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Yoon-Young Lee

+1 202 663 6720 (t)
+1 202 663 6363 (f)
yoon-young.lee@wilmerhale.com

By Electronic Delivery

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-0609

Re: **Proposed Rule Changes of the New York Stock Exchange, LLC and National Association of Securities Dealers, Inc. Relating to Research Analyst Conflicts of Interest, File Nos. SR-NYSE-2006-78, SR-NASD-2006-113**

Dear Ms. Morris:

We submit this letter on behalf of Citigroup Global Markets Inc.; Credit Suisse Securities (USA), LLC; Goldman, Sachs & Co.; J.P. Morgan Securities Inc.; Lehman Brothers Inc.; Merrill Lynch, Pierce, Fenner & Smith Incorporated; Morgan Stanley & Co. Incorporated; and UBS Securities LLC, in response to a request by the Securities and Exchange Commission ("SEC" or the "Commission") for comments regarding the above-referenced proposed rule changes ("Proposed Rule Changes")[1/] by the New York Stock Exchange LLC ("NYSE") and the National Association of Securities Dealers, Inc. ("NASD"), collectively, the self-regulatory organizations ("SROs").

I. OVERVIEW

First and foremost, we would like to thank the SROs for their continuing willingness to engage in a dialogue with member firms on the important topic of equity research and to respond to firms' concerns in a meaningful manner. In particular, we appreciate the SROs' recent analysis of the operation and effectiveness of their research analyst conflict of interest rules ("Research Rules") and subsequent publication of a Joint Report regarding the results of this analysis.[2/] We also appreciate the SROs' recent efforts to codify existing interpretive guidance relating to certain provisions of the Research Rules, and to harmonize this guidance.[3/]

1/ Exchange Act Release No. 55,072 (Jan. 9, 2007), 72 Fed. Reg. 2058 (Jan. 17, 2007) ("Proposed Rule Changes").

2/ *See Joint Report by NASD and the NYSE On the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules* (December 2005), *available at* http://www.nasd.com/groups/rules_regs/documents/rules_regs/nasdw_015803.pdf ("Joint Report"). For purposes of this letter, the Research Rules are NASD Rule 2711 and NYSE Rule 472.

3/ *See* Exchange Act Release No. 54616 (Oct. 17, 2006), 71 Fed. Reg. 62,331-01 (Oct. 24, 2006).

The SROs' efforts to harmonize their guidance in the area of research is a welcome step and is consistent with the broader proposal to consolidate member regulation operations into a single SRO and establish a uniform set of rules.[4/] In the extended period between initial publication of the Proposed Rule Changes and their official publication in the *Federal Register*, regulatory consolidation has not only been proposed, but is well on its way to becoming a reality. As noted by Chairman Cox, the use of one rulebook, one set of interpretive standards, and one integrated staff to interpret rules and standards will ensure a "coordinated, integrated effort to keep our markets free of fraud and unfair dealing."[5/] In light of these important developments, it is imperative that the SROs adopt consistent rules going forward to facilitate the creation of a single rulebook. As currently drafted, the NASD's and NYSE's Proposed Rule Changes differ in certain key areas. For these areas, we suggest a uniform approach based on the merits of each SRO's proposal. If consolidation is to work, the SROs must continue to take steps to adopt consistent rules for research.

Also, while we strongly support the majority of the Proposed Rule Changes, we believe there are a number of critical modifications that the SROs should make. These modifications relate to: (1) the proposed prohibitions on factual reviews of analysts' research reports; (2) the proposed prohibitions on certain communications with internal sales personnel; (3) the proposed alternative disclosure method for research reports; (4) the meaning of "significant news or events"; (5) the restrictions on the publication of research reports due to "lock-up" agreements; and (6) the exclusion of certain firm personnel from the research registration requirements. We describe our proposed modifications more fully below, along with our responses to the SROs' specific requests for comments and outstanding issues relating to the Joint Report.

II. THE SROs SHOULD MAKE CERTAIN IMPORTANT MODIFICATIONS TO THE PROPOSED RULE CHANGES

A. The SROs' Proposed Prohibitions on the Ability of Non-Research Personnel to Review Research Reports Are Overly Broad and Inconsistent with the Global Research Settlement, and Would Damage the Quality of Research.

4/ *See* News Release, *NASD and NYSE Group Announce Plans to Consolidate Regulation of Securities Firms* (Nov. 28, 2006), *available at* http://www.nasd.com/PressRoom/NewsReleases/2006NewsReleases/NASDW_017973. *See also* Rule Harmonization, NASD Notice to Members 07-12 (Feb. 2007).

