ Extending the disclosure of analyst holdings in some respects (*see* pages 5-6 below);
- ❖ Broadening the disclosure of 13D holdings by the analyst’s firm to include such holdings by parent company and other broker-dealer affiliates of the firm if these positions are reported to the SEC on a consolidated basis (*see* page 7 below);
- ❖ Adding to the proposal a requirement comparable to the provision of New York Stock Exchange (“NYSE”) Rule 472 that a supervisory analyst approve research reports in advance (*see* page 21 below).

SIA also has concerns that over-regulation in this area may have significant unintended consequences. Accordingly, we believe that the existing rule should not be revised in ways that could either undermine its purpose of conveying meaningful information to investors, conflict with the SEC mandatory disclosure regime, or increase

² Available at <http://www.sec.gov/investor/pubs/analysts.htm>.



the potential for conflicts of interest affecting research reports. In this vein, we have the following suggestions, among others:

- ❖ Most importantly, ensure that the amendment relies on position reporting under SEC Rule 13D, so that it does not work at cross-purposes with the disclosure system set out by Sections 13(d) and (g) of the Securities Exchange Act of 1934 (“Exchange Act”)(see pages 9-11 below);
- ❖ Clarify that disclosures of 13D or 13G positions are to be based on the reporting time periods provided for 13D or 13G filings (see page 8 below);
- ❖ Define the term “investment banking services” to include acting (i) as an underwriter in a publicly filed or announced registered or exempt offering for the issuer, or (ii) a financial adviser in a publicly-announced merger or acquisition (see page 12 below);
- ❖ Weigh carefully the possibility that investors might find disclosure of compensation for investment banking services inherently misleading in some circumstances (see pages 11-12 below);
- ❖ Do not require disclosure of the specific nature of investment banking services (see pages 14-15 below);
- ❖ Revise the proposal for disclosures in public appearances to limit it to disclosing if the analyst has a personal financial interest in the issuer being recommended and a generic disclosure that the member firm may have a proprietary interest or investment banking relationship with the recommended issuer (see page 16 below);
- ❖ Craft a definition of the term “research reports” to which the amendment would apply. Among other things, this would avoid the possibility that the amendments would inappropriately apply to areas where concerns about potential conflicts are irrelevant, such as quantitative analyses or market commentary (see page 19 below); and
- ❖ Create a limited exemption for First Call notes and similar updates to research reports (see page 21 below).

Overview.

Any doubts cast on the integrity of any aspect of our business concern us greatly.



In response, SIA recently adopted its *Best Practices for Research*, which are intended to strengthen analyst integrity and independence. Among other things, our *Best Practices* state that firms should have written statements affirming a commitment to the integrity of research, and should execute that commitment by ensuring that:

- Research does not report to investment banking;
- Recommendations should be transparent and consistent;
- Management should support use of the full ratings system;
- Analysts should not submit research to investment banking or corporate management for approval of recommendations;
- Analysts' pay should not be directly linked to specific investment banking transactions;
- Disclosures should be legible, straightforward, and written in plain English; and
- Personal trading should be disclosed whenever relevant and should be consistent with investment recommendations.

A complete copy of our *Best Practices* is available on our web site at www.sia.com.

It is important to point out that a considerable amount of misunderstanding and confusion has seeped into the debate over this issue. The SEC took a very constructive step in addressing the issue of analyst conflicts of interest when it issued an investor alert titled "Analyzing Analyst Recommendations." That report notes an important point about the role of analysts that is often overlooked in the discussion about analyst conflicts: "Remember that analysts generally do not function as your financial adviser when they make recommendations – they're not providing individually tailored investment advice, and they're not taking your personal circumstances into consideration."³ Because of this, the SEC correctly emphasizes that investors need to do

³ <http://www.sec.gov/investor/pubs/analysts.htm>, at 4.



their own homework before investing, rather than rely solely on the recommendation of a single analyst. SIA agrees with this advice. No disclosure requirement or other regulatory action regarding research reports or analysts is any substitute for investors taking steps to educate themselves about their investment choices in light of their own financial circumstances and goals.

The breadth of activities conducted by large full-service broker-dealers is such that, while potential conflicts of interest may exist, these conflicts can be managed without compromising analyst integrity. Good internal procedures that maintain information barriers and support the integrity of research and research analysts can minimize or eliminate the risk that research will be influenced by a broker-dealer's other activities or outside influences. Nevertheless, we agree that potential conflicts of interest exist and that enhanced disclosure of them might strengthen public confidence in the securities industry. In our comments below we offer a number of suggestions for strengthening NASD-Regulation's proposed rule amendment, as well as clarifying its meaning and practical application. If NASD-Regulation adopts our comments, the resulting amended rule will create in many respects a more stringent disclosure obligation for "sell-side" analysts and their firms than currently exists with regard to "buy-side" firm or firms that specialize exclusively in securities analysis.⁴

Discussion.

