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February 23, 2007

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street N.E.
Washington, DC 20549

Re: Securities and Exchange Commission Release No. 34-55072

Dear Ms. Morris:

I am writing on behalf of my client, Millennium Wave Securities, LLC ("Millennium") and appreciate this opportunity to comment on the NASD's proposal to amend NASD Rule 2711 (the "Rule") relating to research analysts' conflicts of interest (the "Rule Proposal").[1] Of concern to Millennium is the portion of the Rule Proposal that amends the definition of "research report" to exclude sales literature relating to open-end registered investment companies that are not listed or traded on an exchange or public direct participating programs ("DPPs").

The language of the definition of "research report" in the Rule is drawn from Section 15D of the Securities Exchange Act of 1934 (the "Exchange Act"). Section 15D was added to the Exchange Act by Section 501 of the Sarbanes-Oxley Act of 2002 and mandated the adoption of the Rule in order to "address conflicts of interest that can arise when securities analysts recommend equity securities in research reports . . . in order to improve the objectivity of research and provide investors with more useful and reliable information." The Rule is intended to give effect to this stated statutory purpose; however, we do not believe the public policy risks that Section 15D and the Rule are intended to address are present with respect to communications that are clearly presented as sales literature and that are governed by the rules and standards applicable to sales literature. While sales literature is expected to be "fair and balanced,"[2] there should be no expectation that it is objective analysis. Accordingly, we believe the Rule

1 Securities and Exchange Commission ("SEC"), Release No. 34-55072, *Self-Regulatory Organizations; New York Stock Exchange LLC and the National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Changes to Amend NYSE Rules 472 and 344, and NASD Rules 1050 and 2711 Relating to Research Analyst Conflicts of Interest* (Jan. 9, 2007); 72 F.R. 2058 (Jan. 17, 2007).

2 *See* NASD Rule 2210(d)(1).

Proposal should be amended to ensure that sales literature relating to hedge funds or private equity funds (collectively, "private funds") is not subject to the requirements of the Rule.

I. Background

The definition of "research report" is a "written (including electronic) communication that includes an analysis of equity securities of individual companies or industries, and that provides information reasonably sufficient upon which to base an investment decision."[3] The NASD believes that the definition is clear that the Rule applies to sales literature relating to private funds, public closed-end funds, exchange traded funds ("ETFs") and other equity alternative investment products. In our experience we have found that private fund distributors are generally unaware that the Rule applies to private fund sales literature.[4] Moreover, the fact that few are aware of the Rule's scope indicates confusion over the scope and application of the Rule to private fund sales literature. This lack of awareness and confusion may also indicate that the effect of the Rule and its costs and benefits were not fully understood nor adequately considered at the time the Rule was adopted.[5]

The breadth of the definition of "research report" has created significant uncertainty about the Rule's scope and application, including its application to mutual fund sales literature. The *Joint Report by NASD and the NYSE on the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules*, published in December 2005 (the "Joint Report"), noted the very broad definition of "research report" and recommended codifying certain interpretations of the Rule so that it would not apply to sales literature relating to "registered investment companies." (The Joint Report did not include the qualifier "open-end" to registered investment companies, which is in the Rule Proposal.) The Rule Proposal amends the definition of "research report" to, among other things, exclude sales literature relating to open-end registered investment companies that are not listed or traded on an exchange or public DPPs.

Millennium, a registered broker-dealer, produces a newsletter that is directed to accredited investors interested in private funds and contains information, such as performance information, about private funds, which we believe may be "sufficient upon which to base an investment decision." Many other private fund distributors also use sales literature that appears to meet the definition of "research report" under the Rule. Millennium has sought clarification from the NASD about whether the NASD intended

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3 NASD Rule 2711(a)(8).

4 A review of the relevant literature has not identified any instance in which the NASD has publicly stated its expectation that the Rule would apply to private fund sales literature, nor are we aware that the NASD has sought to enforce the Rule against publishers of such sales literature either through examination or disciplinary action.

5 We note that the definition of "Research Report" in the Rule is the same as the definition in SEC Regulation AC.

for the Rule to cover its private funds newsletter and other sales literature. The NASD staff advised Millennium that the Rule was clear as written and, accordingly, declined to provide any further clarification. After the Joint Report was published, Millennium again advised the NASD of its reading of the Rule in light of the Report; however, the NASD staff verbally reiterated to Millennium that they believed that the Rule applied to private fund sales literature. Therefore, Millennium has assumed that the Rule applies to its private funds newsletter and other sales literature, and has complied with the Rule's requirements.