5/ *See* Press Release, Statement by SEC Chairman Cox at News Conference on Self Regulation Consolidation, (Nov. 28, 2006), *available at* http://www.sec.gov/news/press/2006/2006-195.htm.

As a general proposition, we agree that non-research personnel (other than legal and compliance) should not be allowed to direct, supervise, or suppress the content of a research report. We also agree that investment banking personnel should not be allowed to review draft research reports prior to publication. We strongly disagree, however, with the SROs' proposal to change the Research Rules to broadly prohibit *all* non-research personnel from reviewing draft research reports prior to publication, under any circumstances. In that regard, we disagree with the SROs' rationale for this proposed prohibition, *i.e.*, that *any* reviews by non-research personnel (1) are inconsistent with the Global Research Settlement, (2) are "unnecessary," and (3) "only raise concerns about the objectivity of the report."[6/]

With regard to this first point, it is not true that the Global Research Settlement prohibits non-investment banking, non-research personnel from reviewing draft research reports prior to publication. While the Global Research Settlement prohibits investment banking personnel from reviewing draft reports, it does not extend this prohibition more broadly to all non-research personnel. As such, the Global Research Settlement, like the current Research Rules, does not prohibit certain non-research personnel from reviewing reports prior to publication.

Second, we disagree with the SROs' rationale that it is "unnecessary" under any circumstances for non-research personnel to review draft research reports prior to publication. In that regard, we note that many firms have established research committees that review reports prior to publication to assess changes of stock ratings and recommendations for objectivity, integrity, and the application of a rigorous analytical framework in the development of all recommendations. Some of these firms require non-research personnel (other than investment banking personnel) to serve on these committees because they provide a valuable perspective and important insight into the needs, concerns, and nature of a firm's customer base. In fact, the proposed prohibition is in direct conflict with the 2002 equity research analyst settlement between the New York Attorney General and Merrill Lynch, Pierce, Fenner & Smith Incorporated, which requires non-research personnel (such as institutional and private client sales management) to serve on that firm's Research Recommendation Committee and review certain research prior to publication. The proposed prohibition also is inconsistent with the Global Research Settlement's provision that firms must establish oversight committees, which are responsible for reviewing certain research before publication and which may include non-research personnel (other than investment banking personnel).[7/]

[6/] Proposed Rule Changes, at 2074. The "Global Research Settlement," which was reached among certain investment banking firms, the SEC, NYSE, NASD, and other regulators on April 28, 2003, is available at http://www.sec.gov/spotlight/globalsettlement.htm.

[7/] *See* Section I.12 of the Global Research Settlement.

Also, apart from serving on research committees, non-research personnel may provide an important function by reviewing research reports prior to publication because they may possess unique technical, product, or other expertise necessary to verify the factual accuracy of reports. For example, research analysts may need to consult with internal technical or financial experts such as tax, accounting, actuarial or statistical personnel, strategists, or product experts when drafting reports. In such cases, these persons play a critical role by reviewing a draft report prior to publication to confirm that the analyst's statements are accurate and complete. We do not believe these consultations and reviews present the types of conflicts of interest the Research Rules were designed to address.

Finally, we disagree with the assertion that reviews by non-research personnel "only raise concerns about the objectivity of the report."[8/] As discussed above, it may be necessary for non-research personnel to review draft reports to verify the factual accuracy of reports and perform conflicts checks. Also, any potential for conflicts of interest or improper influence presented by such reviews would be addressed by the current requirement in the Research Rules that these reviews be overseen by authorized legal or compliance personnel.[9/] Further, the certifications required by the SEC's Regulation Analyst Certification[10/] ("Regulation AC") help ensure that research reports remain objective.

B. The SROs' Proposed Prohibitions on Communications Between Research Analysts and Internal Sales Personnel Are Overly Broad and Go Beyond the Prohibitions in the Global Research Settlement.

The SROs' proposed extension of the prohibition on research analysts communicating with investment banking personnel or company management in the presence of current or prospective customers *or internal sales personnel* regarding a specific investment banking transaction is overly broad and inconsistent with the Global Research Settlement. Specifically, the Proposed Rule Changes do not take into account situations where research analysts may participate, along with Equity Capital Markets ("ECM") personnel, in efforts to educate the internal sales force regarding a proposed transaction.[11/] Also, the Proposed Rule Changes are inconsistent with the Global Research Settlement because they would not allow research personnel to participate in commitment committee meetings regarding potential investment

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8/ *See* Proposed Rule Changes, at 2069.

