

## COMMENT LETTER

March 5, 2007

# Institute Letter on NASD and NYSE Proposals Relating to Research Analyst Conflicts of Interest (pdf)

March 5, 2007 Nancy M. Morris Secretary U.S. Securities and Exchange Commission 100 F Street, N.E. Washington, D.C. 20549-1090 Re: Research Analyst Conflicts of Interest (File Nos. SR-NASD-2006-113 and SR-NYSE- 2006-78) Dear Ms. Morris: The Investment Company Institute<sup>1</sup> supports NASD's and the NYSE's continuing efforts to address research analyst conflicts of interest. The proposed amendments to NASD and NYSE rules in this area<sup>2</sup> are the latest in a series of rulemaking and interpretive guidance to address such conflicts.<sup>3</sup> Of significance to Institute members are proposed changes to the definition of "research report" for purposes of the rules and, in particular, the exclusion of sales material about certain registered open- end investment companies from the definition. While the Institute strongly supports this aspect of the proposal, we believe that sales material about all registered investment companies similarly should be excluded from the definition.<sup>4</sup>

**Exception to Definition of "Research Report" for Certain Open-End Investment Companies**

Currently, the definition of "research report" includes a "written (including electronic) communication that includes an analysis of equity securities of individual companies or industries, and 1 The Investment Company Institute is the national association of the U.S. investment company industry. More information about the Institute is included at the end of this letter. 2 SEC Release No. 34-55072 (January 9, 2007), 72 FR 2058 (January 17, 2007) ("Release"). 3 The NASD and NYSE proposed rule changes are almost identical. For purposes of this letter, we refer to the language in the NASD proposed rule change. 4 References in the letter to "registered investment companies" include exchange-traded funds ("ETFs"), closed-end investment companies, and unit investment trusts ("UITs"). Nancy M. Morris March 5, 2007 Page 2 of 5 that provides information reasonably sufficient upon which to base an investment decision."<sup>5</sup> The proposal would amend the definition to exclude any communication that includes an analysis of an "open-end registered investment company that is not listed or traded on an exchange."<sup>6</sup> The Institute strongly supports expressly excluding these communications from consideration as a "research report." As the Institute explained in several comment letters on the initial NASD and NYSE rules as well as amendments to those rules,<sup>7</sup> communications regarding registered investment companies and by investment company personnel are very different from communications regarding corporate issuers. As such, including these communications in the scope of the rules would not address the types of conflicts that were the impetus for the rules. It also could place burdensome requirements on sales material and other communications about registered investment companies with no discernable benefits.

**Sales Material Regarding All Registered Investment Companies Should be Excluded from**

the Definition of "Research Report" While the proposal would exclude sales material and other similar communications regarding certain open-end funds from the scope of the rule, sales material relating to other registered investment companies would remain subject to the rules' requirements. We believe that all registered investment companies should be treated the same under the rules and should be excluded from the definition of "research report." We do not believe there are practical reasons to distinguish between different types of registered investment companies for purposes of the rules. Doing so will only lead to confusion and uncertainty on the rules' application. It also could place these investment companies at a competitive disadvantage to other investment companies that are not subject to the rules' requirements. The Release provides two reasons why only open-end investment companies that are not listed or traded on an exchange would be excluded from the definition of "research report." First, the conflicts underpinning the rules do not exist with respect to research on open-end investment companies that 5 NASD Rule 2711(a)(9). The Release states that because investment companies are "equity securities" as defined in Section 3(a)(11) of the Securities Exchange Act of 1934, related sales material that analyze those securities and provide certain information sufficient upon which to base an investment decision technically is covered by the definition. 6 NASD and the NYSE, in a recent amendment to their rules, codified existing interpretive guidance relating to the definition of "research report." The amendment excludes from the definition "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 account's past performance or the basis for previously made discretionary investment decisions." SEC Release No. 34-54616 (October 17, 2006), 71 FR 62331 (October 24, 2006). 7 See, e.g., Letter from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute to Barbara Z. Sweeney, NASD Regulation, dated August 15, 2001; Letter from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated April 18, 2002; Letter from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated March 10, 2003; and Letter from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated June 19, 2003. Nancy M. Morris March 5, 2007 Page 3 of 5 are not listed or traded on an exchange as they do for other types of issuers. Second, sales material regarding investment companies is already subject to a separate regulatory regime, including NASD Rule 2210 and SEC Rule 482, and all advertisements and sales literature regarding registered investment companies must be filed with NASD within ten business days of first use. Registered Investment Company Sales Material Do Not Raise the Conflicts Underpinning the Rules The concerns that led to the enactment of the rules did not relate to any type of registered investment company, whether or not listed or traded on an exchange or organized as an open-end fund. These concerns directly related to conflicts raised by securities offered by corporate issuers and the interaction between investment bankers and research analysts in this area. As compared to corporate issuers, research analysts covering registered investment companies are not subject to the same influences and conflicts that may compromise the objectivity of their research, or to pressure from registered investment companies and their shareholders to maintain favorable ratings. We also are not aware of any registered investment company that have been the subject of any enforcement actions or examinations related to compliance with the rules. Finally, the proposed rule changes are the result of a NASD and NYSE joint report examining the operation of the rules and any necessary changes to the rules.<sup>8</sup> The numerous examples cited in the report as the basis for the rules all relate to corporate issuers. Registered Investment Company Sales Material are Subject to a Rigorous Regulatory Regime The Release correctly does not differentiate

