

April 19, 1999

Katherine A. England  
Assistant Director  
Division of Market Regulation  
Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, D.C. 20549  
Mail-Stop 10-1

Re: SR-NASD-98-32 - Proposed Rule Change Relating to Filing Requirements for  
Independent Research Reports

Dear Ms. England:

This letter summarizes and responds to comment letters submitted by Morningstar, Inc. ("Morningstar"), the Securities Industries Association ("SIA"), T. Rowe Price Associates, Inc. ("T. Rowe Price"), and the Investment Company Institute ("ICI") in response to publication by the Securities and Exchange Commission ("SEC") of the proposed rule change referenced above. All of the commenters strongly supported the proposal, though they requested that NASD Regulation clarify its application and scope in certain circumstances.

1. Morningstar and the ICI requested clarification that proposed subparagraph (c)(6)(G)(ii), which would prohibit an investment company, its affiliates and any member from "procuring" the services of a research firm in order to qualify for the filing exemption, would not be interpreted to prohibit: (i) research firms from charging funds or members subscription fees or fees for producing, distributing and redistributing their reports, or (ii) the payment of fees to research firms retained on a "by request" basis to create customized reports or perform other separate research services based on a repackaging of information already published by the research firm.

**Response:** NASD Regulation proposes to address these comments by changing the rule proposal so that it prohibits the commissioning of research, rather than the procurement of a research firm's services. In addition, NASD Regulation now proposes to provide more flexibility to research firms and members to develop customized reports, provided that these

reports include only information that the research firm already has compiled and published in another non-customized report and does not omit information necessary to make the report fair and balanced. (Please see proposed new subparagraph (c)(6)(G)(vi), attached.)

2. Morningstar requested clarification that proposed subparagraph (c)(6)(G)(iii), which would require that the research firm prepare and distribute similar types of reports with respect to a substantial number of investment companies, would not be interpreted to require that each report be in an identical format or contain identical information. Morningstar expressed special concern about customized reports prepared on request.

**Response:** NASD Regulation proposes to amend proposed subparagraph (c)(6)(G)(iii) to clarify that, in order to qualify for the filing exemption, the research firm must prepare and distribute reports “based on similar research.” The requirement that the research firm prepare and distribute “similar types of reports” would be eliminated. The new proposal thus would provide greater flexibility with respect to this condition.

3. Morningstar requested clarification that proposed subparagraph (c)(6)(G)(iv), which would require that research reports be distributed and updated with reasonable regularity in the normal course of the research firm’s business, would not prohibit the distribution of customized reports prepared on request. Morningstar stated that such reports are entirely comprised of information that is otherwise issued under a distribution cycle and, when aggregated with reports issued under a distribution cycle, should be considered to have been distributed with reasonable regularity in the ordinary course of the firm’s research business.

Morningstar and the ICI requested clarification that proposed subparagraph (c)(6)(G)(iv) would not prohibit the distribution of research reports containing performance information that does not meet the currentness standards of SEC Rule 482, so long as the reports are accompanied with information that complies with the currentness standards in SEC Rule 482.

**Response:** As discussed above in the responses to comments 1 and 2, new proposed subparagraph (c)(6)(G) would still exempt from the filing requirements customized reports prepared on request that are entirely comprised of information completed and published in another report, provided that the customized report does not omit information necessary to make it fair and balanced. In addition, the Advertising/Investment Companies Regulation Department of NASD Regulation has a long-standing informal interpretation that members may distribute a research report that does not meet the currentness standards of SEC Rule 482, so long as the research report represents the most recent version issued by the research firm and is accompanied with information that meets those standards.\* The proposed rule change would not affect that interpretation.

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\* Frequently, the most recent version of an independent research report was issued prior to the most recent calendar quarter end. Accordingly, the report has performance information that may not meet the requirements of SEC Rule 482(f), which requires all performance data contained in any investment company advertisement to be current as of the most recent practicable date (cont’d)

4. The SIA, T. Rowe Price and the ICI requested clarification that proposed subparagraph (c)(6)(G)(v), which would provide that a member may not materially alter a research report subject to the filing exemption, would not be interpreted to prohibit a member from supplementing the report with additional information, such as the clarification of terms and/or ranking systems, or additional disclosure required by NASD or SEC rules. Morningstar similarly requested clarification that a research report that did not meet the NASD and SEC content requirements, but was accompanied by additional information necessary for the report to meet the applicable content requirements, would still be eligible for the exemption.

