



Securities Industry Association

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May 9, 2003

Margaret H. McFarland
Deputy Secretary, United States Securities and Exchange Commission
450 Fifth Street NW
Washington, DC 20549-0609

Re: Proposed Rule Changes of New York
Stock Exchange and National
Association of Securities Dealers
Relating to Research Analyst Conflicts
of Interest, File Nos. SR-NYSE-2002-49,
SR-NASD-2002-154

Dear Ms. McFarland:

On behalf of the Federal Regulation Committee (the "Committee") of the Securities Industry Association ("SIA")¹ I would like to offer some supplemental comments to the letter that the Committee submitted to you on March 10, 2003 regarding the above-referenced proposed rules by the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers ("NASD")

¹ The Securities Industry Association brings together the shared interests of more than 600 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. Collectively they employ more than 495,000 individuals, representing 97 percent of total employment in securities brokers and dealers. The U.S. securities industry manages the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2001, the industry generated \$280 billion in U.S. revenue and \$383 billion in global revenues. (More information about SIA is available on its home page: <http://www.sia.com>.) SIA's Federal Regulation Committee, consisting of over two dozen chief legal officers of securities firms, is SIA's principal legal and regulatory committee.



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(collectively the "SROs"). Last week the Securities and Exchange Commission ("SEC" or "Commission"), the SROs and a number of state authorities announced a settlement with ten major broker-dealers of an enforcement initiative involving the issue of research analyst conflicts of interest. As part of that settlement, each of the ten broker-dealers agreed to abide by a set of undertakings (the "Term Sheet"²) that impose a number of obligations on those firms regarding, among other things, the behavior of research analysts, the structure of research supervision and research departments, and disclosures about potential conflicts in research reports.

The areas addressed by the Term Sheet are generally ones that the current SRO rules and the proposed amendments to those rules also address. Understandably, many of the requirements of the Term Sheet are more demanding of the settling firms than are the current or proposed SRO rules. However, in some respects that we describe below, the Term Sheet contains language that is easier to understand or to apply than the requirements of the current or proposed SRO rules. Without expressing a view at this time as to which, if any, of the substantive requirements of the Term Sheet should be imported into SRO rules, we think that it would be advisable to make some limited modifications to certain of the current and proposed SRO rules to bring them into better alignment with these aspects of the Term Sheet.

1. Definition of Covered Personnel. As we noted in our March 10 letter, the current and proposed amendments to the SRO rules sweep very broadly in their

² The Term Sheet is available at <http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf>.



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coverage, and, contrary to the SROs' likely intentions, seem to make a wide range of employees outside the research department subject to the research rules. In particular, proposed amendments to NYSE Rule 472.40 would expand its definition of the "associated persons" covered by the rules to include anyone "making recommendations or offering opinions in public appearances," a definition that could sweep in an enormous number of people who are not in any way responsible for the preparation of the substance of research reports. The NASD definition in Rule 2711(a)(5), which focused on persons directly or indirectly responsible for the "preparation of the substance of a research report," is more workable, but still runs the risk of sweeping up someone who unwittingly prepares a single document or electronic communication that could be deemed to be a research report

Part I (1)(d) of the term sheet defines the persons covered as, *inter alia*, "all firm personnel engaged principally in the preparation and/or publication of research reports" This approach focuses regulatory requirements on exactly the right category of people, those who are *engaged principally* in writing research reports. NASD Rule 2711(a)(7), defining the term "research department," uses the similar term "principally responsible" as part of that definition. The SROs should add this element to their definitions of the types of personnel covered by their research rules.

2. Definition of Research Report. Part I (1)(e) of the Term Sheet defines the key term "research report" more realistically than either the current or proposed SRO rules. Both current and proposed SRO rules define research reports so broadly that they seem to sweep in commentary or analyses prepared by traders



or salespeople for current or prospective customers, as well as many communications with current or prospective investment company shareholders or discretionary investment account clients discussing past performance of the reasons for past discretionary investment decisions. Part I (1)(e)(ii) of the Term Sheet expressly exempts these types of communications from the definition.

Part I (1)(e) also limits the definition to communications “furnished by the firm to investors in the U.S.” The SRO rules’ definitions of research do not specifically address this point. We think it is appropriate for the definitions to contain this limitation, since U.S. regulators do not have a direct interest in communications furnished to non-U.S. investors, and application of these rules to dealings with foreign investors raises issues of comity and/or conflict with foreign laws, may exceed the statutory authority of the SROs, and risks placing U.S. firms at a competitive disadvantage in foreign markets with other financial institutions that are only subject to their home market’s rules.

