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Securities and Exchange Commission
150 F Street, NE
Washington, DC 20549

Re: **File Nos. SR-NASD-2006-112 and SR-NYSE-2006-77– Response to Comments**

Dear Mr. Brigagliano:

This letter responds to certain comments received by the Securities and Exchange Commission ("SEC" or "Commission") to the above-referenced rule filings, proposals to amend NASD Rule 2711 and NYSE Rule 472 to codify interpretations to the rules and make other non-substantive changes. The proposed rule changes were published for comment in the Federal Register on October 24, 2006.[1]

The SEC received three letters in response to the proposed rule changes.[2] SIFMA expressed concerns about the supervisory review and approval requirements set forth in the proposed rule changes, asserting that those requirements should be subject to notice and comment because they are new, overly burdensome, duplicative and at odds with the objectives of certain provisions of the "Global Settlement" among regulators and twelve investment banks. ASIR contends that NASD and the New York Stock Exchange ("NYSE")(together "the SROs") improperly changed without comment an interpretation regarding the applicability of the rules to research distributed pursuant to a soft dollar arrangement and further expresses concern that the rules "may be interpreted to impose" a new supervisory obligation on broker-dealers that provide soft dollar research to customers that is delivered directly from the third-party preparer to the customer. SIFMA and ASIR also both perceive an inconsistency between the SRO rules. Both commenters seek to

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[1] Exchange Act Release No. 54616 (October 17, 2006), 71 FR 62331 (October 24, 2006).

[2] This letter responds to comments in letters from The Alliance in Support of Independent Research to Nancy M. Morris, Secretary, SEC, dated November 1, 2006 ("ASIR") and from Securities Industry and Financial Markets Association to Nancy M. Morris, Secretary, SEC, dated November 14, 2006 ("SIFMA"). A third comment letter was received after the published deadline for comments from Charles Comer to Nancy M. Morris, Secretary, SEC, dated November 17, 2006, and is not addressed herein.

have the rule filings withdrawn in part and resubmitted for comment. In the alternative, ASIR asks the Commission to abrogate the filing; SIFMA does not.

The SROs do not find the comments persuasive. Indeed, several of the comments are predicated on a misreading or misapprehension of the rules. And the other comments merely reflect interpretations of the rules that the commenters would substitute for those chosen by the SROs. However, disagreement with a particular interpretation does not establish that the SROs failed to satisfy the statutory requirement for filing a rule change for immediate effectiveness. As such, no action by the Commission is warranted.

While the SROs disagree with the comments, we do intend to include some clarifying language in an NASD *Notice to Members* and an NYSE Information Memo announcing the rule changes to hopefully allay some of the concerns expressed by the commenters. That language is set out below.

Supervisory Review

SIFMA asserts that the rule filing establishes for the first time a supervisory review and approval requirement for third-party research reports and that such change should not have been included in a rule filing for immediate effectiveness. SIFMA then proceeds to comment on the substance of the provisions, arguing that they are overly burdensome and should be replaced by a "principles-based approach" where firms would "demand high standards" from third-party research providers and subject those vendors to front-end diligence reviews and periodic monitoring.

Yet SIFMA completely undermines its argument that the rule filings go beyond codifying an interpretation when it acknowledges that research reports constitute sales literature under NASD Rule 2210 and communications under NYSE Rule 472 and, as such, are subject to the approval requirements under these rules.[3] SIFMA further states "[c]ertainly, we believe that member firms do have supervisory review obligations in connection with the distribution of Third-Party Research Reports." In the face of such admissions, the SROs are nonplussed by SIFMA's contention that "the SROs never specified that those requirements applied to Third-Party Research Reports."[4]

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[3] "NASD Rule 2210(b) and NYSE Rule 472(a)(1) require supervisory review and approval of communications with the public, including "sales literature." NASD Rule 2210(a)(2) and NYSE 472.10 extend those requirements to research reports through their respective definitions of the terms "sales literature" and "communications." *See* page 4 of 15, footnote 6 of the SIFMA Comment Letter.

[4] The SIFMA Letter also asserts that the Interpretation of NYSE Rule 472 indicates that member firms may not be subject to the same review and approval requirements for externally prepared materials including third-party research reports. This interpretation pre-dates the SRO Research Analyst Conflict of Interest Rule amendments. Subsequent to approval of the amendments, the Exchange conditioned regulatory relief, pursuant to 472/07, predicated on the inclusion of prescribed disclosures on third-party research reports, as required by Information Memos 02-26 and 04-10. In this regard, the inclusion of these third-party disclosures implied review of such reports by the distributing member organization. This standard was

SIFMA acknowledges what is self-evident from the language of NASD Rule 2210: the supervisory review requirements apply to all types of sales literature produced by third parties that are distributed by members.[5] Rule 2210(b) provides that "a registered principal must approve by signature or initial and date each advertisement, item of sales literature and independently prepared reprint before the earlier of its use or filing with NASD's Advertising Regulation Department." The definition of "sales literature" expressly includes research reports and is not limited to the member's own research reports. Moreover, NASD Rule 2210(d)(1)(b) states in relevant part that "[n]o member may publish, circulate or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading." This language is purposefully broad and intended to encompass all communications put out by a member, irrespective of their origin.