9/ *See* NASD Rule 2711(b)(3) and NYSE Rule 472(b)(3).

10/ 17 C.F.R. §242.500-502.

11/ *See* Section I.10(d)(iii) of the Global Research Settlement. As defined by the Global Research Settlement, ECM personnel are persons whose principal job responsibility is the pricing and structuring of transactions.

banking transactions where members of the committee include both investment banking and sales personnel. Like educational efforts involving ECM personnel, this activity is specifically permitted by the Global Research Settlement.[12/] We assume the failure to include carve outs for educational efforts involving ECM and commitment committee participation was unintentional, and we ask the SROs to clarify that these activities do not fall within the proposed prohibition.

C. While We Welcome the SROs' Proposed Alternative Disclosure Method, We Urge Them to Eliminate the Proposed "Prominent Warning" and to Expand the Proposal to Cover Price Charts and Ratings Distribution Tables.

1. The proposed prominent warning is misleading and unnecessary.

We support the SROs' proposal to permit firms to make required disclosures for research reports via websites. We believe that web-based disclosure promotes efficiency, provides important information to investors in a meaningful manner, and is consistent with important initiatives by the SEC to promote the use of electronic media. However, we urge the SROs to eliminate the requirement that firms include a prominent warning on the cover of research reports in order to rely on the alternative disclosure method because: (1) as currently drafted, the proposed prominent warning is inaccurate and may be confusing to investors; (2) the prominent warning is unnecessary, as evidenced by current Research Rules that allow firms to make web-based disclosures for compendium reports and do not require a prominent warning; and (3) for firms that are subject to the Global Research Settlement, the prominent warning would be confusing and conflict with the warnings that the Global Research Settlement requires such firms to include on the covers of their research reports.

With respect to the first point, we believe the proposed language of the warning is misleading and inaccurate because it requires a firm to state that (1) it and/or its analyst *has* a conflict of interest, and (2) such conflict may prevent the firm or analyst from providing objective analysis. In truth, however, the disclosures required by the Research Rules may represent *remote potential* conflicts of interest, *not actual* conflicts of interest. Indeed, in some cases, there may be no conflict at all because the analyst is not aware of the relationships described in research disclosures at the time he or she is drafting the report or because the firm does not have or is not seeking any business from the subject company. It is inappropriate and incorrect, then, for the SROs to require firms to post a disclosure that makes an affirmative determination that actual conflicts exist that may impair the analyst's or firm's ability to provide objective analysis. For these reasons, we urge the SROs to eliminate the requirement that firms

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12/ *See* id. at Section I.10(b).

post an additional prominent warning on the front cover of research reports in order to make web-based disclosures.

Further, we believe the proposed prominent warning is unnecessary. The SROs currently permit firms to make web-based disclosures for research reports analyzing six or more companies ("compendium" reports), and this well-established disclosure method requires firms to direct readers in a clear and prominent manner as to where they may obtain applicable current disclosures – it does not require firms to make a prominent warning.[13/] We believe a similar clear and prominent instruction to readers would be appropriate for the web-based disclosures proposed by the SROs, and would clearly alert readers as to where they may find important disclosures. To that end, we do not understand why it should be necessary to include the lengthy, proposed prominent warning on research reports covering five or less companies, but not on compendium reports.

Finally, for firms that are subject to the Global Research Settlement, the proposed prominent warning is overlapping, and at the same time inconsistent with, the disclosures that the Global Research Settlement requires such firms to include on the covers of their reports. As discussed, while the Global Research Settlement disclosure refers to *potential* conflicts of interest, the proposed prominent warning requires firms to disclose that they have *actual* conflicts of interest. Should the SROs choose to impose the prominent warning, firms subject to the Global Research Settlement would be required to place voluminous, and somewhat contradictory, disclosures on the covers of their research reports, which will make it difficult to fit any substantive discussion of a company on the front page of a report.

2. The proposed prominent warning should not be required for compendium reports.

As stated above, the SROs currently permit firms to make web-based disclosures for compendium reports by directing readers in a clear and prominent manner as to where they may obtain applicable current disclosures. This well-established disclosure method has worked well for both investors and firms for years. While the NYSE has not proposed any revisions to its disclosure requirements for compendium reports in the Proposed Rule Changes, the NASD has revised its disclosure rules for compendium reports by adding new language suggesting that disclosures "required by paragraph (h)(2)" may not be made using the general compendium report disclosure method.[14/] There is no discussion of this change in the NASD's proposal and it is not clear what this new language is intended to address or why any change is necessary.