In addition, Part I (1)(e)(i) of the Term Sheet embodies a number of exceptions to the definition of the term “research report.” Most of these types of communications are also set out in the NASD/NYSE Joint Interpretive Memorandum, NASD NTM 02-39 (the “Joint Memorandum”). However, the Term Sheet broadens these exemptions to include the following:

- Reports commenting on trading conditions;
- Reports that recommend increasing or decreasing holdings in particular types of securities;



- Broad-based summaries or listings of recommendations or ratings contained in previously-issued research reports, providing that no analysis of individuals companies is included.

3. Prohibition on Soliciting Investment Banking Business. Part I (9) of the Term Sheet takes a markedly different approach from the SRO rules regarding research analysts' involvement in soliciting investment banking business. The Term Sheet flatly prohibits research analysts from "participating in efforts to solicit investment banking business." It goes on to state that this means that research analysts cannot, among other things, participate in "pitches" for investment banking business to prospective investment banking clients or "have other communications with companies for the purpose of soliciting investment banking business."

In contrast, the proposed SRO amendments do not bar research analysts from soliciting investment banking business as such, but instead bar a research analyst from publishing research on a company for some unspecified period of time if the analyst "engaged in any communication with the subject company in furtherance of obtaining investment banking business" prior to the subject company entering into an agreement with the broker-dealer designating it as an underwriter of the company's initial public offering. We detailed on pages 5-6 and 11-15 of our March 10 comment letter a range of concerns that we had with this proposal. Those concerns were spawned in large part by the vagueness of the phrase "in furtherance of obtaining investment banking business." As we noted, the opaqueness of this provision could have the effect of discouraging analysts from paying routine visits to private companies within their industry sector, for fear that if an investment banking relationship with the company later



develops, a regulator might view such a visit as having been “in furtherance of obtaining” that business.

At this time we do not have a view on whether the SRO rules should incorporate a flat ban on research like the Term Sheet, or instead a restriction on the ability of analysts to write research on a company if they were involved in pitching investment banking services that resulted in the company retaining the analyst’s firm for an IPO. However, we think the Term Sheet’s phrase “soliciting investment banking business” is a fairly comprehensible test of what is and is not permitted. It is much harder to understand what is permitted under a directive that analysts should not to have communications “in furtherance of” obtaining investment banking business. The SROs’ proposed rule on soliciting investment banking business would be more workable if it substituted “soliciting” for “obtaining” investment banking business.³

4. Compensation. Part I (5) of the Term Sheet clarifies three issues that are not clear in the current and proposed SRO rules. First, Part I (5)(b) specifies that compensation for Research personnel can relate to the revenues or results of the firm as a whole. The NYSE has given similar guidance in the Joint Memorandum, but the NASD has been silent on this question.

Second, Part I (5)(c) and (d) of the Term Sheet make clear that the obligations concerning how to calculate compensation are limited to compensation for the

³ We noted on pages 12-13 of our March 10 letter that there is some confusion as to whether the SRO proposal is supposed to apply to “initial public offerings” or “investment banking business.” We argued in that letter that the provision should be limited to analysts soliciting IPO mandates.



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“lead analyst”, as defined by SEC Regulation AC. This is helpful guidance, and we recommend that the SRO rules provide comparable guidance.

Third, Part I (5)(d) makes explicit that firms can consider “the market for the hiring and retention of analysts” as one of the factors in determining lead analyst compensation. It would be helpful if the SRO rules gave similar explicit recognition to this factor.

We hope that these proposed technical modifications to the proposed SRO rules, together with the more substantial suggestions of our March 10 letter, will result in a more workable set of rules that will help to improve public trust and confidence in research analysts. If you have any questions on any aspect of this letter, please contact George R. Kramer, staff adviser to the Committee, at 202-296-9410. or by e-mail to gkramer@sia.com.

Sincerely,

Robert C. Dinerstein, Chairman
SIA Federal Regulation Committee

Cc: Chairman William H. Donaldson, U.S. Securities and Exchange
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Commissioner Paul S. Atkins, U.S. Securities and Exchange
Commission
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