I. Disclosure of Analyst's Financial Interest.

Summary: SIA supports the proposal to require disclosure of any financial interest held by analysts in a security of the recommended issuer. We do not believe that analysts should have to disclose the nature of such interests, other than whether they have a long

⁴ For example, the Code of Ethics on Personal Investing of the Investment Company Institute does not require a portfolio manager to disclose his or her financial interest when recommending a security in a public appearance. See http://www.ici.org/pdf/personal_investing.pdf. The NASD



or short interest. We have some suggestions for extending the required disclosure.

Disclosure of Other Related Interests. We believe that the proposal should extend to holdings by members of the analyst's household, or holdings in which the analyst has direct or indirect control over investment decisions.

Clarify Personnel Subject to Proposal. The proposal is vague about who is subject to mandatory disclosure. We believe that it should apply solely to the analyst preparing the report and other professionals on his or her team who play a substantive role in preparing the report.

Broad-Based Collective Investment Vehicles. As written, the proposal does not distinguish between direct financial interests and indirect interests, such as holding an interest in a company through a broad-based collective investment vehicle, such as a mutual fund, unit investment trust, or blind trust. SIA believes that interests held through a vehicle that invests in a range of instruments, and over which the analyst has no trading authority, should be excluded from the requirement. It would be all but impossible for a firm to monitor employee positions in companies held through such vehicles, and disclosure of such secondary interests would not be meaningful to anyone. Such vehicles do not permit the analyst to formulate any investment decisions. They also report positions on a delayed basis, which would make it extremely difficult or impossible for the analyst or member firm to track whether a particular collective investment vehicle has a position in a recommended issuer at the time the report is published.

II. Membership Holdings.

Summary. SIA supports the proposal to require that the report indicate if the analyst's firm owns five per cent or more of the recommended issuer's equity securities, but

amendment, with our support, would require disclosure of personal financial interests whenever a recommendation is made, including in public appearances.



believes such disclosure should be limited to the firm's positions in voting equity as reported in Form 13D, and possibly to some positions reported on Form 13G. However, we believe that the proposal should be broadened to include disclosure of filings by the firm's parent or other broker-dealer affiliates, if the member firm and its broker-dealer affiliates report their positions on a consolidated basis. We have some suggested clarifications to the proposal to avoid confusion and to allow member firms to rely on current reporting procedures. In response to a question posed in the proposing release, we think that setting a lower threshold for disclosure requirements than 13D or 13G filings would result in very confusing disclosures and would be inconsistent with the purpose of the Rule 13D reporting system.

a. Suggested Improvements Regarding Member Holdings.

Broaden to Include 13D Filings by Broker-Dealer Affiliates. Member firms should be required to disclose their 13D positions on the same basis as they do with the SEC. The proposal is too narrow in the sense that it does not give the member firm the flexibility to include positions taken by other broker-dealer affiliates in situations where the parent or an affiliate files on a consolidated basis reflecting the positions of some or all broker-dealer affiliates. Reports under Rule 13D are filed at the holding company level for many broker-dealers. This information would not be picked up in the proposal as written. If the broker-dealer and its affiliates have information barriers between themselves, so that the broker-dealer and other affiliates make their own position filings separately with the SEC,⁵ then consistent with the proposal the broker-dealer should report just whether it has any current filings of its own.

Exclude Some 13G Positions. We do not agree with the suggestion in the proposing

⁵ We encourage the NASD to interpret its requirement so that it is consistent with existing or future SEC no-action statements regarding 13D disclosures.



release that this disclosure requirement should extend to all 13G positions. 13G positions reflect positions acquired in the ordinary course of business with no purpose or effect of changing or influencing control of the issuer. Form 13G therefore applies to “passive” investments such as, for example, fiduciary positions over which the acquirer may have voting and/or investment discretion, or positions accumulated in the ordinary course of market-making activities. Given the nature of 13G positions, we think the potential for such positions to impact an analyst’s views is very remote and that disclosing many 13G positions in research reports would not be helpful to investors. The proposal should permit broker-dealers to exclude 13G positions of corporate affiliates engaged in an asset management capacity or positions acquired by broker-dealer in a market-making capacity, since these positions do not represent the type of firm interest that will raise a potential conflict when the firm recommends the securities held by the asset management fund or market-making desk.