SIFMA also acknowledges that the supervisory requirements of NYSE Rule 472(a)(1) and .10 apply to all communications generally distributed or made available to customers or the public, which includes third-party research reports, pursuant to the Rule 472.10 definition of "communication" which includes "research reports." To make clear that the NYSE and NASD have consistent standards with respect to the approval requirements for third-party research reports, NYSE will clarify the interpretation in 472/07 for materials externally prepared to convey that the requirements are only applicable when the member organizations "distributes" or "pushes out" these materials and not simply when the material is made available by a member organization. The changes to the NYSE interpretation will conform the NYSE standard to that in NASD Rule 2210 for the approval of third-party research reports.

These rule changes merely codify in NASD Rule 2711 and Rule 472 the existing review and approval requirement from NASD Rule 2210 and NYSE Rule 472 with respect to distribution of third-party research. As such, they fall squarely within the statutory parameters for filing a rule change for immediate effectiveness – it is nothing more than a "stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule."[6] SIFMA's suggestion that the SROs may only codify those interpretations that it previously set forth in two joint interpretive memoranda regarding Rule 2711 and Rule 472 is without legal support. Moreover, with respect to the NASD filing, SIFMA overlooks the fact that those joint memoranda addressed interpretations to Rule 2711, whereas the interpretation at issue here involves Rule 2210. Ultimately, SIFMA doesn't so much dispute that a supervisory obligation exists; rather, it

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codified in the filing that is the subject of this letter. NYSE Interpretation 472/07 is substantially similar to the NASD standard in Rule 2210 applicable to "independently prepared reprints."

[5] For purposes of this letter, the term "member" shall mean NASD members and NYSE member organizations.

[6] *See* Section 19(b)(3)(A) of the Exchange Act of 1934 ("the Act") and Rule 19b-4(f)(1) thereunder.

does not support the manner in which the SROs have interpreted this existing obligation and instead offers up a review scheme that it would prefer.

SIFMA's substantive concerns with the supervisory requirements are not compelling. SIFMA suggests that the supervisory requirements will discourage the distribution of third-party research and disadvantage customers who do not receive research directly from the vendors. This argument ignores a basic distinction of the interpretation that SIFMA also acknowledges in its letter. Neither the third-party disclosures nor the supervisory review requirements apply unless the research is "distributed" by a member.[7] As set forth in NASD *Notice to Members* 04-18 and NYSE Information Memo 04-10, and codified in the rule filings, a member is not considered to have "distributed" research if it makes available *non-affiliate* third-party research either on its website or upon request by a customer. Research is only "distributed" when a member "pushes it out" to a customer or makes available *affiliate* research on its website or provides affiliate research upon request. To use an example cited by SIFMA in its letter, no supervisory review obligation would result where a member makes available on its website or upon request all Morningstar or S&P research reports (assuming the member is not affiliated with either research provider) and does not selectively push them out to customers.

Thus, contrary to SIFMA's assertion, nothing in the SRO rules prevent firms from timely providing their customers research from those "truly independent voices that are not subject to the types of conflicts of interest that sometimes exists within member firms." For these same reasons, the SRO rules are not inconsistent with the provision of the Global Settlement that requires firms to make available independent research to its customers.

The review and approval requirement therefore applies only when a member "distributes" or pushes out third party research. But even in those circumstances, the review required by NASD Rule 2210 and NYSE Rule 472 imposes a minimal burden on firms. SIFMA does not complain about the requirement that a registered principal or supervisory analyst must review a report to ensure that the third-party disclosures required by NASD Rule 2711 and NYSE Rule 472– i.e., those pertaining to the distributing member – if applicable, are complete and accurate. Beyond that, a member must only review third-party research to meet the standards of NASD Rule 2210(d)(1)(B) and NYSE Rule 472(i), which generally prohibit a member from distributing any third-party research that the member knows or has reason to know contains any untrue statement or omission of a material fact or is otherwise false or misleading.[8] As will be set forth in the forthcoming NASD *Notice to Members* and NYSE Information Memo, a member's obligation to review the content of a third-party research report in this regard extends to any untrue statement of

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[7] In this regard, NASD's rule operates the same as the NYSE rule: if a member does not "distribute" third-party research, then the supervision requirements do not attach. Both SIFMA and ASIR expressed concern that the SRO rules might differ in that regard. They do not.

[8] *See* also NYSE Interpretation 472/08.

a material fact or any false or misleading information that (1) should be known from reading the report or (2) is known based on information otherwise possessed by the member.

