Setting the global standard for investment professionals

5 March 2007

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington DC 20549-9303

Re: Self-Regulatory Organizations: Proposed Rule Changes to Amend NYSE Rules 472 and 344; and NASD Rules 1050 and 2711 Relating to Research Analyst Conflicts of Interest (Ref. SR-NYSE-2006-78 and SR-NASD-2006-113)

Dear Ms. Morris:

The CFA Institute Centre for Financial Market Integrity ("CFA Centre" or the "Centre")[1], in consultation with its Capital Markets Policy Council, is pleased to comment on the Securities and Exchange Commission's (the "SEC" or the "Commission") consultation paper on self-regulatory organizations ("SROs"), *Proposed Rule Changes to Amend NYSE Rules…and NASD Rules…Relating to Research Analysts Conflicts of Interest* (collectively and individually the "Proposals"). The CFA Centre represents the views of investment professionals before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the efficiency and integrity of global financial markets.

The CFA Centre recognizes and supports the need for the SROs to review and update their rules to remedy problems and concerns that may have developed since they were original implemented. And while the CFA Centre supports some of the Proposals, it does not support all of them. For example, the loosening of restrictions on the investing activities of household members of analysts who are not principals with their investment firms is acceptable with appropriate disclosures. On the other hand, permitting firms to choose where to publish information about the conflicts of interest they and their analysts have on the firm's Web page is not acceptable. Likewise, the Proposals reducing the quiet periods imposed on firms involved with initial public offerings and lock-up agreements would create a situation that may impair the integrity of investment research.

[1] The CFA Centre for Financial Market Integrity is a part of CFA Institute. With headquarters in Charlottesville, Virginia, USA, and regional offices in London, Hong Kong, and New York, CFA Institute, is a global, non-profit professional association of nearly 89,500 financial analysts, portfolio managers, and other investment professionals in 129 countries and territories of which more than 77,000 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 134 Member Societies and Chapters in 55 countries and territories.

Charlottesville Hong Kong London
560 Ray C. Hunt Drive
PO Box 3668
Charlottesville, VA
22903-0668 USA
434 951 5499 tel
434 951 5262 fax
info@cfainstitute.org
www.cfainstitute.org

Summary of the Proposed Rule Changes

The Proposals relate to two separate sets of proposed rule changes relating to analyst conflicts of interest. One is from the New York Stock Exchange ("NYSE" or the "Exchange") and the other is from the National Association of Securities Dealers ("NASD"). For the most part, the two sets of Proposals relate to the same issues and propose to handle them in similar ways. The primary issues are the following:

- Exemptions to current restrictions on trading securities by authors of investment research;
- Restrictions on trading securities by persons associated with the authors of investment research;
- The term of the blackout periods imposed on investment firms and analysts surrounding initial public offerings which the firms helped underwrite;
- The term of the blackout periods imposed on investment firms surrounding the expiration/termination/waiver of lock-up agreements;
- The location of disclosures about the conflicts of interest affecting the investment firms and analysts who publish and author investment research;
- Changes to the definition of investment research to exclude both the securities of open-ended investment companies that are not listed on an exchange, and public direct participant programs;
- Further restrictions on pre-publication reviews of investment research; and
- Prohibitions on retaliation against research analysts for the content of their research.

The specific rules covered by the Proposals include Rules 472 ("Communications with the Public") and 351 ("Reporting Requirements") of the Exchange, and Rules 1050 ("Registration of Research Analysts") and 2711 ("Research Analysts and Research Reports") of the NASD (collectively the "Rules").

As noted by the NYSE in the Proposals, these rules were implemented in 2002 to "improve objectivity and transparency in equity research and provide investors with more reliable and useful information to make investment decisions… [T]he rules were intended to restore public confidence in the validity of research and the veracity of research analysts… [T}he trustworthiness of research had eroded due to the pervasive influences of investment banking and other conflicts that had manifest themselves during the market boom of the late 1990s."

The CFA Centre supports the perspective given by the Exchange regarding the original need and intent of the Rules and believes these perspectives remain relevant. Furthermore, with the revival of the initial public offering market, confidence in the validity of investment research and the veracity of research analysts is as important today as it was in 2002. It is with this perspective in mind that the CFA Centre responds to each of the specific Proposals.

NYSE and NASD Proposed Rule Amendments

Restrictions on Trading Securities by Associated Persons

Both SROs propose to provide exceptions from prohibitions on trading securities for analysts with firms that have internal policies prohibiting analyst ownership of covered securities. The exception also would cover firms where the analysts are engaged in orderly and planned liquidation of such securities.

The CFA Centre does not object to this Proposal in large part because if the firms have policies against trading and their analysts are found to be trading, the analysts are likely to face termination from the firm. Consequently, it is likely that most analysts at these firms won't be trading and that the firms will police their employees to ensure their policies and procedures are followed.