**Response:** The new proposal would explicitly permit material alterations necessary to make the report consistent with NASD, SEC or other applicable standards. The proposal would not require the filing of material that will accompany the report and that merely clarifies terms or other information in the report itself.

5. Morningstar and the SIA noted that, although the proposed rule change would eliminate the requirement to file research reports with NASD Regulation, Section 24(b) of the Investment Company Act of 1940 (the “1940 Act”) and Rule 24b-3 thereunder appear to require that the reports be filed with the SEC if they are not filed with a national securities association, such as the NASD. Commentators assert that this requirement would produce a result inconsistent with the purpose of the proposed rule change, especially if funds and fund underwriters choose to continue to file with NASD Regulation to satisfy the requirements of Section 24(b). The SIA suggested that NASD Regulation provide guidance to the industry on this matter.

**Response:** The application of the 1940 Act and SEC rules thereunder is ultimately a matter for the SEC to decide. Nevertheless, NASD Regulation would recommend that the SEC confirm in the release adopting the proposed rules that research reports eligible for the filing exclusion under the proposed rule change do not need to be filed with the SEC.

6. The ICI proposed that NASD Regulation include a definition of “research report” to clarify that it is a report that provides an in-depth analysis of a particular fund, but is not intended to cover reprints of articles that appear in widely circulated financial magazines. T. Rowe Price supports the ICI’s proposed definition but suggests that it also include article reprints sent to institutional customers in order to exclude such reprints from the filing requirements. T. Rowe Price also suggested including a definition of “institutional customer” in the proposed rule change.

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considering the type of investment company and the media through which the data will be conveyed. It further provides that any investment company advertisement containing total return quotations shall be considered to have complied with this requirement if the quotations are current as of the most recent calendar quarter ended prior to submission of the advertisement for publication. The NASD Regulation staff has interpreted this provision as allowing the use of an independent research report that has total return information that is not current as of the most recent calendar quarter end, so long as the report represents the most recent version issued by the research firm and is accompanied by total return information that is current as of the most recent calendar quarter end.

**Response:** The proposal would not apply to article reprints, which Rule 2210 includes in the definition of “sales literature.” NASD Regulation believes that the proposal as amended provides sufficient guidance to members concerning the meaning of “research report.” In addition, NASD Regulation staff is considering whether to recommend amendments to Rule 2210 concerning the treatment of institutional sales material that would address the concerns voiced by T. Rowe Price, but because of the many collateral issues related to this issue, we do not believe it is appropriate to amend the proposed rule for this purpose.

7. The ICI requested confirmation that the proposed rule change would exempt research reports that included performance ranking information, provided the reports meet the proposed exemption criteria.

**Response:** The proposal would exempt research reports that present performance ranking information, provided that they meet the exemption criteria. Of course, such reports would be required to comply with the content requirements of IM-2210-3 regarding rankings, as well as any other applicable SEC and NASD requirement.

Very truly yours,

Thomas M. Selman

Attachment

cc: Christine Richardson  
Division of Market Regulation  
Securities and Exchange Commission

## TEXT OF PROPOSED AMENDMENTS

Paragraph (c)(6) of Conduct Rule 2210 is amended by adding a new paragraph (G), as follows (please note that new text that differs from the prior version published for comment is italicized and deletions of text in the prior version are bracketed):

(6) The following types of material are excluded from the foregoing filing requirements and (except for research reports under paragraph (G)) the foregoing spot-check procedures:

\* \* \*

(G) any research report concerning an investment company registered under the Investment Company Act of 1940, provided that:

(i) the report is prepared by an entity that is independent of the investment company, its affiliates, and the member using the report (the “research firm”);

(ii) [the services of the research firm have not been procured by the investment company, any of its affiliates or any member in order to prepare the report] *the report’s contents have not been materially altered by the member using the report (except as necessary to make the report consistent with applicable standards);*

(iii) the research firm prepares and distributes [similar types of] reports *based on similar research* with respect to a substantial number of investment companies;

(iv) [the report is distributed and updated] *the research firm updates and distributes reports based on its research of the investment company* with reasonable regularity in the normal course of the research firm’s business; [and]

(v) [the content of the report has not been materially altered by the member using the report] *neither the investment company, its affiliates nor the member using the research report has commissioned the research used by the research firm in preparing the report; and*

(vi) *if a customized report was prepared at the request of the investment company, its affiliate or a member, then the report includes only information that the research firm has already compiled and published in another non-customized report, and does not omit information necessary to make the customized report fair and balanced.*