Timing of Disclosures. NASD-Regulation should clarify that the disclosure is based on the reporting time periods provided for 13D or 13G filings. In other words, a firm’s obligation is to disclose the existence of its most recently-filed 13D or 13G, not to disclose changes in those positions as of the date of the research report. It would be inappropriate to require firms to disclose changes in their 13D or 13G positions in research reports that have not been disclosed in SEC filings. The research report, unlike the SEC filing, may not be publicly disseminated and is not available on the SEC’s EDGAR system, so unlike a 13D or 13G filing, only investors who receive the report would know about the change. It would also be extremely costly and burdensome for broker-dealers to develop separate reporting systems for “real-time” updates of 13D or 13G positions every time a research report is issued, and in any event such information would be stale as soon as the report is issued. NASD-Regulation would also have to explain whether the disclosure will have some “shelf-life,” or whether the firm will have to update the research report on a moment-by-moment or some other temporal basis as its proprietary positions change.



b. Lower Thresholds for Disclosure Would Be Unfeasible and Counterproductive.

NASD-Regulation invited comment on whether, rather than relying on 13D and 13G reporting thresholds, a lower threshold, or no threshold at all, should be applied. A lower threshold would be highly problematic. Creating a system to monitor and disclose in contemporaneous research reports proprietary positions falling below existing 13D and 13G requirements would disrupt the disclosure system that Congress created in adopting Sections 13(d) and 13(g) of the Exchange Act, and would create difficult questions as to the timing and shelf-life of the disclosure. It would also be inordinately expensive, and would potentially exacerbate conflicts of interest by calling the attention of research analysts to aggregate firm positions that they might not otherwise know about. In many instances this requirement would also yield information that would mislead rather than aid investors.

Conflict With 13(d) and 13(g) Disclosure System. Sections 13(d) and 13(g) of the Exchange Act reflect Congressional judgments about the thresholds and timing at which ownership of an equity position in an issuer should be made public, as well as the methodology for making that position public. An NASD-Regulation requirement to disclose ownership positions of broker-dealers below these thresholds would turn Sections 13(d) and 13(g) on their heads. Instead of the entire marketplace having a simultaneous opportunity to learn about an equity position, only recipients of a particular research report would have that opportunity. We have always supported the view of regulators and Congress that fundamental information about issuers, such as significant ownership stakes in an issuer's securities, should be disseminated through the SEC filing system.⁶ Requiring disclosure of ownership interests below 13D and 13G levels in

⁶ SIA has differed with the SEC about Regulation FD, which broadens the concept of equal access to corporate information dramatically. Whatever one thinks of Regulation FD, an NASD



research reports is simply inconsistent with an important element of the federal disclosure system.

Expense and Complexity. Tracking positions below 13D or 13G levels for inclusion in research reports will obviously involve a great deal of systems work. Predicting exactly what type of work, or how expensive it might be, is impossible without knowing more specifically what threshold levels NASD-Regulation might propose, and without knowing NASD-Regulation's views on the timing issues noted above. At a minimum, this approach would require firms to enhance their existing systems for tracking 13D and 13G positions, so that they can track positions falling underneath the Rule 13D threshold in time periods that will likely differ from the 13D and 13G reporting time periods. This approach, as applied to international equity research by member firms, will also lead to building entirely new systems in order to track the positions of foreign issuers whose home market does not have a disclosure requirement comparable to Rule 13D.

Exacerbate Conflicts of Interest. By requiring disclosure of positions that are otherwise not reportable, this approach would bring to the analyst's attention proprietary positions of which he or she would likely have been otherwise unaware. Thus the analyst's objectivity might be impaired by new-found awareness of a position where that awareness might not have existed without the reporting requirement.

Misleading Nature of the Information. By disclosing positions below the 13D or 13G threshold, the research report could seriously mislead readers of that report in at least three ways. First, it would strongly imply to investors that the research report was influenced by knowledge of the position, when in fact the analyst may only have learned of the position when his or her compliance department had it inserted into the finished

requirement to use research reports as a vehicle to report ownership positions below the 13D and 13G levels goes diametrically in the opposite direction of that rule as well as against the overall federal disclosure regime.

report. Second, it could be taken to imply that the firm's disclosed position in the security is fairly stable, when in fact the position may be very fluid throughout the day (as in the case of market-making positions), and may not even exist by the time the investor sees the report. Third, it implies a net economic interest in the issuer that may have not existed even as of the moment the report is issued, since the position may be economically hedged by other positions held at some other location in the firm. (These latter two points may also be true of a 13D position, but are even more likely to occur at a lower threshold, since the diminished size of the position increases the chance of a dramatic fluctuation, and makes it more likely that the position is fully hedged).

III. Disclosure of Compensation for Investment Banking Services.

Summary. With some modification, SIA can support this proposal, although we are troubled that in some instances the required disclosure could be misleading rather than helpful to investors. Shortening the disclosure period from three years to one year, and revising the concept of whether the member firm managed or co-managed an underwriting, are sensible ideas. However, the term "investment banking services" needs to be defined and clarified for purposes of the proposal. It is especially important that the types of compensation triggering the requirement should exclude non-public engagements. Responding to NASD-Regulation's request for comment on whether the specific nature of services for which compensation was received should be described, we believe this would compel disclosure in many situations of confidential client information, would increase the potential for biasing an analyst's outlook on an issuer, and would add prohibitive narrative detail to research reports, which investors would find unhelpful.

a. Potentially Misleading Consequences of the Proposal.

