



August 29, 2002

Ms. Barbara Z. Sweeney
NASD
Office of the Corporate Secretary
1735 K Street, NW
Washington, DC 20006-1500

Re: Notice to Members 02-44. Comment on Application of Rule 2711 to Small Firms.

Dear Ms. Sweeney:

The Investorside Research Association (“Investorside”) is pleased to have this opportunity to comment on the above-referenced Notice to Members addressing the new NASD Rule 2711.

The members of Investorside include the following firms:

Argus Research

Avalon Research

Battle Road Research

BNY Jaywalk, Inc.

GARP Research

Investars

OTA-Off the Record Research

Schaeffer’s Investment Research

Vista Research

Vickers Stock Research

The Precursor Group¹

¹ Certain of the above Investorside members have affiliations with NASD member firms.

Ms. Barbara Z. Sweeney
August 29, 2002

Investorside is a Washington D.C. based non-profit organization formed to increase investor and pensioner trust in the U.S. capital market system through the promotion and use of investment research that is financially aligned with investor interests. The goals of our organization are to: 1) increase awareness of the financial interests behind investment research; 2) educate investors as to how they can better align investment research with their interests; 3) promote fair representation of investment research to investors; 4) reduce regulatory and industry barriers to competition; and 5) promote “Best Research Payment Practices” such as unbundling research from banking and proprietary trading. Investorside also seeks increased transparency and accountability over how commissions are spent for research in order that investors will be better able to protect their interests by supporting independent investment research.

Investorside members are required to attest that: 1) they are not in the business of providing investment banking or significant issuer consulting services; 2) they are primarily paid by a client base of investors, not by issuers of securities who are the subject of research; and 3) they are in good standing with all relevant regulatory/governmental authorities.

Our Comments

NASD Notice to Members 02-44 seeks comment on whether smaller NASD members should be exempt from certain provisions of NASD Rule 2711. As providers of independent research to the investment community, we suggest that in determining which NASD members should be exempted from, or relieved from the burdens of, provisions of NASD Rule 2711, the NASD should focus not on the size of the member firm, but on the potential conflicts of interest

Ms. Barbara Z. Sweeney
August 29, 2002

raised by the types of business engaged in by the member firm. Firms such as the members of Investorside, which are structured to avoid the conflicts raised by investment banking relationships or other arrangements with the issuer subjects of research reports, should be exempted from some if not all of the provisions of Rule 2711.

Investorside supports the efforts of the NASD, NYSE and SEC to eliminate research analyst conflicts of interest to the extent possible and to require meaningful disclosure of all conflicts that remain. However, for the reasons noted below, Investorside submits that by imposing burdens on firms producing research independent of investment banking and issuer conflicts, NASD Rule 2711 may actually serve as a barrier to entry for firms seeking to provide an alternative to traditional sell-side research. Investorside believes that the regulatory scheme should encourage, rather than discourage, the use of research free of conflicts of interest.

**Rule 2711 Should Apply to Members Based Upon
Their Business Mix, Not Their Size**

Notice to Members 02-44 seeks comment on whether smaller NASD member firms should be granted an exception to the application of Rule 2711. Investorside believes this line of thinking misses the mark. The purpose of Rule 2711 is to discourage, and/or require disclosure of, conflicts of interest between member firms who produce research and the consumers of such research. Such conflicts arise due to the business activities of member firms, and not the size of the firms. For example, a small NASD member firm who engages in only three investment banking transactions per year would still face a conflict of interest if it chose to publish a research report concerning an issuer who was also an investment banking client, while

Ms. Barbara Z. Sweeney
August 29, 2002

a larger (on a revenue basis) NASD member who has no investment banking department would not face any conflict issues at all with respect to investment banking transactions. Accordingly, Rule 2711 should apply based upon the business activities of member firms and not their size.

In the SEC Release approving the adoption of Rule 2711,² the Commission noted that the purpose of the rule was to address conflicts of interests which arise “when analysts work for firms that have investment banking or other business relationships with issuers of the recommended securities” The definition of research report under Rule 2711, however, is not limited to reports produced by firms with investment banking departments, but rather applies to all NASD members. While many, if not most, of the disclosures required under Rule 2711 do not apply to research produced by Investorside members because our members neither have investment banking departments nor enter into arrangements where they are compensated by the subjects of research reports,³ some of the provisions of the rule apply with equal force to producers of independent, investor-side research as they do to firms with an active investment banking department.⁴

Two provisions of NASD Rule 2711 seem particularly onerous when applied to firms producing independent, investor-side research. First is the requirement in Rule 2711(h)(5)(A) that a member disclose in each research report the percentage of all securities to which the member has assigned a buy, sell or hold rating, even if the member does not employ a rating system that uses these terms. Some Investorside members do not purport to issue “ratings” of

² SEC Release No. 34-45908 (May 10, 2002)

³ See, e.g., Rule 2711(b) (Restrictions on Investment Banking Department Relationship with Research Department); 2711(d) (Prohibition of Certain Forms of Analyst Compensation); 2711(e) (Prohibition of Favorable Research); 2711(f) (Imposition of Quiet Periods); and 2711(h)(2) (Receipt of Compensation).