13/ *See* NASD Rule 2711(h)(11) and NYSE Rule 472(k)(1)(iii)(d).

14/ *See* Proposed Rule Changes, at 2066.

Indeed, the NYSE has not proposed a similar change to its compendium report rules. We hope this new language is not interpreted by the NASD to mean that firms must include a prominent warning on compendium reports. If that is the case, we strongly urge the NASD to maintain the status quo, which has worked so well, and not impose a new requirement on firms. As discussed in subsection 1 above, we believe the proposed prominent warning is misleading and unnecessary.

3. If the prominent warning requirement is retained, it should be amended.

Should the SROs decide to retain the proposed prominent warning, it is critical that they revise it to more accurately reflect the nature of any potential conflicts and to conform to the disclosures required by the Global Research Settlement. As discussed above, the proposed warning conflicts with similar disclosures mandated by the Global Research Settlement and mischaracterizes *potential* conflicts as *actual* conflicts. If the language is not amended, firms will be loathe to take advantage of the streamlined disclosure approach, which the SROs have acknowledged will promote efficiency and provide important information to investors in a meaningful manner. We recommend that the SROs adopt a disclosure that conforms to that required by the Global Research Settlement, which clearly and accurately alerts investors to potential conflicts of interest, *e.g.*:

> **Important information and disclosures about any relationships between companies covered in this research report and [Name of Firm] and its covering analysts (including any ownership of covered securities by analysts and other potential conflicts of interest) appear at [www.firmwebsite.com].**

4. The SROs should expand the disclosures that may be made via websites.

We urge the SROs to expand the disclosures that may be made on a firm's website to include price charts and ratings distribution tables. The SROs currently permit firms to make these disclosures electronically in compendium reports, and we believe a similar standard should be applied in this case. Indeed, price charts and ratings distribution tables are the most cumbersome and difficult disclosures to produce in research reports and it would greatly ease production burdens on firms and streamline research reports if this information could be provided via a firm's website. The dynamic nature of price charts and ratings distribution tables makes them particularly well suited for online disclosure and therefore may provide more meaningful information to investors if they are made available via a firm's website. We respectfully disagree with the SROs' prior statements that these types of disclosures do not lend themselves to abbreviated warnings on the cover of reports and should be "readily available to

investors in the report itself."[15] On the contrary, investors will have immediate access to these disclosures by simply clicking a hyperlink to a firm's website (for electronic reports) or otherwise accessing the firm's website (for hard copy reports). Therefore, we ask the SROs to permit additional disclosures required pursuant to the Research Rules to be made via a firm's website.

5. The SROs should adopt a web-based disclosure regime for public appearances.

The SROs asked whether a similar alternative disclosure regime could be used during public appearances. We enthusiastically support adopting a similar approach for disclosures in public appearances by analysts that firms could choose to utilize as an alternative to the current disclosure regime. We believe the proposed, streamlined disclosure regime is equally, if not more, appropriate for public appearances than for research reports. In particular, the new alternative regime would allow investors to consider and appreciate more fully the disclosures related to public appearances. With web-based disclosures, investors would be able to download, review, and assess them (as opposed to simply hearing them recited before or after an appearance, at which time investors may not focus on the substance of the disclosures). As discussed above, however, the proposed prominent warning should be eliminated or amended to more accurately alert investors to potential conflicts. If the warning is amended, we believe firms will take advantage of this new alternative disclosure regime for public appearances.

D. The SROs Should Harmonize Their Rules for Publication During "Quiet Periods" By Defining "Significant News or Events" to Include Earnings Announcements.

The Research Rules currently prohibit firms and analysts from issuing research reports or making public appearances during certain "quiet periods" surrounding public offerings and the expiration, termination, or waiver of "lock-up" agreements.[16] These prohibitions do not apply where a research analyst publishes a report concerning the effects of significant news or events pertaining to the company. The SROs previously have interpreted "significant news or events" to exclude earnings announcements by companies based on their view that such announcements are not causal events or news items that materially affect a company's operations, earnings, or

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15/ *See* Proposed Rule Changes, at 2072.

