

April 18, 2002

Jonathan G. Katz, Secretary
U.S. Securities and Exchange Commission
450 Fifth Street NW
Washington DC 20549-0609

Re: Release No. 34-45526; File Nos. SR-NASD-2000-21; SR-NYSE-2002-09
Research Analyst Conflicts of Interest

Dear Mr. Katz:

Please accept this letter from the North American Securities Administrators Association, Inc. (NASAA)¹ in response to the above-referenced Release relating to Research Analyst Conflicts of Interest. NASAA's primary mission is the protection of investors and, clearly, analyst objectivity is an important component in achieving an even playing field for those investors. We commend both the NYSE and the NASD for initiating thoughtful responses to the lamentable conflicts of interest on the part of research analysts observed in the late '90s. These excesses contributed to the steepness, rapidity and persistence of the decline in, particularly, the high-tech sector of the market the last two years. While the subject Release addresses many facets of the relationship between the research department and the rest of a firm, we will confine our commentary to those proposals which most directly affect investor confidence and which arouse regulatory concerns.

The intent of the Release is to eliminate conflicts of interest. We are not convinced that this goal has been achieved. Ultimately, current examinations and investigations may reveal the necessity for prohibiting the coexistence of the investment banking function and the research function within a single firm. We recognize that this would be a substantial departure from investment banking practice in the United States but, as facts continue to develop, it may be appropriate for the SEC to attempt a more profound solution than suggested by the NYSE and the NASD in this Release. It is, however, incumbent upon the SEC to carefully monitor the function of these Rules to see that a substantial degree of analyst independence is achieved.

NASD DEFINITIONS

As a general matter, NASAA urges that the Rules be of broad applicability and clearly understandable as to scope and reach. Departure from these principles occurs first in the definitions. For example, "research analyst" and "research report" must be considered together. A covered "report" would only be a communication distributed "...with *reasonable regularity*." Likewise, a "research analyst" would include only associated persons engaged in the production of a research report. It is nonsensical that the proscriptions on conflicts of interest contained later in the Release should be conditioned upon the frequency or regularity with which the conflicted opinion is published. Any associated person of such stature as to be afforded a public forum for the expression of his or her company-specific opinions about the future performance of an equity security should be covered by the Rule. What logic is there in applying these protections to the activities of every analyst who produces a "research report," no matter how thinly followed, and not applying them to the manager of a multibillion dollar mutual fund who even just once touts the merits of his largest holdings on national television?

The definition of "public appearance" would benefit from a second reference to electronic communication to make it clear that it extends to any form of public address. We would suggest that the definition read as follows: "public appearance" means any participation in a seminar, forum (including an interactive electronic forum), radio or television interview, or other public speaking activity, in person or electronically, in which a research analyst makes a recommendation or offers an opinion concerning an equity security.

It is ambitious, and meritorious in concept, that the NYSE and the NASD have undertaken to extend the reach of the regulation to cover additional persons who might benefit from an analyst's improperly influenced research reporting. This is commendable in intent but difficult of application. The SROs have fashioned a definition for any "member of a research analyst's household," which means, "any individual whose principal place of residence is the same as the

research analyst's principal residence." Accounts of persons covered by this definition would be subject to the same restrictions as the analyst's own account. One would presume that this language is intended to prevent an analyst from enjoying vicariously and/or collusively the benefits that the Rule seeks to preclude directly. While this formulation certainly picks up some relationships where abuse is possible, it may also pick up unintended individuals. It does not extend to others, such as business associates, who arguably are as likely to engage in the questioned behavior as any housemate. There is probably no perfect solution to this conundrum. Compliance with any formulation is going to be difficult to ascertain. NASAA suggests that the SEC thoroughly study this proposal to see if an alternative definition of analyst account can be crafted to more precisely accomplish the goals desired. In any event, the Rule should be carefully written and be closely monitored to see that it is accomplishing the desired result.

RESTRICTIONS ON INVESTMENT BANKING/RESEARCH DEPARTMENT RELATIONSHIPS AND SUBJECT COMPANY REVIEW

In developing these proposed rule changes, the NYSE and the NASD have chosen to limit, but not prohibit, communications between investment banking departments, subject companies, and research departments regarding content of research reports. The proposals permit review of and communications regarding the "factual accuracy" of information, or in the case of the investment banking department, screening for potential conflicts of interest. The legal or compliance department is installed as the "gatekeeper" through which communications from investment banking must pass, or where pre-publication modification of a report must be approved. We do not think that this is a workable structure, and are not convinced that research reports need to be reviewed at all by investment banking departments or subject companies.

If the purpose of the gatekeeper function is to prevent the highly profitable investment banking department from intimidating the dramatically less profitable retail department within the firm culture, the distinctly unprofitable compliance department is hardly the place to look for reinforcements. Likewise, research analysts are highly compensated individuals with considerable firm resources behind them. It is not unreasonable to expect them to get their facts straight without giving that portion of the report to the subject company for its own gloss, emphasis, and interpretation.

FORMS OF COMPENSATION

The NYSE/NASD rule proposals would prohibit compensation to an analyst, whether in the form of salary, bonus, or any other form of compensation, based upon a specific investment banking transaction. This is a natural and correlative principle, which flows from the rationale for all of these rule proposals. NASAA would suggest that it needs to be extended to include an anti-retaliation component, as discussed below. Likewise, a member should be prohibited from formulating or conditioning a research result based upon the receipt of business or compensation from a subject company.

QUIET PERIODS

NASAA does not believe that the "quiet periods" are sufficiently extended. We also believe that the quiet period should apply to the offerings of all companies, regardless of reporting status or size of public float.