Some investors could feel that the requirement causes inherently misleading



disclosures in some situations. Investors could assume that a firm's disclosed investment banking relationship constitutes the full extent of its business relationship with the issuer. This may not be so if the firm has, or is seeking, other confidential investment banking business with the issuer. For example, a firm may state correctly that it has received no investment banking compensation from the recommended issuer, but it would not, and could not under both law and public policy, disclose that it expects to be engaged in a very substantial relationship with that issuer regarding a potential merger or acquisition. Investors may later feel misled in such a situation. NASD-Regulation should weigh this carefully in deciding whether to proceed with this aspect of its proposed amendment.

b. Suggested Improvements Regarding Investment Banking Compensation.

"Investment Banking Services." The proposal does not define the term "investment banking services." Many services are not traditionally viewed as "investment banking," such as leveraged finance and loan arranging, block sales, or management of employee stock purchase or retirement programs. Obviously, many such services seem far-removed from concerns about analyst objectivity, and would therefore make the disclosure less useful to investors. We propose that the term be defined to include

acting as (i) an underwriter in a publicly filed or announced registered or exempt offering for the issuer, or (ii) financial adviser in a publicly-announced merger or acquisition, in either case during the previous 12 months.

This approach should provide meaningful disclosure to investors that goes well beyond current requirements, since it would reveal whether the firm has received compensation for exempt offerings and merger and acquisition advisory work. It would also minimize uncertainty for members about how to apply the rule. Requiring disclosure of relationships that involve other services would require firms to build extensive new tracking systems while not providing a great deal of additional meaningful information.



Non-public transactions. The proposal would be very problematic if applied to non-public investment banking transactions. For years the industry has responded to legislative and regulatory concerns about insider trading and other potential abuses by constructing information barriers to shield information about non-public investment banking transactions from other parts of the firm. Requiring that analysts and recipients of research reports be informed about any aspect of these transactions is directly contrary to the policy objectives of information barriers. It is also inconsistent with the objectives of prohibitions on insider trading, and especially with the mandates of Rule 14e-3 and other rules adopted under Section 14(e) of the Exchange Act, which establish especially stringent prophylactic standards for handling non-public information about tender offers.⁷ Even revealing that the firm received compensation, with no indication what the nature of the services was, could be material information that could lead to speculation that the firm had been retained on a sensitive matter such as an acquisition.

On many occasions, the client may have included in its engagement letter a provision that the fact of the engagement itself is to be kept confidential. It may also be that the client has not even revealed the relationship to its other financial advisers. It therefore seems appropriate to let the issuer determine whether to reveal the existence of a non-public engagement.⁸

⁷ Rule 14e-3 makes it a fraudulent act for any person in possession of material non-public information relating to a tender offer to purchase or sell the securities to be sought by the tender offer if he or she has reason to know that the information was acquired directly or indirectly from the offeror or issuer. If the NASD were to require disclosure in research reports (which in many cases are themselves non-public documents shared only with a limited set of clients) of any information relating to a non-public tender offer, it could unwittingly place recipients of the report in jeopardy of violating Rule 14e-3, and place the member firm in jeopardy of aiding and abetting or causing such a violation.

⁸ The determination of whether the transaction is public or non-public for purposes of the disclosure requirement should rest with the issuer. For example, the existence of market rumors about a deal should not trigger the disclosure requirement. Only a decision by the issuer to issue a press release, or to make an 8-K filing disclosing the engagement, should trigger the disclosure requirement for the analyst and his or her firm.



Requiring disclosure in research reports of non-public investment banking transactions is also likely to increase the potential for impaired analyst objectivity. In general, analysts will not be aware of nonpublic investment banking engagements. Disclosing each such engagement, where the analyst would not otherwise know about it, may increase the possibility of impaired analyst objectivity

We therefore believe that the proposal should explicitly not require disclosure of ongoing or contemplated non-public investment banking transactions.

c. Disclosure of Specific Nature of Services Would Be Harmful to Clients and Markets.

The NTM asks for comment on whether members should be required to disclose the specific nature of services for which compensation has been received. SIA can support requiring a brief description of the nature of services that are already publicly known,⁹ but we would oppose a requirement to make detailed disclosure of these services, or disclosure of non-public information. A requirement for a detailed narration of each service provided could add a prohibitive amount of detail to each research report. Many investment banking engagements are highly complex and multi-faceted, and a conservative firm seeking to stay well within the rule might include voluminous detail that would not prove helpful to investors' understanding of potential conflicts.