16/ Generally, a "lock-up agreement" is a binding contract executed between an underwriter and insiders of the company that prohibits these individuals from selling any shares of stock for a specified period of time.

financial condition.[17] The NYSE now proposes to revise this prior interpretation to *include* earnings announcements.[18]

In furtherance of regulatory consolidation, we assume the SROs will adopt a consistent rule regarding quiet periods. Accordingly, we urge the SROs to harmonize their rules by adopting the NYSE's proposal to expand the meaning of "significant news or events" to include earnings announcements by companies. We agree with the NYSE that expanding the exception to include earnings announcements will promote the flow of potentially important information to the markets and investors.[19] As acknowledged in the proposal, earnings announcements and guidance are essential sources of information for analysts and support the basis of their recommendations.[20] As such, analysts should be permitted to publish reports and make public appearances regarding these important announcements. Moreover, the current Research Rules provide safeguards to help ensure that any publication or public appearance that occurs during a quiet period occurs in response to significant news or events, and is not made for an improper purpose.[21]

It is important to emphasize that we are asking the SROs to include earnings announcements *only* in the "significant news or events" exception for publications during the "quiet periods" surrounding public offerings and the expiration, termination, or waiver of "lock-up" agreements. We recognize the concern raised by the NASD that a carve-out for earnings-related announcements might be problematic in the context of the "black out" periods surrounding an analyst account's personal trades in a security that is the subject of a research report.[22] Accordingly, we are not asking the SROs to include earnings announcements in the

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17/ *See* NASD and NYSE Provide Further Guidance on Rules Governing Research Analysts' Conflicts of Interest, NASD Notice to Members 04-18 (Mar. 2004); Amendments to Disclosure and Reporting Requirements, NYSE Information Memo No. 04-10, Exhibit A (Mar. 2004).

18/ *See* Proposed Rule Changes, at 2070.

19/ *See id.*

20/ *See id.*

21/ Specifically, the Research Rules require that legal and compliance personnel review and pre-approve any publications of research reports or public appearances that occur pursuant to the significant news and events exception.

22/ The Research Rules impose "black out" restrictions on analysts' trading before and after the issuance of a research report or changes in ratings or price targets. These restrictions mean that a report may not be issued and a price or rating change may not occur within thirty days after a trade by an analyst account, *unless* the report is issued due to "significant news or events." If the SROs expand the "significant news or events" exception for quiet periods, as we advocate, we would support amending the rules regarding personal trading (NASD Rule

"significant news or events" exception for situations where there is a "black out" period due to a trade by an analyst account.

Finally, we ask the SROs to confirm that the "significant news or events" exception is not limited to announcements that are required to be formally codified by issuers in regulatory filings such as Forms 8-K, 10-K and 10-Q. While earnings announcements are generally incorporated into regulatory filings, not all "significant news or events" are part of such filings.[23/] Also, information included in a company's press release generally precedes, and, in some cases, may not be included, in Form 8-K filings. We believe that it is beneficial to investors to allow analysts, who are often better suited to interpret the significance of an event, to comment on such material news or events in a timely manner, regardless of whether the issuer is required to file as a result of the event.

E. The SROs Should Harmonize Their Rules for Lock-Ups By Eliminating any Restrictions or Requirements on the Publication of Research Due to Lock-Up Agreements.

The SROs must adopt a uniform rule regarding lock-ups in order to facilitate the creation of a single regulatory regime. To that end, they should harmonize their rules by eliminating required "quiet periods" surrounding the expiration, waiver, or termination of lock-up agreements, as they did for secondary offerings.[24/] In doing so, however, they should *not* impose additional requirements or regulatory burdens on firms (*i.e.*, by requiring firms to provide additional certifications for research reports).

We agree with the NASD that changes in the internal structure of investment banks and other safeguards imposed by the current Research Rules obviate the need for quiet periods surrounding lock-up agreements. Also, as noted, these restrictions may be harmful to investors because they inhibit the flow of information to the marketplace.[25/] Ironically, in some instances, the quiet periods – which were intended to prevent overly-optimistic, "booster shot" reports by firms – may prevent analysts from issuing revised, negative views regarding a company. This

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2711(g)(2)(B) and NYSE Rule 472(e)(4)(ii)) to note that the exception to personal trading prohibitions for "significant news or events" does *not* include earnings announcements.

23/ It also is not always clear whether a company must or intends to file a Form 8-K in relation to news or events. Such uncertainty would hinder firms' ability to provide research to investors in a timely manner. Frequently, by the time it is clear whether a company will file a Form 8-K, the value of the research to investors, which is intrinsically linked to the speed of delivery, has been greatly diminished.

24/ *See* Proposed Rule Changes, at 2070 and 2075.