A member is not required to validate the preparing firm's methodologies, analysis or judgment or, where the preparing firm is an NASD or NYSE member, to verify the completeness and accuracy of that firm's disclosures. SIFMA's concern that the rule is overly burdensome and requires the distributing member to duplicate the preparing member's content review is therefore unfounded.

Registration Requirements

SIFMA also asserts in its letter that the rule filings impose "research-specific" registration requirements on member firms that produce no research of their own, but instead distribute only third-party research. The SROs understand "research-specific" to mean the Series 86 and Series 87 examinations. However, with respect to NASD, the express language of Rule 2711(h)(13) states that "[a] registered principal (or supervisory analyst approved pursuant to Rule 344 of the New York Stock Exchange) must approve by signature or initial third-party research distributed by a member." This language merely embeds in Rule 2711 the principal review required of any advertisement, item of sales literature and independently prepared reprint pursuant to Rule 2210(b) and permits either a General Securities Principal (Series 24) or a Series 16 Supervisory Analyst to conduct the required supervisory review of third-party research. It does not require that such registered principal pass the Series 86 or 87 examinations.

NYSE Rule 472(k)(4)(i)(a) requires a supervisory analyst qualified under NYSE Rule 344 (Series 16 qualified) to approve any third-party research distributed by a member organization. A candidate for the Series 16 does not have to take the Series 86 or 87 as a prerequisite to becoming a supervisory analyst. A Series 16 candidate must have at least three years experience within the immediately preceding six years involving securities or financial analysis or qualify for an exemption.[9] The review of third-party research for applicable standards regarding communications with the public and for the third-party disclosures, as they pertain to the distributing member organization, may be done by either a supervisory analyst or a qualified person under NYSE Rule 342(b)(1).[10] This language, like NASD's, merely clarifies that the existing review and approval required by Rule 472(a)(1) and (a)(2) for communications and research reports, respectively, applies to third-party communications and imposes no additional registration requirements.

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[9] Completion of the CFA Level I Examination will suffice to allow a Supervisory Analyst candidate to qualify by taking Part I of the Series 16 Examination.

[10] *E.g.*, a person who has taken and passed the Series 9/10, or another examination acceptable to the Exchange which demonstrates competency relevant to assigned responsibilities, including the Series 24 if taken and passed after July 1, 2001.

Accordingly, the rule filings impose no new registration requirements on member firms and should not necessitate additional hires.

Soft Dollar Research

ASIR objects to the fact that the rule text regarding third-party research reports does not include an exception for third-party research distributed through a soft dollar arrangement. The SROs' prior joint interpretive guidance had stated that the third-party disclosure requirements did not apply to third-party research provided pursuant to a soft dollar arrangement. ASIR offers no policy rationale why soft dollar research should be treated differently from all other third-party research, but instead simply argues that the SROs cannot change or withdraw its existing interpretation in a rule change filed for immediate effectiveness.

As a practical matter, the rule language does not deviate from the existing interpretation, even if it does not provide for an express exemption for third-party research provided pursuant to a soft dollar arrangement. This is because both the prior interpretive guidance and the rule language are based on SRO staff's understanding that generally member firms that distribute independent third-party research through a soft dollar arrangement do so only upon customer request. As explained in more detail above, the third-party research disclosure and supervisory obligations apply only where research is "distributed" or pushed-out to customers, but do not attach where independent research is either requested by a customer or pulled-down from a member's website. ASIR essentially recognizes this point, but nonetheless contends that the absence of an explicit exemption may "imply" that some soft dollar arrangements would not be exempt from the disclosure requirements. The SROs note that ASIR did not identify any examples of other such arrangements.

To the extent that any member would "distribute" or push-out third-party research pursuant to a soft dollar arrangement, the previous interpretation did not contemplate such circumstances. And the SROs see no reason why the disclosure and supervisory requirements, which are intended to promote transparency of conflicts and protect investors against false and misleading communications, should apply differently based on the compensation arrangement between the member and the third-party research provider. In choosing not to incorporate an exemption for soft dollar research from the third-party research rules, the rule language now clarifies the SROs' interpretive position in the event that facts exist where a member "distributes" third-party research that it paid for via a soft dollar arrangement.

ASIR also expresses concern that the third-party research supervisory requirement might apply even where research is furnished to the customer directly by the third-party preparing firm. As explained above, so long as the research is provided upon customer request and is not the research of an affiliate of the member, the supervisory requirements would not apply to the "providing broker."

In sum, all of the non-technical changes in the rule filing reflect interpretations with respect to the meaning, administration, or enforcement of existing SRO rules and therefore are appropriate for a rule change filed for immediate effectiveness pursuant to Section 19(b)(3)(A) of the Act and Rule 19b-4(f)(1) thereunder. The SROs hope this response to comments is helpful and adequately addresses the issues raised by the commenters. Please feel free to contact Philip Shaikun at (202) 728-8451 or William Jannace at (212) 656-2744 if you wish to discuss this matter further.

Sincerely,

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