between sales material of open-end funds that are not listed or traded on an exchange and other registered investment companies when it states that one of the reasons for the proposed exemption is that sales material regarding “investment companies” is already subject to a separate regulatory regime. Advertising and sales literature of registered investment companies are subject to NASD review and SEC rules and regulations in the same or a similar manner as open-end funds not listed or traded on an exchange. The Institute believes these rules and regulations help ensure that investment company sales material and advertising will contain content that is fair and objective and should resolve many of the concerns that NASD and the NYSE are trying to address. Because both UITs and ETFs (which are organized as either registered open-end funds or as UITs) are covered by the filing and substantive requirements of NASD Rule 2210, NASD reviews sales material and advertisements related to UITs and ETFs. To the extent ETFs are organized as open-end

8 “Joint Report by NASD and the NYSE On the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules,” December 2005. Nancy M. Morris March 5, 2007 Page 4 of 5 funds, they are fully subject to the requirements of Rule 482 under the Securities Act of 1933. While the SEC’s performance advertising standards of Rule 482 do not apply to UITs as they do to open-end funds, UITs (and those ETFs organized as UITs) are subject to similar requirements under Rule 34b-1 under the Investment Company Act, which generally requires investment company sales literature that contains performance data to meet the requirements of Rule 482.9 Sales literature and advertising about closed-end funds primarily occur during their public offering period and must be filed within 10 days of first use under NASD Rule 2210. While any advertisements or sales literature about closed-end funds that may occur once the fund is trading on an exchange do not have to be filed,10 all sales material is subject to Rule 156 under the Securities Act and to the NASD’s content standards under Rule 2210.11 \* \* \* \* \*

Given the reasoning behind the conflict of interest rules and experience with the application of the rules to date, we question the need to apply the requirements of the rules to any registered investment company. The Institute therefore urges NASD and the NYSE to exclude all registered investment company sales material and similar communications from the definition of “research report.” If you have any questions about our comments or would like any additional information, please contact me at 202-371-5408. Sincerely, /s/ Ari Burstein Ari Burstein Senior Counsel 9 In addition, Section 24 of the Investment Company Act and Rule 24b-3 thereunder require all sales literature used by open-end funds and UITs to be filed with the SEC or NASD before use or within 10 days afterward. This creates filing liability for such literature under Section 34 of the Investment Company Act. The requirements of Rule 156 under the Securities Act, which make it unlawful for any person to use sales literature that is materially misleading in connection with the offer or sale of securities issued by an investment company, also apply to all registered investment companies. 10 Certain closed-end funds, i.e., “interval funds,” are continuously offered and therefore must continue to file within 10 days of first use all advertisements and sales literature. 11 Under the NASD’s content standards, any sales material must be balanced and provide a sound basis for evaluating the facts with respect to an investment in such funds. Nancy M. Morris March 5, 2007 Page 5 of 5 cc: Erik R. Sirri, Director James A. Brigagliano, Associate Director Division of Market Regulation Andrew J. Donohue, Director Division of Investment Management Securities and Exchange Commission Marc Menchel, Executive Vice President and General Counsel Patrice M. Gliniecki, Senior Vice President and Deputy General Counsel Philip Shaikun, Associate Vice President and Associate General Counsel NASD \* \* \* \* \*

About the Investment Company Institute ICI members include 8,839 open-end investment companies (mutual funds), 658 closed-end investment companies, 363 exchange-traded funds, and 4 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately \$10.445 trillion (representing 98 percent of all assets of US mutual funds); these funds

serve approximately 93.9 million shareholders in more than 53.8 million households.

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