25/ *See id.* at 2075.

problem may not be cured by the fact that analysts may publish during lock-up quiet periods if there is significant news or a significant event regarding the company. For example, if an analyst covers Company X (a pharmaceutical company) and during a lock-up period, Company X's competitor (Company Y) receives patent approval for a similar drug that Company X is developing, the news regarding Company Y likely would have a significant negative impact on Company X's stock and the analyst's outlook. The analyst, however, would be precluded from publishing a report downgrading the stock because the SROs have interpreted "significant news or events" to exclude certain events away from the company that, nevertheless, may affect the company's stock price.[26/]

This restriction on analysts' ability to publish information not only fails to serve any public policy purpose, but results in a disservice to investors who expect and desire analysts' views on such important developments.[27/] In addition to impeding the flow of information, restricting publication after an analyst has initiated coverage on a company may inadvertently reveal information regarding an impending event (such as a lockup waiver) to market participants. This problem is another adverse consequence of a prohibition that is not necessary in the current environment.

While we support the NASD's proposal to eliminate quiet periods surrounding lock-ups, we believe the difficulties of complying with the proposed certification and documentation requirements overwhelm the benefits of the proposed change. As currently drafted, the NASD's proposal would eliminate quiet periods, but require firms to publish a certification in research reports that the firm has a bona fide reason for issuing the report. This certification requirement would impose additional burdens and costs on firms by requiring them to establish new mechanisms and technical specifications for making and maintaining the disclosures and tracking the lock-up expirations, waivers and terminations. Firms would be required to expend time and resources to create new technology and compliance infrastructures to support the additional certification requirement. The additional certification also would require firms to expand current supervisory reviews, which could delay the publication of reports and add an additional level of logistical challenges.

Any resulting benefits from the proposed certifications is questionable, given that Regulation AC currently requires analysts to, among other things, attest that all of the views

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[26/] *See* NASD Notice to Members 04-18; NYSE Information Memo No. 04-10, Exhibit A (stating that the "significant news or event exception is intended to allow for coverage in research reports and public appearances of news or events that have a material impact on, or cause a material change to, a company's operations, earnings or financial condition.")

[27/] The consequences are particularly acute for retail investors who are more likely to rely on one firm for all their research needs.

expressed in their research reports accurately reflect their personal views about any and all of the subject securities or issuers. The Regulation AC attestation encompasses the concepts the NASD proposes to cover in the new, additional certification and is broad enough, along with general market manipulation prohibitions, to address the NASD's concern that an analyst might issue a research report for the purpose of propping up the price of a stock. Moreover, supervisory review of research reports helps ensure that reports are issued for legitimate reasons and eliminates the potential for improper "booster shot" reports, which the quiet periods are designed to prevent. For these reasons, we do not believe the NASD's proposed additional certification requirement strikes an appropriate "balance between ensuring objective and reliable research on the one hand and permitting the flow of information to investors... on the other."[28/] Accordingly, we urge the SROs to eliminate any "quiet periods" surrounding the expiration, waiver, or termination of lock-up agreements without imposing new certification and documentation requirements.

F. While We Support the Proposed Exclusion from the Research Analyst Registration Requirements for Non-Research Personnel, We Urge the SROs to Apply This Exclusion More Broadly.

We thank the SROs for recognizing that the research registration requirements should not apply to non-research personnel because such requirements "were intended for those individuals whose principal job function is to produce research."[29/] However, we believe this rationale for excluding non-research personnel from research registration requirements applies *equally* to the majority of the Research Rules. To be sure, many of the Research Rules simply do not make sense in a non-research context and, if applied more broadly to non-research personnel, would lead to illogical and unintended consequences. For example, to the extent that a salesperson or trader may become a "research analyst" by authoring sales literature that falls within the very broad definition of "research report," the Research Rules would prohibit the supervision and pre-approval of such pieces by the sales or trading supervisor. Clearly, this would be an irrational outcome and undesirable from a regulatory perspective. Also, to the extent a salesperson or trader produces a one-off piece that meets the definition of "research report," his or her compensation would need to be determined pursuant to the factors in the Research Rules, which are specifically tailored for persons who are research analysts and totally inapposite for salespeople and traders.

While we appreciate the SROs' concern that an overly narrow definition of "research analyst" might cause firms to redirect research to other channels (*e.g.*, registered representatives

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28/ *See* Proposed Rule Changes, at 2068.

