

# Notice to Members

JULY 2006

## SUGGESTED ROUTING

Executive Representatives  
Fixed Income  
Investment Banking  
Legal & Compliance  
Operations  
Research  
Senior Management

## KEY TOPICS

Research Conflicts of Interest  
SEC Regulation Analyst Certification  
Supervision  
Rule 2711  
Rule 3010

## GUIDANCE

### Research Analysts and Research Reports

NASD and NYSE Joint Interpretive Guidance on  
Fixed Income Research

#### Background

In December 2005, the New York Stock Exchange (NYSE) and NASD (the SROs) issued a joint report that assessed the effectiveness of the SRO research analyst conflict of interest rules.<sup>1</sup> Those rules apply only to equity research reports.<sup>2</sup> However, the joint report noted that the SROs would monitor the extent to which firms have adopted the Bond Market Association's (BMA) "Guiding Principles to Promote the Integrity of Fixed-Income Research" (Guiding Principles)<sup>3</sup>, which are voluntary, principle-based guidelines designed to help firms manage potential conflicts of interest that may arise in the context of fixed income research activities. According to the BMA, the Guiding Principles were designed "to address the issue of research integrity in the fixed income markets in a manner that takes into account their unique characteristics."

The SROs note that voluntary trade association conduct standards are not the equivalent of sanctionable rules. As such, the SROs maintain the right to promulgate rules in the fixed income research area that may be different from, or analogous or additive to, the Guiding Principles. Nonetheless, the SROs regard as a worthy objective trade association efforts to promote aspirational standards and agree with the BMA that the Guiding Principles "serve as a helpful reference point as firms review and modify their own fixed income research practices." The SROs therefore believe a review of compliance with the Guiding Principles helps to inform consideration of whether more definitive rules are needed to regulate fixed income research.<sup>4</sup>

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To that end, the SROs conducted examinations of certain member organizations to assess how those firms have addressed conflicts of interest with respect to fixed income research. The examinations found many instances in which firms had failed to adhere to the Guiding Principles. Even more significantly, the examinations discovered several instances where firms failed to establish, maintain and enforce written supervisory procedures in the fixed income research area—a fundamental obligation under SRO rules<sup>5</sup>—or comply with existing SEC Regulation Analyst Certification (Regulation AC).<sup>6</sup> A general synopsis of the examination results follows.

### Questions/Further Information

Questions or comments concerning this *Notice* may be directed as follows:

**NASD:** Philip Shaikun, Associate Vice President and Associate General Counsel, Regulatory Policy and Oversight, at (202) 728-8451.

**NYSE:** William Jannace (212) 656-2744, Stephen Kasprzak (212) 656-5226 and Erika Lazar (212) 656-4591.

### Supervision

Instances were noted in which member organizations did not have effective written supervisory procedures for fixed income research in place pursuant to the SRO supervision rules and BMA Guiding Principle 4.10.1, which provide that firms should establish appropriate written policies and procedures to supervise fixed income research analysts. This Principle follows from the broader guideline found in Principle 4.10, which states that firms should allocate sufficient supervisory resources to promote the integrity of the fixed income research process.

In other cases, member organizations had supervisory procedures in place but failed to enforce them. For example, instances were noted in which fixed income research analysts made public appearances without documented approval by a supervisor, as required by the firm's written supervisory procedures. Further, several instances were noted in which analysts maintained outside personal investment accounts that were not approved by their legal and compliance departments, though such approval was required by the firm's written supervisory procedures. Apart from violating the member organizations' internal policies, these infractions are inconsistent with BMA Principle 4.5, which suggests that firms impose personal trading restrictions on fixed income research analysts to manage conflicts of interest.<sup>7</sup>