If narrow exclusion in the Rule Proposal is adopted, there will be no remaining doubt that the Rule applies to sales literature relating to all securities not covered by the exclusion, namely, private funds, public closed-end funds, ETFs and other equity alternative investment products. The proposed exclusion should be expanded so that the definition of "research report" is limited to communications: (i) relating to equity securities that are traded in public secondary markets, (ii) relating to equity securities that are not redeemable at the option of the investor, and (iii) published by someone who is not the distributor or agent of the issuer. We do not believe the Rule should apply to private fund sales literature because the risks that the Rule is intended to address are not present with respect to sales literature relating to securities that are not traded in secondary markets or that are redeemable by the issuer. Moreover, sales literature that is clearly marketing material and not objective analysis should not be subjected to the additional regulatory regime designed to preserve the objectivity of research.

As discussed in more detail below, Millennium believes that private fund sales literature should also be excluded from the definition of "research report," and therefore from the Rule, because:

- The regulatory rationale for exempting open-end registered investment companies and public DPPs from the Rule applies to private funds and the NASD advertising rule adequately regulates private fund sales literature; and
- The concerns that justify regulating research reports do not apply in the context of private fund sales literature because
  - Private funds are priced at net asset value ("NAV"), not by the market, and
  - Private fund sales literature is more similar to open-end registered investment company sales literature than to single company equity security research reports.

Subjecting broker-dealers distributing private funds, as well as foreign funds sold in private placements in the U.S. and other types of equity alternative collective investment products, to the Rule's requirements is unnecessary because private fund distribution practices were not the reason behind adopting the Rule. Imposing the requirements of the Rule on private fund distributors will affect the use of offering summaries, pitch books, power-point presentations, term sheets and other commonly used forms of sales literature that are not prospectuses or offering memoranda.[6]

II. The NASD's Rationale for Exempting Open-End Registered Investment Companies and Public DPPs From the Rule Applies Equally to Private Funds

In the Rule Proposal, the NASD justifies carving out the sales literature of open-end registered investment companies from the definition of "research report" because such sales literature is subject to a separate regulatory regime, including NASD Rule 2210 and SEC Rule 482, both of which set the content standards for sales literature. The NASD also notes that registered fund sales literature is subject to filing with the NASD within ten days of its first use, but does not explain how the filing requirement justifies limiting the exclusion to open-end registered investment companies.

The NASD also proposes to exclude public DPP sales literature because it is subject to NASD Rule 2210, including the requirement that it must be filed with the NASD within ten business days of its first use. The Rule Proposal notes that the sales literature of DPPs generally consists of "tombstone" advertisements and, therefore, is also subject to SEC Rule 134. The NASD asserts that public DPPs typically are not traded on an exchange and do not have an active secondary market.[7] The NASD does not cite any source for this assertion. Public DPPs are sometimes exchange listed or traded in the secondary market because they are registered. In fact, it is precisely these characteristics that appear to make public DPPs more akin to individual company equity securities. Unregistered funds that are organized as DPPs or limited liability companies, by contrast, do not have secondary markets because of their structural characteristics such as redemption restrictions and resale prohibitions.

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6 NASD, SR-NASD-2006-112, *Proposed Rule Change to Amend NASD Rule 2711 to Codify Existing Interpretive Guidance Relating to Research Analyst Rules*, filed for immediate effectiveness on Sept. 27, 2006 and published at 72 F.R. 62331 (Oct. 24, 2006), codified an interpretation that excludes "periodic reports or other communications prepared for investment company shareholders or discretionary investment account clients that discuss individual securities in the context of a fund's or an account's past performance or the basis for previously made discretionary investment decisions" from the definition of "research report." This change clearly permits performance information in prospectuses and offering memoranda, while the Rule Proposal's exclusion is more limited and would prohibit the use of performance information in private fund sales literature that is not a prospectus or offering memorandum.

7 Release No. 34-55072, *supra* note 1, at 11.

Rule 2210 regulates the content of private fund sales literature[8] and requires sales literature to be based on "principals of fair dealing and good faith." Sales literature must be fair and balanced and must not omit any material facts if the omission, in light of the context, would cause the communication to be misleading.[9] In addition, Rule 2210 prohibits members from making any false, exaggerated, unwarranted or misleading claim in communications with the public, and communications with the public may not predict or project performance, imply that past performance will recur or make any exaggerated claim, opinion or forecast. Rule 2210 also specifies that sales literature must disclose the relationship between the registered broker-dealer and the non-member or individual who is named. Finally, even if a non-member private manager prepares the sales literature, the sales literature is subject to the content requirements of Rule 2210 if a member uses it to sell a private fund.[10]

Although private fund sales literature is not subject to post-use review by the NASD, such review is not necessary.[11] Unlike open-end registered investment companies and public DPPs, the distribution of private fund sales literature is limited to sophisticated investors.[12] These investors are considered more

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8 The NASD and others have interpreted Rule 2210 to apply equally to the sales literature of registered funds and private funds. *See* NASD, Interpretative Letter, *Further Interpretative Advice to Members Concerning the Sale of Hedge Funds* (Oct. 2, 2003) [hereinafter SIA Letter]; *see also* NASD, Interpretive Letter, *Guidance Regarding Use of Related Performance Information in Sales Material for Private Equity Funds* (Dec. 30, 2003) [hereinafter Davis Polk Letter].

