

NYSE, NASD Propose to Apply Research Analyst Rules to Fund and Alternative Investment Product Sales Literature SEC Approves Publication for Comment

On January 9, 2007, the SEC approved for publication and comment proposed changes to the NYSE's and NASD's Research Analyst rules ("Proposed Rule Changes"), NYSE Rule 472 and NASD Rule 2711 (the "Rules").¹ The Rules implement the recommendations in the December 2005 Joint Report by the NASD and NYSE on the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules (the "Report").² Comments must be submitted to the SEC by 45 days from publication in the Federal Register.

The Proposed Rule Changes amend the definition of "Research Report" so that sales literature for certain privately placed funds, public closed-end funds and ETFs, and other alternative investment products will be covered by the definition and will be subject to the requirements of the Rules. The change to the definition of "research report" is achieved by excluding sales material relating to "*open-end registered*

investment companies and *public* direct participation programs" ("DPP") (emphasis added). However, because the exclusion does not include other types of sales literature, such sales literature (for private funds, hedge funds, public closed-end funds and ETFs, and other alternative investment products) is included in the definition.³

The Proposed Rule Changes are a significant narrowing of the recommendations in the Report, which discussed how those rules cover investment company and DPP sales literature and recommended clarifications to exclude such sales literature from the coverage of the Rules.⁴ The Report did not distinguish between registered public funds and unregistered private funds and hedge funds, or alternative investment products. The NASD has, so far, declined several opportunities to clarify the definition in

¹ The proposed rule changes were filed with the SEC on September 27, 2006. The SEC published them for comment in Release No. 34-55072, SR-NYSE-2006-78, and SR-NASD2006-113 (Jan. 9, 2007); 72 F.R. 2058 (January 17, 2007).

² One set of changes recommended in the Report were routine and uncontroversial clarifications, and were previously published for comment and simultaneously approved by the SEC. See, Notice of Filing and Immediate Effectiveness of Proposed Rule Changes Relating to NYSE Rule 472 and NASD Rule 2711; Release No. 34-54616; File Nos. SR-NYSE-2006-77; SR-NASD-2006-112 (October 17, 2006); 71 F.R. 62331 (Oct. 24, 2006).

³ The current language of the definition of "research report" in Rules 2711 and 472 is "any . . . communication that includes an analysis of equity securities of individual companies or industries, and that provides information reasonably sufficient upon which to base an investment decision. . . ." The Proposed Rule Change amends the definition to add the italicized language: "any . . . communication that includes an analysis of equity securities of individual companies or industries (*other than an open-end registered investment company that is not listed or traded on an exchange or a public direct participation program*) and that provides information reasonably sufficient upon which to base an investment decision."

⁴ Report at p. 30.

any public forum. In fact, the NASD has privately stated that it views the Rules as applying to private fund and alternative investment product offering material and sales literature.⁵

In order to address this definitional issue and restrict the application of the Rule to its intended target—research reports on individual operating companies and the individual equity securities they issue—the Report recommended that “periodic reports, solicitations or other communications prepared for current or prospective investment company shareholders (or similar beneficial owners of trusts and limited partnerships) or discretionary investment account clients and that discuss individual securities,” should not be included within the definition of ‘research report,’ “provided that such communications discuss past performance or the basis for previously made discretionary investment decisions.”⁶

The Report recognized that such reports about investment company or similar securities do not present the same conflict of interest or disclosure risks to in-

vestors and that their content is heavily regulated or their circulation is carefully controlled.⁷

A representative of the NASD has orally advised us that the Proposed Rule Changes narrowing the Report’s recommendation were intentional and he agreed that the proposed definition of “research report” would cause unregistered investment companies and other equity alternative investment products to be subject to the draconian requirements of Rule 2711. The NASD and NYSE also chose not to exclude ETFs from the definition, but requested comment on whether ETFs should be excluded.

The NASD and NYSE did not request comment or otherwise raise the issue of whether unregistered investment companies or other equity alternative investments should be excluded from the definition. Indeed, structured products, although mostly debt issues, and some securities issued in private offerings that rely on Rule 144A under the 1933 Act, are occasionally considered equity issues, and sales literature on such products would also be subject to the Rule.

⁵ Because Regulation AC, adopted under the Securities Act of 1933 (“1933 Act”) and the Securities Exchange Act of 1934 to govern certification of analysts’ reports, uses the same definition of “research report,” the same conclusion could be drawn that Regulation AC also applies to private fund and alternative investment product offering material and sales literature.

⁶ Report at p. 30.

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⁷ *Id.* at p. 31.

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