29/ *Id.* at 2074.

or traders),[30] we believe there already are a variety of safeguards in the SROs' rules governing communications with the public by non-research personnel. These safeguards require, among other things, that non-research personnel's communications with the public "shall be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service."[31] Also, there are a variety of disclosure requirements regarding conflicts of interest that apply to non-research personnel's communications.[32] For these reasons, we urge the SROs to exclude non-research personnel from the ambit of the Research Rules. Indeed, such exclusion is consistent with the Global Research Settlement, which strikes an appropriate balance by excluding materials produced by salespersons and traders from the definition of "research report."[33]

III. RESPONSES TO THE SROS' SPECIFIC REQUESTS FOR COMMENTS

A. We Support the Proposal to Exclude from the Definition of "Research Report" Materials Relating to Open-End Investment Companies and DPPs, and We Strongly Support an Exclusion for ETFs.

We support the SROs' proposal to exclude sales materials analyzing unlisted open-end investment companies and public direct participation programs from the definition of "research report" in the Research Rules. The SROs have determined to exclude these types of sales materials, in part, because they already are subject to "a separate regulatory regime, including NASD Rule 2210 and SEC Rule 482, and all sales literature must be filed with the NASD Advertising Regulation Department within ten business days of first use"[34] subject to certain enumerated exceptions. Because sales material analyzing open-end exchange-traded funds ("ETFs") also is subject to the same regulatory regime and must be filed with the NASD prior to use subject to applicable exceptions,[35] we believe such material also should be excluded from the definition of "research report." Sales material about ETFs presents the same issues as material regarding open-end investment companies and can be reviewed by the NASD in a similar manner.

30/ *See id.* at 2074.

31/ NASD Rule 2210(d)(1)(A).

32/ *See* NASD Rule 2210(d)(2); NYSE Rule 472(i) - (j).

33/ *See* Section I.1(e)(ii)(1) of the Global Research Settlement.

34/ *See* Proposed Rule Changes, at 2068-69.

35/ *See* NASD Rule 2210(c).

B. We Generally Support the NASD's Proposed Changes to the Personal Trading Rules Regarding Investments in Funds, and Also Urge the SROs to Provide Clarification Regarding the Calculation of Analysts' Fund Holdings.

As an initial matter, we reiterate the importance of adopting consistent rules in order to advance regulatory consolidation. While the SROs have proposed different rules regarding analysts' investments in funds, we assume a uniform standard ultimately will be adopted. In that regard, we generally support the NASD's proposal but believe it should be refined to address certain practical concerns. The NASD has proposed to: (1) eliminate the prohibition on analysts from investing in funds that have invested more than 20% of their assets in securities of issuers engaged in the same types of businesses as companies that the analysts follow; (2) retain the requirement that the research analyst account collectively owns no more than 1% of the assets of the fund; (3) retain the requirement that neither the analyst nor his or her household member has any discretion or control over the fund; and (4) impose a *new requirement* that neither the analyst nor his or her household member is made aware of the fund's holdings or transactions other than through periodic shareholder reports and sales material based on such reports (*i.e.*, the new "knowledge" requirement).

We agree with the NASD that the 20% prohibition imposes an unnecessary burden on analysts, their household members, and compliance professionals because (1) the 1% limitation guarantees a minimal ownership interest and provides adequate protection against any "conflicts," and (2) the notion that an analyst might have an incentive to influence a fund's investments via research is entirely remote.[36/] For these reasons, we ask the NYSE to conform its rules to the NASD's proposed formulation by deleting the 20% requirement.

However, we urge the SROs, in adopting this proposal, to *eliminate* the new knowledge requirement, *i.e.*, that in order for analysts and their household members to invest in funds, they must not have been "made aware of the fund's holdings or transactions, other than through periodic shareholder reports and sales materials based on such reports."[37/] Currently, the SROs' rules regarding analysts' investments in funds do *not* impose a requirement that analysts have no knowledge of a fund's holdings or transactions. We believe this current formulation is appropriate because there may be legitimate instances where a research analyst becomes aware

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36/ In addition to providing little protection beyond that already captured by the 1% limitation, the 20% requirement imposes burdens on firms, particularly where the analyst wishes to invest in a non-registered fund. It often is difficult for firms and analysts to obtain information about the holdings of non-registered funds, so firms are left in a position where they must prohibit investments in these funds or face regulatory risk. This result is unwarranted considering the negligible marginal benefit of the 20% limitation.

37/ *See* Proposed Rule Changes, at 2064.

of a fund's holdings or transactions. For example, the fund may be a customer of the firm, and the analyst may become aware of a fund's holdings or transactions while servicing the fund in a customer capacity. Further, an analyst may become aware of a fund's holdings in the normal course of performing due diligence on companies under his or her coverage universe, if the fund is a significant investor in a company covered by the analyst. In these cases, the analyst has no improper purpose for acquiring knowledge of fund holdings; he or she simply learns this information in the normal course of performing his or her duties.