The NASD also proposes to make an additional exception that would permit research analysts to invest in any fund "so long as neither the analyst nor a member of his or her household is aware of the fund's holdings or transactions other than through periodic shareholder reports and sales material." The NASD's proposal also stipulates that the research analyst cannot own more than 1% of the assets of the fund, thus eliminating the NASD's "20% asset diversification threshold."

The 20% asset diversification threshold refers a provision relating to the percentage of a fund's assets that are invested in securities of issuers whose business is principally the same as those that the research analyst covers.

The NASD says the change would simplify the ability of analysts to invest in mutual funds, and hedge funds that "do not disclose their holdings other than through periodic reports and sales material." If neither the analyst nor a household member has "discretion or control of an account or contemporaneous knowledge of the account's transactions," the NASD believes that "a minimal investment by a research analyst will not influence the analyst to compromise research objectivity to benefit the account."

The Exchange, on the other hand, has chosen to retain the 20% asset diversification threshold. The reason it gives for this difference is the threshold "has the potential for limiting possible conflicts of interest in the issuance [of] research reports by analysts with a vested interest in a fund."

The CFA Centre believes that while a 1% stake in an investment fund is a small percentage of the ownership of the fund, it could represent a significant portion of a research analyst's personal wealth. Consequently, such an investment could affect the objectivity of the analyst's research reports. The 20% diversification threshold appears to limit the ability of a research analyst to invest in a fund that places a large percentage of its assets in companies or sectors that the research analysts covers, thus reducing the potential conflicts of interest.

Consequently, the CFA Centre supports the NYSE's choice to retain the 20% asset diversification threshold.

Trading restrictions on research analysts and their household members

The Proposals also contain provisions to clarify that investment professionals who are household members of investment analysts can maintain control and discretion over their firms' investment activities, so long as the household members are not principals in their firms.

The CFA Centre recognizes the difficulties presented by placing wholesale trading restrictions on household members of analysts who produce investment research. Nevertheless, the potential access to material non-public information is a serious issue about which investors should be made aware. Consequently, the CFA Centre supports the Proposal to clarify the restrictions but urges the SROs to require that analysts and firms publishing the research to fully disclose such relationships on the front pages of their research reports.

Restrictions on Issuance of Research Reports and Participation in Public Appearances

Under current rules, firms are not permitted to publish research about the securities of an issuer for which the investment firm has acted as a manager, co-manager, underwriter or dealer in an initial public offering until 40 days after the offering date. A black-out period of similar length is imposed on investment analysts who work for such firms to prevent them from recommending the securities in a public appearance. The Proposals would reduce the blackout period to 25 days after issuance.

Reducing the blackout period from 40 days may provide some benefits to investors, as an embargo on research of this length gives new investors in the securities plenty of time to access research from other firms and analysts. It also likely that any inside information obtained by a research provider during the underwriting process will have lost its value by this time.

However, the CFA Centre believes that investors should have at least 30 days after the close of an initial public offering to make their determinations about valuation without the potentially conflicted perspective of analysts working for firms that helped underwrite the offerings. More importantly, the extra few days provided by a 30-day instead of a 25-day quiet period will provide sufficient time to ensure the research and recommendations are not based on inside information gained by the analyst of the firm through investment banking activities or contacts.

A quiet period of 30 days also is a best ethical practice contained in the CFA Centre's Sell-Side Research Objectivity Standards (the "Standards"). The Standards were developed by a task force of investment professionals with significant and direct experience in the investment business and in research. Their view that 30 days is needed following the conclusion of an initial public offering for many of the reasons cited provides further support for this view.

Black-out periods for research around the expiration/termination/waiver of a lock-up agreement

In this Proposal, the SROs suggest reducing the blackout periods around the end of lock-up agreements to 5 days from 15 days. The NYSE notes as justification for the two-thirds reduction that the five-day period is sufficient to balance against the potential issuance of "booster shot" reports — research intended to raise the stock price of the company just before the locked-up shares become freely saleable into the market — with the prompt dissemination of valuable information to the market.

Nevertheless, the Exchange justifies the retention of a five-day quiet period because of the "recent strength of the IPO market" and the common inclusion of lock-up agreements in these offerings. It also says that "at this juncture it is appropriate to maintain a form of prohibition absent some compelling empirical data/evidence to the contrary." Finally, it says that an embargo on research around the end of such agreements is necessary because "an analyst can conceivably write a research report with an honestly held opinion, but advantageously time the publication of the report for inappropriate reasons."