This would also greatly exacerbate the concern noted above about requiring firms to disclose highly sensitive non-public information. This proposal would compel disclosure in many situations of highly confidential client information. The requirement would be especially troubling in connection with compensation for merger and acquisition-related services. For example, disclosure that a firm has received an up-front

⁹ Rule 2210 as well as NYSE Rule 472 currently require disclosure if, within the past three years, the member firm was a manager or co-manager of the issuer's most recent public offering.



payment to help a firm with a prospective tender offer would breach the firm's duty to keep that information confidential. Disclosure that a member firm is acting as an underwriter in a publicly announced transaction can also constitute "gun-jumping" in violation of the Securities Act in some circumstances.¹⁰

In many instances the services provided would also be highly competitively sensitive for the broker-dealer. Firms would find it more difficult to build lasting business relationships with clients if every transaction had to be publicly disclosed in detail in research reports. This would place them at a competitive disadvantage with foreign competitors and other financial institutions that are not encumbered with the same requirement.¹¹

A description of the nature of services provided could also increase the chance that an analyst will become sensitive to a client engagement. Therefore, this requirement might exacerbate the potential for a conflict to influence an analyst's judgment.

¹⁰ "Gun-jumping" is a prohibited practice under the federal securities laws involving a selling effort prior to the filing of a registration statement for the offering, or prior to satisfaction of conditions for an exemption from the registration requirement. Disclosure of an underwriter's role in a publicly announced offering can raise gun-jumping concerns if the transaction has been announced through a safe harbor that prohibits the issuer from identifying the names of the underwriters, such as Rules 135 or 135C under the Securities Act. Violation of these provisions can lead to significant private liability as well as SEC enforcement actions. *See Chris-Craft Industries, Inc. v. Bangor Punta Corp.*, 426 F.2d 569, 574 (2d Cir. 1970).

¹¹ Rule 98(j) of the New York Stock Exchange ("NYSE") recognizes the sensitivity of information about current investment banking activities. That rule requires monthly after-the-fact reporting of material investment banking activities by associated persons of exchange specialist firms by filing a non-public report with the NYSE.



IV. Disclosures in Public Appearances.

Summary. We agree that some disclosure obligation should extend to public appearances, and we share NASD-Regulation's concern that the utility of mandated disclosure in public appearances would be lost if the disclosure is required to be too verbose. After carefully considering NASD-Regulation's approach and possible alternatives, we have concluded that, while disclosing whether or not an analyst has a personal financial interest in a recommended issuer is workable, as is a generic disclosure that the firm may have other proprietary interests or business relationships with the issuer, other required disclosures would not be realistic in public appearances.

a. Difficulties With Conveying Complex Disclosures in Public Appearances.

There are obvious practical constraints on public appearances compared to written disclosures. In situations where an analyst has only a very abbreviated amount of air time, such as where he or she is part of a panel discussion, is being interviewed for a "sound bite" or squeezed into a time slot before a commercial, the proposal could substantially hinder substantive communications by expending limited air time reciting mandated disclosures. Moreover, the disclosure is likely to be lost on a viewing or listening audience if it is too detailed. Ironically, the analyst may appear alongside a mutual fund manager or investment adviser not affiliated with a broker-dealer, but with similar potential conflicts, who would not be required to say anything at all about those conflicts.

Despite this disparity, we agree with NASD-Regulation's proposal to require analysts to disclose in public appearances if they have a personal financial interest in a security, consistent with our views on disclosing this information in research reports. It is



reasonable to expect an analyst to know whether he or she has a financial interest in a security of an issuer that is discussed in a public appearance.

If NASD-Regulation imposes a requirement to disclose 13D or 13G positions in research reports, a recitation in a public appearance of 13D or 13G positions taken by the analyst's firm or its affiliates would be a dry and obscure disclosure in the context of a television appearance. One way around this problem might be to require the analyst to say simply "my firm has a long position in the securities of the recommended company."

Unfortunately, even this abbreviated disclosure would be unworkable in many public appearances. Analysts are often asked, by a host, other guests, or call-in viewers, to discuss a variety of securities. Analysts often have no way of knowing in advance what securities might be brought into the conversation, and it would be unrealistic to expect an analyst to know in advance every security in which his or her firm or its affiliates has a disclosable interest.¹² Even if the analyst avoids commenting on a security brought up by someone else, the analyst's appearance on the show, or failure to express a different view on the stock from others on the show, might be taken by some, in the words of the proposed amendment, as "making a recommendation (whether or not labeled as such)."