9 *See* NASD, IM-2210-1, *Guidelines to Ensure That Communications With the Public Are Not Misleading*; *see also* NASD, Notice to Members 03-07, *NASD Reminds Members of Obligations When Selling Hedge Funds* (Feb. 2003).

10 SIA Letter, *supra* note 7.

11 The Rule Proposal noted that the "NASD Advertising Regulation Department review of registered investment company and public DPP sales literature reduces the likelihood that it will contain content that is not fair and balanced." Release No. 34-55072, *supra* note 1; *see* Davis Polk Letter, *supra* note 7; SIA Letter, *supra* note 7.

12 Sophisticated investors are investors that are "qualified institutional buyers," as defined by Rule 144A under the Securities Act of 1933, as amended ("Securities Act"), "qualified purchasers," as defined by Section 2(a)(51) of the Investment Company Act of 1940 ("Investment Company Act"), or "accredited investors," as defined by Rule 501(a) under the Securities Act.

Though the SEC is proposing to revise the definition of "accredited investors," as it applies to natural persons, the SEC is not proposing to change the principle that select investors do not need as much regulatory protection as the public. SEC, Release 33-8766, *Prohibition of Fraud by Adverse to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles* (Dec. 27, 2006) (proposing new standards to limit the number of investors that qualify as accredited investors because overall personal wealth has increased, as a result of inflation and increased personal residence values, so capable of objectively evaluating sales literature and, therefore, the concerns related to the widespread public dissemination of research are not present. In fact, the NASD, in an interpretive letter concerning a particular class of private funds, noted that, with respect to related performance in sales literature, private funds do not present the same investor protection concerns compared to mutual funds.[13] For example, private funds are generally exempt from the registration requirements of the Investment Company Act and Securities Act because their shares are sold to sophisticated investors in limited offerings.[14] Since sales literature for private funds is subject to the same content standards as that for open-end registered investment companies and public DPPs, the NASD's justifications should apply equally to private fund sales literature. In addition, any performance information in private fund sales literature must meet the same Rule 2210 requirements that apply to registered investment companies.[15] Since Rule 2210 sets advertising standards, the NASD should not need to create additional regulatory burdens by classifying private fund sales literature as research reports.

III. Regulatory Concerns Justifying the Regulation of Research Reports Do Not Apply in the Context of Private Fund Sales Literature

A. Private Funds Are Priced at Net Asset Value, Not by the Market

The conflicts of interest that the NASD sought to address when enacting Rule 2711 are not a regulatory concern for private funds. The NASD adopted the Rule to address the influence that investment bankers exert on research analysts to speak favorably about specific securities.[16] The NASD noted that "[t]he primary biasing forces came from investment bankers who pressured research analysts to speak favorably of current and prospective clients and, with management acquiescence, linked analysts' compensation directly to their role in landing lucrative investment banking deals."[17] The NASD was concerned about research analysts having a financial interest in the securities that they covered and, as a result, attempting

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that the percentage of U.S. households that qualify for accredited investor status has increased from 1.87% to 8.47% between 1982 and 2003, while investment products have increased in complexity).

13 Davis Polk Letter, *supra* note 7.

14 *See id.*

15 *See id.*

16 The NASD sought to address the circumstances that compromised the objectivity of research by research analysts "and to restore public confidence in the validity of research and the veracity of research analysts, who are expected to function as unbiased intermediaries between issuers and the investors who buy and sell their securities." *Id.* at 2.

17 *Joint Report* ("In the succinct words of a retired Wall Street research analyst who testified before Congress in the summer of 2001: 'Investment banking now dominates equity research.'").

to manipulate the price of securities traded on an exchange through the issuance of unduly favorable research reports.[18]

By contrast, it is impossible to manipulate the price of a private fund. A private fund's value is calculated in the same manner as the value of a registered open-end registered investment company—using the fund's NAV. Because private fund sales literature cannot affect the NAV of a private fund, subjecting such sales literature to regulation under a rule that was designed to prevent price manipulation is unnecessary and burdensome.