Indeed, it is unclear how a firm could rectify the situation where an analyst is made aware of a fund's holdings – would the analyst be required to dispose of the holdings or cease coverage? For these reasons, we believe the SROs should eliminate the proposed new knowledge requirement. The 1% ownership limitation and the requirement that the analyst or household member has no control or discretion over a fund's investments should, in our view, provide adequate protection against any conflicts of interest that may arise by virtue of an analyst's or household member's investment in a fund.

Finally, we urge the SROs to clarify that, for purposes of determining the 1% ownership interest, the analyst's holdings should be calculated at the time the analyst *initially invests* in the fund and at the time of any *subsequent voluntary investments* that are unrelated to the initial investment. We believe this formulation is sensible and consistent with the approach the SROs have adopted for Divided Reinvestment Plans. Indeed, it is extremely difficult and sometimes impossible to calculate the percentage that an analyst's holdings represent in a fund on a daily basis. We believe the costs associated with such frequent recalculations exceed any marginal benefits that daily tabulations provide. The limitations on an analyst's initial and subsequent investments coupled with the other Research Rules (*e.g.*, disclosures of financial interest in subject company securities and other material conflicts, Regulation AC certifications) should be sufficient to address any potential conflicts arising from such ownership interest.

IV. OUTSTANDING ISSUES FROM THE JOINT REPORT: STREAMLINING REGISTRATION REQUIREMENTS FOR ANALYSTS AND SUPERVISORY ANALYSTS

We appreciate the thorough analysis of U.S. equity research contained in the Joint Report and ask that the SROs continue to implement the Report's recommendations. In particular, we urge the SROs to reconsider requests to eliminate the Series 7 or alternative prerequisite exam for analysts who are required to take the Series 86/87 exams.[38/] We believe analysts should be tested on job-specific requirements, and that relevant topics should be imported from the Series 7

38/ *See* Section V.B.9 of the Joint Report at 41-42.

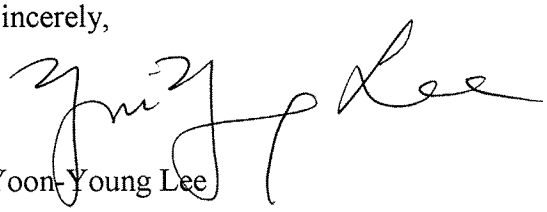
or its equivalent to the Series 86/87 exams. This more streamlined approach to registration would enable analysts to focus on the topics actually relevant to their daily work and communications with customers.

Also, in the interest of rule harmonization, we urge the SROs to harmonize their respective rules regarding the registration requirements for supervisory analysts. Currently, the NASD recognizes that a person who is registered as *either* a Series 16 or Series 24 and 87 may review and approve research reports, while the NYSE only allows persons who are registered as Series 16s to perform this function.[39/] In furtherance of regulatory consolidation and the important goal of a single rulebook, we ask the SROs to adopt a consistent rule regarding the registration requirements for supervisory analysts.

V. CONCLUSION

We reiterate our appreciation of the SROs' willingness to engage in a dialogue with the industry on the important topic of equity research and to respond to firms' concerns in a meaningful manner. Thank you for providing us with the opportunity to comment on the Proposed Rule Changes. If you have any questions, or if we can provide any further information, please contact the undersigned at 202-663-6720.

Sincerely,



Yoon-Young Lee

cc: ***U.S. Securities and Exchange Commission***

The Hon. Christopher Cox, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Roel C. Campos, Commissioner
The Hon. Annette L. Nazareth, Commissioner
The Hon. Kathleen L. Casey, Commissioner

39/ *See* NASD Rule 1022(a)(5) and NYSE Rule 344.11.

Erik K. Sirri, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation
James A. Brigagliano, Associate Director, Office of Trading Practices and Processing, Division of Market Regulation
Racquel L. Russell, Branch Chief, Division of Market Regulation

NASD

Mary L. Schapiro, Chairman and Chief Executive Officer
Elisse B. Walter, Senior Executive Vice President, Regulatory Policy and Programs
Marc Menchel, Executive Vice President and General Counsel, Regulatory Policy and Oversight
Phillip Shaikun, Associate Vice President and Associate General Counsel

NYSE

Richard G. Ketchum, Chief Executive Officer
Grace Vogel, Executive Vice President, Member Firm Regulation
Michael Rufino, Senior Vice President, Member Firm Regulation
William Jannace, Director, Rule and Interpretive Standards