For this reason, we think that any proposal requiring specific disclosures in public appearances of an analyst's firm's interests (whether proprietary or business-related) in an issuer that is discussed in the appearance is unworkable. A better approach would be for the analyst to disclose if he or she has a financial interest in any specific issuer discussed in the appearance, as well as make a generic disclosure that his or her firm may

¹² The amendment also contemplates that an associated person making a recommendation in a public appearance would have to disclose whether any discretionary account managed by that person has a financial interest in a security of the recommended issuer. It would be unrealistic to expect an associated person who manages many discretionary accounts for customers to know



have an interest in any issuer discussed in the appearance, and direct the viewer or listener to the SEC's web site for more information about any possible 13D filing. A scrolling legend or subtext making the disclosures or referring to the web site for detailed disclosure should also be permitted.

b. Other Concerns.

If NASD-Regulation proceeds with the proposal for disclosures in public appearances, we would like to note some additional issues that should be addressed.

"Client of the Member." One confusing aspect of the proposed rule is that it requires disclosure in public appearances if the recommended issuer "is a client of the member." While the text of the proposing release indicates that this is intended to be limited to investment banking clients from whom the firm has received compensation within the past 12 months, the rule itself is worded much more broadly. The text of the rule should be amended to clarify that "client of the member" has the same meaning as with regard to disclosures in written research of investment banking relationships.

Need for Cooperation by the News Media. NASD-Regulation will need to obtain the cooperation of the news media for this provision to work. For example, what if a TV or webcast producer edits out the disclosures? What if a producer tries to pressure an analyst to cut short or omit a required disclosure? With the increasing coverage of the financial markets, and the increased emphasis on sound bites and instant analysis, it will be challenging to ensure that news media outlets do not seek to place analysts in violation of the rule. We also urge NASD-Regulation to create a safe harbor under the rule that would provide that the rule is not violated if the broker-dealer has provided the required disclosure to the media in connection with the analyst's interview appearance.

instantly whether any of those accounts have a financial interest in a security of an issuer that he or she did not know in advance was to be discussed in the appearance.

V. Other Issues.

Need for a Definition of Research Reports. One fundamental drafting weakness of both existing Rule 2210 and the proposed amendment is the failure to have specific rules directed to research reports. The concerns that drive the proposed amendments are primarily based on recommendations made in analyst's research reports, not on advertising and sales literature generally. Continuing to craft the rule as a generic standard applicable to both research and advertising and sales literature generally is awkward and confusing. Drawing a distinction in the rule between requirements that apply to advertising generally, and requirements that apply to research, is appropriate. SIA recommends that NASD-Regulation consider recrafting Rule 2210 to define the term "research" and assign it regulatory requirements distinct from requirements applicable to "advertisements and sales literature."

A logical starting point is NYSE Rule 472.10 (2), which defines research reports as "an analysis of individual companies, industries, market conditions, securities or other investment vehicles which provide information reasonably sufficient upon which to base an investment decision." This definition may be too broad for purposes of NASD-Regulation's proposed disclosure requirements, in light of the concerns that we raise below about applying those requirements to quantitative analyses or market commentaries. We suggest that the definition should be limited to

An analysis regarding a company disseminated by a member that: (a) provides information reasonably sufficient upon which to base a decision regarding an equity investment in that company, and (b) has been prepared by an employee hired by the member to work within the member's research department in the normal course of his or her duties.

Application to Quantitative Analysis and Market Commentary. The proposed amendment seems to be unnecessary and potentially counterproductive with regard to



two categories of research: quantitative analyses of securities portfolios, and market commentary. These concerns can be addressed, at least in part, if NASD-Regulation adopts the definition of research reports that we propose above.

1. Quantitative Analyses. SIA recommends that the rule not be applied to quantitative or relative analyses of securities or portfolios of securities. Such analyses contain recommendations derived from quantitative models based on objective publicly known measures of stock performance, or by comparing the relative performance of a security to a benchmark (such as a comparison between a fixed income security yield and the yield on the Treasury long bond). These reports may recommend transactions in specific issuers based on this quantitative analysis, or they may recommend trading strategies, quantify value or offer forecasts for entire sectors based on a portfolio analysis of volatility and return of indices for these sectors. Since these reports are based on objective criteria, rather than on any subjective judgments about the economic prospects of particular companies, it is hard to see any purported benefit to investors from having “conflict” information in such a report.

2. Market Commentary. The proposed amendment is also not appropriate as applied to market commentary. Many firms put out frequent reports on overall market conditions, discussing matters such as factors contributing to intraday market index movements, or the potential macroeconomic impact of current news developments such as an interest rate change by the Federal Reserve Board, new information from the Labor Department on unemployment statistics, an international political crisis, etc. While these reports may comment on specific issuers, these reports have nothing to do with concerns about internal conflicts biasing analyst coverage of specific companies. The requirements of the proposed amendments in this context would make little sense, merely creating an additional expense and procedural hurdle that might delay issuance of these time-sensitive reports, and inserting disclosures that would annoy, bewilder or distract readers of the reports.



