

NYSE and NASD that would require a compensation committee to review and approve analyst compensation; prohibit firms from issuing reports by a research analyst who participated in solicitation meetings with prospective investment-banking clients; require notification to customers when a member or member organization terminates research coverage of a subject company and require that the final report include a final recommendation or rating; and amend the definition of "public appearance" to include research analysts' making a recommendation in a newspaper article or similar public medium.

We are working with NASAA and its members, as well as the NYSE, NASD, and New York State Attorney General, on a joint formal inquiry into market practices concerning research analysts and the conflicts that can arise from the relationships between research and investment banking. On December 20, 2002, the Commission announced an agreement in principle that, if approved by the Commission, would result in a settlement with the nation's largest investment banking firms to address issues of conflicts of interest with respect to their brokerage departments, and would conclude the joint inquiry.²⁷

D. Shorter Settlement Cycles, Straight-Through Processing, and Immobilization and Dematerialization of Stock Certificates

Over the past year, the securities industry has undertaken an initiative to achieve several straight-through processing goals. In order to reach these goals, the industry, through the Securities Industry Association ("SIA"), has proposed that we promulgate a number of regulatory changes. One of the more controversial of the proposed changes is adding rules to discourage the issuance and use of physical certificates. According to an SIA study, the costs of processing physical securities and the risks inherent with the use of physical securities are significant to the industry and ultimately their customers. Therefore, the industry is proposing that new securities be issued in book-entry form only. Although such a requirement could be imposed at the federal level, another possibility would be to implement a book-entry-only standard through exchange listing standards and issuer action. One issue is that several states' corporate laws still require that an issuer make physical securities available to shareholders who request

them. The Commission staff hopes to explore with NASAA ways in which to discourage the issuance and use of physical certificates, restrictions imposed by certain state corporate laws, and exchange listing standards regarding the issuance of physical certificates.

E. IPO Underwriting and Allocation Process

The initial public offering underwriting process has come under a lot of scrutiny lately—especially with regard to perceived abuses in the pricing and allocation of IPO shares. We are currently reviewing industry practices regarding the roles of issuers and underwriters in the price setting and the allocation of IPO shares as well as the offering process in general. Moreover, the NYSE and NASD have convened a panel of business and academic leaders to conduct a broad review of the IPO process and to recommend ways to address the problems so as to improve the underwriting process and restore investor confidence. The panel hopes to report by the end of March. The Commission has also brought at least one enforcement action, the Robertson Stephens case, relating to underwriting activities in connection with a number of IPOs.²⁸ In addition, the NASD recently sought comment from its members on proposed new rules regarding the regulation of IPO allocations and distributions.²⁹ According to the NASD, the rules will better ensure that members avoid unacceptable conduct when they engage in the allocation and distribution of IPOs.

F. Possible Changes to SRO Rules

1. *Branch Office Definition.* The NYSE recently filed a proposed rule change, SR-NYSE-2002-34, which proposes to amend NYSE Rule 342, Offices—Approval, Supervision, and Control, to provide for a new definition of the term "branch office." The proposed amendment to the rule would limit the requirement to register certain business locations as "branch offices—to account for advances in technology used to conduct and monitor business and changes in the structure of broker-dealers and in the lifestyles and work habits of broker-dealers. On December 4, 2002, the Commission published the proposed rule change for public comment.³⁰

²⁸ Litigation Release No. 17923 (Jan. 9, 2003).

²⁹ NASD Notice 02-55, "NASD Requests Comments on Proposed New Rule 2712 and Amendments to Rule 2710," August 2002.

³⁰ Release No. 34-46888 (Dec. 4, 2002) [67 FR 72257].

2. *CRD—Expungement.* The NASD recently filed a proposed rule change, SR-NASD-2002-168, which proposes to establish procedures for expunging customer dispute information from the Central Registration Depository system. The proposed rule would require all arbitral directives to expunge customer dispute information from the CRD system to be confirmed or ordered by a court of competent jurisdiction. The proposed rule also would require member firms and associated persons seeking expungement to name the NASD as an additional party in any judicial proceeding seeking expungement relief or confirming an arbitration award containing expungement relief. The proposed rule would state that the NASD will participate in such judicial proceedings and will oppose expunging dispute information in the proceedings unless specific findings have been made that the subject matter of the claim or the information in the CRD system: (1) Is without factual basis (*i.e.*, is factually impossible or clearly erroneous); (2) fails to state a claim upon which relief can be granted; (3) is frivolous; or (4) is defamatory in nature. The proposed rule would also permit member firms and associated persons to ask the NASD to waive the requirement to name the NASD as a party on the basis that the expungement order meets at least one of the standards for expungement articulated in the proposed rule. The Division of Market Regulation is preparing to recommend release of the proposal for public comment and anticipates extensive public commentary.

3. *NYSE and NASD Proposals to Amend Rules Relating to Supervisory Control Over Customer Accounts.* Adequate supervisory systems are integral to investor protection and to the integrity of the securities market. Operational and sales practice abuses can stem from ineffective supervisory control procedures. The recent Gruttadauria case,³¹ which involved the alleged misappropriation of customer funds, highlighted the ongoing problem of operational and sales practice abuses at firms and the importance of firms effectively monitoring their employees.

The NYSE and NASD have submitted proposals to amend their rules relating to supervisory control over customer accounts.³² Specifically, the proposed rules would: (1) Require members to develop general and specific

³¹ Litigation Release No. 17590 (June 27, 2002).

³² NYSE 2002-36, Release No. 34-46858 (Nov. 20, 2002) [67 FR 72661]; NASD 2002-162, Release No. 34-46859 (Nov. 20, 2002) [67 FR 70990].

²⁷ Securities and Exchange Commission, Press Release 2002-179, December 20, 2002.