⁴ See, e.g., Rule 2711(h) (1), (3)-(10).

Ms. Barbara Z. Sweeney
August 29, 2002

securities, but because of the broad definition of research report, Rule 2711(a)(8) may arguably find their research publications within such definition when they address the strengths and weaknesses of various issuers or securities. Producers of investor-side research are not subject to the same conflicts as firms with investment banking departments, accordingly, imposition of such a rigid methodology on their research would serve only to stifle innovation and competition in the investment research market. Furthermore, many institutional consumers of research prefer “pure” research without a rating or valuation component.

The requirement in Rule 2711(h)(6) that research reports contain a price chart also is unduly burdensome and unnecessary when applied to producers of investor-side research. As discussed above, some investor-side research firms do not intend to assign ratings to securities, but may be drawn into this requirement by the expansive definition of research report. Requiring such firms, who do not face the investment banking conflicts which gave impetus to Rule 2711, to adopt expensive procedures to track ratings of securities, is unnecessary and unduly burdensome, especially for smaller firms. Moreover, in the absence of a demonstrated conflict, it should be up to the producers and consumers of research to determine the format in which research is presented.

Lumping together independent investor-side research with traditional sell-side research disserves the investing public in two ways. First, by imposing additional compliance and disclosure obligations upon investor-side research firms who have not been involved in the types of abuses chronicled in the financial and mainstream press in recent months, Rule 2711 impedes the distribution of such independent research to the public by raising compliance costs on firms

Ms. Barbara Z. Sweeney
August 29, 2002

that cannot subsidize their research through an investment banking department. Second, if investor-side research reports are required to contain the full panoply of disclosure required by Rule 2711, investors may wrongly assume that the firms who produce such reports are subject to the same conflicts of interest as firms who engage in investment banking transactions on behalf of issuers who are the subject of research reports. This would undermine the work Investorside has been doing to distinguish independent research from traditional, sell-side research.

Producers of Investor-Side Research Should be Treated The Same as Other Producers of Independent Research

In Attachment B to Notice to Members 02-39, the NASD and NYSE interpreted Rule 2711 not to apply to research distributed by an NASD member if the research is produced by an independent third party pursuant to a soft-dollar arrangement. The interpretation goes on to state that the provisions of Rule 2711 do not apply to research distributed by an NASD member but produced by a non-member affiliate (such as a foreign broker/dealer or an investment adviser) or an independent third party other than through a soft-dollar arrangement,⁵ as long as the NASD member distributing the research discloses the following, to the extent applicable:

- the member's and its affiliates 'ownership of the subject company's securities;
- that the member or its affiliates managed or co-managed a public offering of the subject company's securities in the past 12 months, received compensation for investment banking services in the past 12 months, or expects to receive or intends to seek compensation for investment banking services in the next three months;

⁵ It is unclear why research produced by an independent third party delivered other than through a soft dollar arrangement should be treated differently than research produced by an independent party through a soft dollar arrangement.

Ms. Barbara Z. Sweeney
August 29, 2002

- that the member was making a market in the subject company's securities at the time the research report was published; and
- any other actual, material conflict of interest of the member known at the time of distribution of the research report.

The interpretation presumably distinguishes between research produced internally by an NASD member and research produced by non-NASD member third parties and distributed by an NASD member, because third parties who produce research are not normally subject to the same conflicts of interest that apply to traditional sell-side research.

Investorside recommends that broker-dealers who do not have an investment banking department, and thus are free of the potential conflicts attendant thereto, should be exempted from NASD Rule 2711 in a similar manner as non-NASD member third parties, i.e., only be required to make the disclosures noted above to the extent applicable.⁶ Investorside further notes that the disclosures described above are comprehensive of potential conflicts which may arise between a producer of research and a consumer of such research, and thus exempting investor-side research firms who do not have an investment banking department from the provisions of Rule 2711, conditioned on their making the disclosures noted above, will not impede the NASD's goal of investor protection. Finally, by predicating the exemption from NASD Rule 2711 on the absence of an investment banking department, most smaller NASD member firms will receive relief from this regulatory burden, inasmuch as they typically do not have an investment banking department.

⁶ Of course the second item listed above would not apply to firms providing investor-side research

Ms. Barbara Z. Sweeney
August 29, 2002

* * * * *

We hope these comments assist the NASD in formulating a modification of Rule 2711 which addresses the concerns noted in this letter.

Sincerely,

Scott C. Cleland
Chairman
Investorside Research Association
CEO of the Precursor Group

John Eade
Vice Chairman
Investorside Research Association
President of Argus Research

cc: U.S. Securities and Exchange Commission:

Hon. Harvey L. Pitt, Chairman

Ms. Annette L. Nazareth, Director, Division of Market Regulation

Mr. Paul F. Roye, Director, Division of Investment Management

Mr. Robert L. D. Colby, Deputy Director, Division of Market Regulation

Mr. James A. Brigagliano, Assistant Director, Trading Practices
Division of Market Regulation, Office of Risk Management and Control