Need to Coordinate with NYSE Rules. SIA encourages NASD-Regulation and the New York Stock Exchange (“NYSE”) to work together to ensure that their respective rules on required disclosures in research reports work well together. This might entail amending NYSE Rule 472 to more closely match any amendments to Rule 2210. It might also be appropriate to redraft Rule 2210 to more closely parallel NYSE Rule 472 in some respects. For example, as noted above, NYSE Rule 472 uses the defined term “research report,” albeit in a way that we think is too broad for purposes of the proposed amendment to Rule 2210. The NYSE also sets out a specific requirement that a supervisory analyst prepare or approve the report in advance. We recommend that NASD-Regulation include a similar requirement to NYSE Rule 472 that a supervisory analyst prepare or approve the report in advance.

Application to First Call Notes and Other Communications. In addition to formal research reports, broker-dealers often put out on a daily or other interim basis research updates that are distributed through vendors such as First Call, or e-mailed to customers. Because these updates may be issued very frequently, it would be impractical to update disclosures in every new update. We suggest that a research report, or series of reports, should be exempted from the rule as long as

- it is issued within 90 days of a prior research report on the same issuer,
- it clearly states in its introduction that it is an update of the prior research report and gives the date of that report and explains how the original report can be obtained or viewed, and
- the prior research report to which it refers contained all the disclosures required by the rule.

Reports by Officers. The proposed change to disclosures of options, rights and warrants to purchase securities of the recommended issuer is somewhat ambiguous. We read the proposed amendment to require only a generic disclosure to the effect that one or more



officers or directors owns some of these instruments. However, it may be possible to read the provision as requiring an enumeration of each officer or partner who owns options, rights or warrants of the issuer. Requiring specific disclosures of holdings by each officer of the member firm could be an onerous undertaking that will yield a great deal of superfluous information. In contrast to firm proprietary positions, which need be disclosed only if they exceed five per cent of outstanding shares, this requirement requires disclosure “unless the extent of such ownership is nominal.” In the case of a widely held company, this could require disclosure of a great many positions held by officers of the firm who have nothing to do with preparation of the research report. This would be uninformative to investors and would crowd out on the page or screen other required disclosures that would be more significant to an investor’s appraisal of potential conflicts. In addition, since these positions could change on a frequent basis, this raises questions about whether or when the disclosure must be updated. We recommend that NASD-Regulation redraft this provision to make it clearer that the required disclosure of rights, options and warrant positions of officers and partners is intended to be generic.

Application to Portfolio Managers of Discretionary Accounts. Endnote 1 of the proposing release states that the proposed rule would apply to portfolio managers of investment companies and other discretionary accounts in instances where they are also associated persons of an NASD member. SIA believes that this sweeps too broadly and is unnecessary.

Asset management functions are generally conducted either through separate affiliates, or a separate business line of the broker-dealer that is dually registered as a broker-dealer and an investment adviser. Portfolio managers of affiliates may be registered as associated persons of the broker-dealer for technical reasons. For example, such a portfolio manager may be registered because he or she has nominal contact with the broker-dealer sales force, explaining the product and answering questions about it. These communications do not rise to the level of a securities recommendation for



purposes of the proposed amendment. Further, discussion by the portfolio manager of specific securities holdings are not intended to promote the acquisition of the securities, but rather to explain investment strategies or objectives. It is also unclear under the proposal whether marketing materials and discussions relating to an investment fund would constitute a recommendation of the security. Additionally, dually registered firms may employ individuals who either act exclusively in a portfolio management role or who act both in a brokerage or a portfolio management capacity with different clients. There is no reason for any of these portfolio managers to have access to or knowledge about ongoing investment banking activities of the broker-dealer.

Regulatory oversight of investment advisory activities traditionally has been within the purview of the SEC. In recognition of this, the NASD-Regulation staff has not viewed mutual fund advertisements of dually-registered broker-dealers or their affiliates as falling within existing Rule 2210. We see no reason to now extend the more detailed requirements of the proposed amendment to portfolio managers. We recommend that Rule 2210 should continue *not* to apply to portfolio managers of mutual funds and other discretionary accounts, regardless of their collateral registration as a broker-dealer associated person. Similarly, the rule should continue not to apply to the advertising and sales materials of mutual funds and separately managed accounts, since the purpose of such materials is to describe and solicit interest in these investment advisory products and services, rather than to recommend the purchase of individual securities held by a fund.

Guidance on “Specifically and Prominently.” The phrase “specifically and prominently” in the proposed amendment, together with the discussion in the proposing release, raises many uncertainties. Usually recommendations are made at the front of the report, and in the ordinary case it may be appropriate for the disclosures to be made there as well. But a blanket requirement to make the disclosure at the front of the report might not always make sense. For example, depending on how firms organize their research reports, it may be more useful to investors to place the disclosure at the end of the report, set off on

its own page, rather than at the beginning of a report which is already “front-loaded” with a great deal of summary information. NASD-Regulation should also consider how its requirements on typeface and location will interact with those of foreign regulators, who may have different requirements for typeface and placement that would apply to the same research report.