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## Disclosures

The examination results revealed that the most prevalent failure among member organizations with respect to the Guiding Principles involved the inadequacy of disclosures contained in fixed income research reports. BMA Guiding Principle 4.6<sup>8</sup> lists certain disclosures that should be included in a fixed income research report to inform investors of potential conflicts of interest that may affect fixed income research. These disclosures include: whether the analyst's compensation is based on such factors as the firm's overall performance, or the profitability or revenues of the fixed income department or the asset class covered by the analyst; whether the analyst or certain relatives have a financial interest in the security that is the subject of the research report (other than investment grade sovereigns); whether the analyst is affiliated with the issuer; whether the firm or its affiliates has managed or co-managed a public or Rule 144A offering for the issuer within the past 12 months; whether the firm trades or may trade as principal in the securities that are the subject of the research report; and, if the report contains ratings established by the firm, the meaning of those ratings. Instances were noted in which firms failed to include tailored disclosures in research reports specific to a subject company and/or did not include all of the necessary relevant disclosures. Blanket or boilerplate disclosures should not be used in a fixed income research report when more specific disclosures are necessary to alert investors to specific conflicts.

## Analyst Certifications

The examinations also found instances in which member organizations failed to comply with the requirements set forth in Regulation AC, which applies equally to fixed-income and equity research. Specifically, member organizations issued reports<sup>9</sup> that did not include the requisite analyst certifications in connection with research reports or that included references to analyst certifications that were insufficient because they did not direct the reader to the correct place to find the certification. Failures were similarly noted with respect to certifications required in connection with public appearances.<sup>10</sup>

## Conclusion

The SROs appreciate industry initiatives like the BMA Guiding Principles that foster better compliance policies within firms. In considering whether to engage in more definitive rulemaking, the SROs will continue to monitor the extent to which firms have adopted and adhered to the Guiding Principles or other supervisory systems regarding fixed-income research conflicts of interest that are reasonably designed to achieve compliance with applicable SRO rules and securities laws and regulations.

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## Endnotes

- 1 See "Joint Report by NASD and the NYSE on the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules" at [www.nasd.com/web/groups/rules\\_regs/documents/rules\\_regs/nasdw\\_015803.pdf](http://www.nasd.com/web/groups/rules_regs/documents/rules_regs/nasdw_015803.pdf) and [www.nyse.com/pdfs/rajointreport.pdf](http://www.nyse.com/pdfs/rajointreport.pdf).
- 2 NASD Rule 2711 (Research Analysts and Reports) and NYSE Rule 472 (Communications with the Public).
- 3 See "Guiding Principles To Promote Integrity of Fixed Income Research," May 2004, [www.bondmarkets.com/assets/files/Guiding\\_Principles\\_for\\_Research.pdf](http://www.bondmarkets.com/assets/files/Guiding_Principles_for_Research.pdf).
- 4 As the joint report noted, anti-fraud statutes, as well as existing SRO rules such as NYSE Rules 401 (Business Conduct), 476(a)(6) (allowing for disciplinary proceedings against a member organization for "conduct or proceeding inconsistent with just and equitable principles of trade"), and NASD Rule 2110 (which requires that members "observe high standards of commercial honor and just and equitable principles of trade") can reach and address any egregious conduct involving fixed income research.
- 5 See NYSE Rule 342 (Offices Approval, Supervision and Control) and NASD Rule 3010 (Supervision).
- 6 17 CFR 242.500 et seq.
- 7 Note also that NYSE Rule 407 (Transactions – Employees of Members, Member Organizations and the Exchange) prohibits any employee of a member organization to "establish or maintain any securities or commodities account...at another member or member organization, or a domestic or foreign non-member broker-dealer, investment adviser, bank, other financial institution, or otherwise without the prior written consent of another person designated by the member or member organization under NYSE Rule 342 (b)(1) to sign such consents and review such accounts." NASD Rule 3050 (Transactions for or by Associated Persons) requires an associated person to notify his or her employer member in writing when opening a securities account at a broker-dealer.
- 8 "Firms and research analysts should promote investor awareness of potential research analyst conflicts of interest by disclosing in fixed income research reports and/or elsewhere certain material factors that may be viewed as potentially affecting the integrity of specific security recommendations or investment conclusions."
- 9 17 CFR 242.501.
- 10 17 CFR 242.502.

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