B. Private Fund Sales Literature Does Not Contain Analysis

Private fund sales literature is more similar to open-end registered investment company sales literature than to single company equity security research reports. A "research report" has (i) "information reasonably sufficient upon which to base an investment decision" and (ii) "analysis" about securities of "individual companies." Although investors may use private fund sales literature to decide whether to purchase or sell a fund, private fund sales literature does not generally contain the type of analysis that is in research reports. The two main types of analysis that are in research reports are technical analysis[19] and fundamental analysis. Technical analysis refers to:

> research into the demand and supply for securities, options, mutual funds and commodities based on trading volume and price studies. Technical analysts use charts or computer programs to identify and project price trends in a market, security, fund or futures contract. Most analysis is done for short- or intermediate-term, but some technicians also predict long-term cycles based on charts and other data.[20]

Fundamental analysis is the:

> analysis of the balance sheet and income statements of companies in order to forecast their future stock price movements. Fundamental analysts consider past records of assets,

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18 Conflicts included basing analysts' compensation on their contributions in support of investment banking transactions and the profitability of the investment banking unit, as well as analysts covering companies underwritten by the analysts' firms; investing in pre-initial public offerings of companies that they initially covered and for which their firms had acted as underwriters; and issuing favorable research reports or "buy" recommendations close to the expiration of a lock-up period. *Id.*

19 In the recent NASD Notice to Members 04-18, *Research Analysts and Research Reports* (March 2004), the NASD asserted that, in the discussion of the definition of "research report" under the research analyst rules, it would not exclude technical or quantitative analysis from the definition of research report.

20 Dictionary of Finance and Investment Terms, 548-49 (4th ed. 1995).

> earnings, sales, products, management and markets in predicting future trends in these indicators of a company's success or failure. By appraising a firm's prospects, these analysts assess whether a particular stock or group of stocks is undervalued or overvalued at the current market price.[21]

Technical analysis is not applicable to a registered fund or private fund. Demand and supply, the basis of technical analysis, do not influence the price of a registered fund or private fund, because, as noted earlier, a fund's price is based on the value of its underlying portfolio securities. For example, the newsletter that Millennium produces includes information about economic and market developments, but such information is general and is not about the underlying portfolio securities of the funds in which the investor is investing.

Similarly, with regard to fundamental analysis, analyzing assets, earnings, sales, products, management and markets in order to identify trends in a private fund would be meaningless because, in some cases, there is no such information, and, in other cases, only the information that relates to the underlying portfolio securities is meaningful. This information would not be about the private fund in which the investor is investing.

Finally, analysis in any of its forms involves the separate examination of constituent parts of an "individual company" engaged in commercial or industrial enterprises to form conclusions as a consequence of reasoning.[22] Unlike a single company equity security, which may be separated into its constituent parts (price and market data, financial statement information, etc.),[23] a private fund is much more difficult to analyze based on an examination of its component parts, such as a particular portfolio's securities, because its components are both concealed and ever changing.

The NASD should recognize that sales literature, regardless if the subject matter is a registered fund or private fund, is not a research report within the context of the Rule because it does not contain the technical or fundamental components of analysis. In addition, information about private funds does not contain information about individual companies that produce a product or provide a service.

Finally, private fund sales literature is likely to include information about the characteristics of the product and an assessment of its manager. Typically, this may be a restatement of information provided in fund offering documents (such as management style and tax consequences) coupled with personal

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21 *Id.* at 211.

22 *See* Webster's II New Riverside University Dictionary, 104 (1984).

23 See the definition of "company," Black's Law Dictionary (5th ed. 1979).

evaluations. This type of discussion in the context of registered funds is not analysis[24] and, accordingly, should not be considered analysis in the context of private funds.

IV. Conclusion

As discussed, the NASD should extend the Rule Proposal to exclude the sales literature of private funds from the definition of research reports because the risks that the Rule is intended to address are not present with respect to sales literature relating to securities that are not traded in secondary markets or that are redeemable by the issuer. Moreover, sales literature that is clearly marketing material and not objective analysis should not be subjected to the additional regulatory regime designed to preserve the objectivity of analysis. In addition, the NASD's rationale for excluding the sales literature of open-end registered investment companies and public DPPs from the Rule because Rule 2210 regulates such sales literature applies equally to private funds because Rule 2210 also regulates private fund sales literature. Further, the regulatory concern that private fund sales literature will manipulate the value of a private fund is not an issue because private funds are priced at NAV, not by the market. In addition, private fund sales literature does not contain the type of analysis that research analysts manipulated, and this manipulation is what led to the adoption of Rule 2711.

We appreciate the opportunity to comment on this rule proposal. If you have any questions concerning the foregoing, please contact me. Thank you for your attention to this matter.

Very truly yours,

Elliott R. Curzon

cc: James A. Brigagliano
SEC Director of Market Regulation

Marc Menchel
NASD Regulatory Policy and Oversight's Office of General Counsel

[24] The NASD staff, in discussions about interpreting the Rule, made this observation.