From the Proposals, it does not appear that the Exchange has data to support a revision of the quiet period, but rather says recent events support its retention. The CFA Centre agrees with the Exchange about the retention of a quiet period, but encourages the Commission to retain the current 15-day embargo until proof is provided that firms and analysts have not attempted to manipulate the market with research just prior to the end of the lock-up.

Disclosure of Conflicts of Interest

The SROs propose to permit research issuers to choose where to disclose conflicts of interest that may affect their objectivity regarding specific research reports. Such conflicts might arise from ownership of securities in a company that is the subject of research published by the firm.

The Proposals would permit the research issuers to choose between disclosing the conflicts of interest (i) on the firm's Web site together with a prominent warning on the front page of the research report noting the conflicts and the Web address to find related information; or (ii) by including the disclosures on the front cover of the research report or by referring the reader to the page of the report where such disclosure is provided, as is currently required.

While the CFA Centre supports Web site disclosure of conflicts of interest affecting investment research, it believes Web site disclosure should supplement, not replace, prominent full disclosure. Further, prominent full disclosure about conflicts of interest, rather than notification of where to find the information, should appear on the front page of the research reports.

Relying solely on a Web site for such disclosures carries at least two important problems. First, it is often difficult for even experienced investment professionals to locate such disclosures on the Web site of a research issuer. Secondly, the separation of the disclosure of conflicts of interest from the actual research report could cause investors to forget to review the Web site after completing a review of the report, thus leaving them uninformed about the conflicts of interest underlying the report.

The CFA Centre also believes that analysts visually or audibly presenting their views about their investment research should disclose prominently verbally and, where applicable, visually the conflicts of interest the analyst and the company have with regard to the subject company. Without such disclosures, investors would face the same difficulties that investors already have in obtaining disclosures from a firm's Website. These difficulties would be exacerbated by the fact that investors often would have to wait until they returned to their offices or homes to engage in the often difficult search for information about the conflicts.

Exemptions for Investment Companies from the Definition of Equity Research

The SROs propose amending the definition of research report to specifically exclude (i) an unlisted open-end registered investment company that is not traded on an exchange, and (ii) a public direct participant program ("DPPs"). These exclusions are justified, the NYSE says, because "these investment companies and DPPs are 'equity securities'" under the Exchange Act and, consequently, related sales material that contains an analysis of those securities and information that is sufficient upon which to base an investment decision is covered by the definition.

However, the exclusion would not extend to exchange-traded funds ("ETFs"). The sole reason given for this position is that these funds trade on an exchange.

The CFA Centre does not believe the amended definition would create difficulties or hardships for investors. However, the NYSE should more precisely define the types of investment companies targeted by this Proposal.

Pre-publication review of research by investment banking

The Proposals would further restrict pre-publication review of investment research by eliminating all such reviews except those provided by individuals from the firm's legal or compliance departments. The NYSE states that a factual review by investment banking is unnecessary because of the "numerous other sources available to verify factual information, including the subject company…" The Exchange adds that such reviews by investment banking personnel could invite pressure "that could be difficult to monitor."

The CFA Centre supports this Proposal and the reasons given in support.

Prohibition on Retaliation Against Research Analysts

The NYSE proposes to amend Rule 472(b) to extend the prohibition on research analysts from communicating their views about an investment banking transaction involving a current or former client in the presence of either investment banking personnel or the investment banking firm's management. The Exchange notes that the amendment seeks to "further mitigate potential conflicts of interest in intra-office communications."

The CFA Centre suggests in the Standards that firms should prohibit research analysts from participating in market activities, including roadshows for IPOs and secondary offerings. The Standards further suggest that in those cases where firms do permit their research analysts to participate in such activities that the analysts should disclose this participation in all interviews and public appearances.

Consequently, the CFA Centre supports the extension of the rule as proposed.

Prohibition on Retaliation Against Research Analysts

The Proposals would extend to all employees of broker/dealers the rule currently prohibiting investment banking personnel from retaliating against a research analyst for unfavorable research reports or public appearances.

The CFA Centre supports the extension of the rule as it will eliminate other potential influences from interfering or pressuring an analyst to change their research opinions.

Concluding Comments

The CFA Institute Centre for Financial Market Integrity is pleased to submit its views on the *Proposed Rule Changes to Amend NYSE Rules…and NASD Rules…Relating to Research Analyst Conflicts of Interest.* If you or your staff have questions or seek clarification of our views, please feel free to contact either Kurt Schacht, CFA, at +1.212.756.7728 or kurt.schacht@cfainstitute.org, or James C. Allen, CFA, at +1.434.951.5558 or james.allen@cfainstitute.org.

Sincerely,

/s/ Kurt Schacht

Kurt Schacht, CFA
Managing Director
CFA Centre for Financial Market Integrity

/s/ James C. Allen

James C. Allen, CFA
Senior Policy Analyst
CFA Centre for Financial Market Integrity