We are also not sure what “specifically and prominently” means in connection with a research report placed on the Internet. Is it not “prominent” if one has to scroll down the screen to see the disclosure? What if the disclosure is connected to the report by a prominently displayed hyperlink? Would a pop-up window that viewers have to see satisfy the requirement? Presumably it would, but this may prove annoying rather than helpful to many viewers. We urge NASD-Regulation to apply the “specifically and prominently” requirement to give firms flexibility to efficiently direct interested Internet users to the required information.

All of these questions suggest that the requirement that the disclosure be made “specifically and prominently” will have to be applied flexibly in order for it to help rather than hinder investors’ ability to see the disclosure information easily. We think NASD-Regulation should let firms make their own judgments as to font size and placement, as long as the disclosure is easily readable and is provided in a manner that does not negate its significance.

Time to Implement. NASD-Regulation will need to allow a reasonable period to implement systems changes to adapt to the proposed rule. This will be especially necessary if the disclosure requirement for firm positions is anchored to something other than 13D filings, since that will require designing and building new systems. Time will also be needed to implement systems for tracking when investment banking fees have been received, and for bolstering existing systems for tracking analyst holdings and holdings of their household members.



Responses to Questions.

1. Should associated persons and their firms be required to disclose potential conflicts of interest when recommending a security in a television, radio, or other public appearance?

Answer: The analyst should be required to disclose if he or she has a financial interest in the issuer being recommended as well as a general disclaimer that his or her firm may have a proprietary interest or investment banking relationship with any issuer discussed in the program. However, in all other respects the disclosures required in the proposal for public appearances may be unworkable, for reasons discussed on pages 16-18 above.

2. If you answered "yes" to number 1, is the definition of "public appearance" within the proposed rule appropriate?

Answer: Yes. However, we note that the amendment does not clearly address the status of written interviews with the print or electronic media.

3. Should the same disclosure rules apply to recommendations made during public appearances as for recommendations in advertisements and sales literature?

Answer: No, for the reasons discussed on page 16 above.

4. Should members and associated persons who make securities recommendations have to disclose that the firm has received compensation for investment banking services provided to the issuer within the last 12 months?

Answer: We can support this proposal if the compensation is related to underwriting public or exempt offerings, or to publicly announced advisory work on a merger or acquisition, although we note on page 12 above that in any formulation this proposal is likely to result in misleading disclosures in some circumstances. If applied too broadly, this requirement might also exacerbate potential conflicts of interest rather than alleviate them, as discussed on page 14 above.

5. If you answered "yes" to 4, is it sufficient disclosure during a public appearance to state only that the issuer of the recommended security is a "client" of the firm?

Answer: No. This requirement is unworkable, for the reasons discussed on page 17 above. However, a requirement that firms make a generic disclosure that the firm may have other proprietary interests or business relationships with the issuer would be feasible.



6. Should members and associated persons who make securities recommendations have to disclose the nature of investment banking services for which the firm has received compensation from the issuer of the recommended security during the past 12 months?

Answer: No, other than a brief description of the nature of services that are already known, such as underwritten public offerings, which are already disclosed under existing NASD Rule 2210 as well as NYSE Rule 472. Disclosing the nature of many non-public investment banking services would cause serious problems for firms and their clients, as discussed on pages 14-15 above, and would seldom yield information that would be useful to investors.

7. Should the person or persons responsible for a recommendation have to disclose that he or she has a financial interest in a recommended security?

Answer: Yes.

8. Should the person or persons responsible for a recommendation have to disclose that a discretionary account they manage has a financial interest in a recommended security?

Answer: Yes.

9. Should the person or persons responsible for a recommendation have to disclose the nature of a financial interest that they, or discretionary accounts they manage, have in the recommended security?

Answer: Yes, but only to the extent of disclosing if it is a long or short interest.

10. Should a member have to disclose an ownership interest of five percent or more of the total outstanding shares of any class of equity securities of a recommended issuer?

Answer: Yes, if it is information required to be disclosed under SEC Rule 13D by the member or its broker-dealer affiliates. See our comments on pages 7-8 above.

11. Should a member have to disclose an ownership interest of less than five percent of the total outstanding shares of any class of equity securities of a recommended issuer?

Answer: No. See our comments on pages 9-11 above.



Barbara Z. Sweeney
August 22, 2001
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Thank you for giving SIA the opportunity to comment on the proposed amendment. If you have questions or need further assistance, please do not hesitate to contact the undersigned, or George R. Kramer of the SIA staff at (202) 296-9410.

Sincerely,

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Chairman, Federal Regulation Committee

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