Absent significant news or unexpected events, there is not a sufficient public interest rationale to permit an obligatory, virtually always positive, research report created by a research analyst employed *by an underwriter* within 90 days of an IPO or 30 days of a secondary offering. We also believe that this prohibition should be applied to public appearances by research analysts employed by the managers or co-managers of such underwritings.

RESTRICTIONS ON ANALYSTS' PERSONAL TRADING

NASAA would note that some firms have expressed the view that restrictions of this sort are unacceptably difficult to monitor and should simply be replaced with a ban on an analyst trading equities of industry participants he or she covers. We agree. Analysts are very highly compensated individuals who can afford to make a choice. They can choose to be analysts and refrain from trading in the industry they cover, or they can be traders, either for themselves or for their firm, and refrain from issuing research recommendations. It is not unreasonable to expect research analysts to be as

independent from their portfolios as they are from the investment banking departments of their firms. In any circumstance, NASAA also would urge that the restriction contained in A(g)(3) forbidding analysts to trade contrary to their own recommendations should be extended to trading by the firm for its own account. Firm trading in this circumstance can be more objectionable than that of the analyst because of the size of trades involved.

As to the investment fund exception, NASAA agrees that such an exception is appropriate as long as the screening criteria only permits investments in funds wherein the analysts' research coverage reaches a *de minimis* portion of a fund's holdings. In this respect, the 20% of assets ownership threshold for fund investment in "the same type of business as companies that the research analyst follows" is vague and may well be too high, depending upon how the cited language is interpreted. There should also be a prohibition on investments with funds that have more than five percent of their assets invested in companies that the analyst has in fact reported on in the past two years.

DISCLOSURE REQUIREMENTS

NASAA generally endorses the disclosure provisions contained in the Release. There is, however, one area where the proposed rule does not go far enough. Under Section A(h)(2)(i), it is NASAA's view that disclosure of member compensation from covered companies should be more extensive than proposed. We would suggest the disclosure extend to any compensation received by the member or an affiliate within three years before a report, or one year after.

The NASD specifically seeks comment on whether there are more appropriate designations of recommendation than "buy," "hold/neutral," or "sell." While there well may be clearer advisory standards, the confusion for investors in abandoning these familiar terms would far exceed the benefits of adopting a numerical or other system of reference. What is important in this regard is that the familiar terms are interpreted by the analysts and their employing firms to mean what they seem to mean.

NASAA approves of the NASD effort to give some meaning to the use of price targets in research reports. We have previously commented on the illogic of price targets such as those which appeared in 1999 and before, when stock prices were crashing through their targets on a weekly basis, only to have analysts raise their targets without explanation. Requiring analysts to disclose the valuation methods undertaken to determine a price target may assist investors in determining the weight to be given the recommendation. Finally, NASAA applauds the mandate that the disclosures must be on the front page of the research report and must otherwise be clear and prominent.

NASAA believes that the disclosure requirement related to employment relationships should be expanded to include disclosure of any past employment of the analyst by a subject company, regardless of the level of the position or the compensation involved. Disclosure should also be required of any employment relationships between subject companies and the analyst's immediate family.

MORE REFORM IS NEEDED

While the NYSE and NASD have taken notice of analyst abuses accompanying the last great run-up in the market, there are additional reforms needed to give their proposals the impact required to really change the way business is done. Professor John C. Coffee, Jr. of Columbia University in recent testimony before the U.S. Senate highlighted three such areas of reform, which NASAA wholeheartedly urges for consideration.

The first is the elimination of the so-called "booster shot." This pernicious practice is a method employed by insiders in an IPO to run up the price of their company's stock at the very end of the lock-up period, which typically extends for six months from the offering date. In this scenario a star analyst issues a highly favorable report just in time for insiders to sell their stock. This practice could be addressed simply by forbidding analysts whose firms are associated with underwriters from issuing reports within 30 days before and after the lock-up expiration date. Such a rule would be in keeping with the spirit of the "quiet period" proposed in Rule 2711.

The SROs should also consider a rule which prohibits research analysts from participating in promotional events designed to sell underwritings. It seems logically inconsistent to erect elaborate mechanisms to prevent investment banking departments from exerting influence over the independence of the research team, while permitting those same analysts to be star attractions at the so-called "road shows" to promote the underwritings. Clearly, an analyst's value to a

firm is in large part determined by how well he or she performs in these promotional activities and it is disingenuous to conclude that compensation is not affected as well.

Finally, to make these Rules work there must be teeth. The NYSE and the NASD should adopt an anti-retaliation rule which would provide severe penalties for attempts to intimidate or punish an analyst for producing negative research reports. Analysts report threats and retaliation from both employers and covered issuers.

CONCLUSION

It would be naive to conclude this letter without reference to the events which are taking place in New York and the disturbing story told by Merrill Lynch E-mails wherein analysts deride their own opinions and express their regret about having to issue positive reports on companies they believe offer poor investment prospects. New York has performed an important service in bringing tangible evidence of these practices to the light of day. In the next few weeks regulatory responses will be forthcoming on many fronts and NASAA expects to fully participate to protect the interests of Main Street investors.

NASAA commends all involved in this undertaking to strengthen the independence of analysts' research and to eliminate the conflicts of interest that are so apparent in the current system. The ultimate goal for all of us is to make the research process a fairer and more useful tool for investors. We are encouraged by the thoughtfulness of many of the proposals and hope that additional measures will be developed to effectuate real reform in the way that research is conducted and delivered to the investing public.

Sincerely,

Joseph Borg
President

¹ The oldest international organization devoted to investor protection, the North American Securities Administrators, Inc. was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.