

Regulatory Notice

11-11

Debt Research Reports

FINRA Requests Comment on Concept Proposal to Identify and Manage Conflicts Involving the Preparation and Distribution of Debt Research Reports

Comment Period Expires: April 25, 2011

Executive Summary

FINRA seeks comment on a concept proposal to apply objectivity safeguards and disclosure requirements to the publication and distribution of debt research reports. The proposal has a tiered approach that generally would provide retail debt research recipients with most of the same protections provided to recipients of equity research, while exempting debt research provided solely to institutional investors from many of those provisions.

Questions concerning this *Notice* should be directed to:

- ▶ Philip Shaikun, Associate Vice President, Office of General Counsel (OGC), at (202) 728-8451; and
- ▶ Racquel Russell, Assistant General Counsel, OGC, at (202) 728-8363.

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by April 25, 2011.

Member firms and other interested parties can submit their comments using the following methods:

- ▶ Emailing comments to pubcom@finra.org; or
- ▶ Mailing comments in hard copy to:
Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

March 2011

Notice Type

- ▶ Request for Comment

Suggested Routing

- ▶ Compliance
- ▶ Fixed Income
- ▶ Investment Banking
- ▶ Legal
- ▶ Research
- ▶ Senior Management
- ▶ Trading

Key Topics

- ▶ Conflicts of Interest
- ▶ Fixed Income
- ▶ Research
- ▶ Trading

Referenced Rules & Notices

- ▶ FINRA Rule 2010
- ▶ FINRA Rule 2020
- ▶ NASD Rule 2711
- ▶ NTM 06-36
- ▶ Regulatory Notice 08-55
- ▶ SEC Regulation AC

To help FINRA process and review comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this Notice will be made available to the public on the FINRA website. Generally, FINRA will post comments on its site one week after the end of the comment period.¹

Before becoming effective, a proposed rule change must be authorized for filing with the SEC by the FINRA Board of Governors, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.²

Background and Discussion

FINRA has long been monitoring firms' management of conflicts of interest related to the publication and distribution of debt research. In a 2005 report³ to the SEC, legacy NASD and the NYSE indicated that they would examine the extent to which firms voluntarily adopted the Guiding Principles of the Bond Market Association (BMA).⁴ The self-regulatory organizations (SROs) subsequently surveyed certain firms' debt research supervisory systems and found many instances where firms failed to adhere to the Guiding Principles. More significantly, the SROs found certain cases where firms lacked any policies and procedures to manage debt research conflicts to ensure compliance with applicable SRO ethical and anti-fraud rules. Those findings were published in *Notice to Members (NTM) 06-36*⁵ as a means to prompt better conflict management, but FINRA expressly noted that it would continue to consider more definitive rulemaking that might differ from or expand on the Guiding Principles.

The staff believes now is the appropriate time to engage in such definitive rulemaking. Among other things, the staff has observed increased retail investment risk in complex debt securities. The allegations of misconduct in the sale of auction rate securities (ARS) illuminated this fact and provided a very concrete example that potential conflicts of interest in the publication and distribution of debt research can exist just as they do for equity research.

Currently, FINRA's research rules apply only to "equity securities," as that term is defined under the Securities Exchange Act of 1934 (Exchange Act), subject to certain exceptions. In contrast, SEC Regulation Analyst Certification (Reg AC), the SEC's primary vehicle to foster objective and transparent research, applies to both debt and equity research. In addition, several foreign regulators have enacted research rules that apply to debt research, many of which are more extensive than Reg AC.

In consultation with industry members including buy-side, the staff has reviewed the appropriateness of applying the provisions of the equity research rules to debt research, taking into consideration the unique nature of debt trading and its market participants. Based on this review, the staff has developed a conceptual debt research rule that would recognize a bifurcated debt research regulatory approach in which retail investors and institutional investors are treated as customers and counterparties, respectively. Thus, the envisioned rule extends to debt research distributed to retail investors the vast majority of the protections currently afforded to equity research, while debt research distributed solely to institutional investors would require a more general “health warning” in lieu of many of the structural safeguards and disclosures applicable to retail debt research. Importantly, the concept would allow for an institutional investor to choose to receive the full protections accorded retail debt research. The concept further would delineate the permissible communications between debt research analysts and sales and trading personnel. As conceived, the rule would contain the following elements:

Definitions

First, a “debt security” would be defined as any “security” other than an “equity security,” a “treasury security” or a “municipal security” (as those terms are defined in the federal securities laws). The definition of “debt research report” would closely follow the current definition of research report in NASD Rule 2711 (*i.e.*, a communication that includes an analysis of securities and that provides information reasonably sufficient upon which to base an investment decision). The definition of “debt research report” would be subject to the same exceptions currently in place for equity in NASD Rule 2711 (*e.g.*, discussions of broad-based indices, commentaries on economic, political or market conditions, etc. would be excepted).

The definition of “institutional investor” would be the same as “institutional account” in FINRA’s suitability rule.⁶ Thus, the proposed definition generally would cover: (a) a bank, savings and loan association, insurance company or registered investment company; (b) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or (c) any other entity (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least \$50 million.

Standards Applicable to Retail Debt Research

The majority of the existing structural safeguards and disclosures in NASD Rule 2711 for equity research would apply to retail debt research.⁷ In addition, unlike the equity research rules, the proposal addresses conflicts between debt research and sales and trading personnel.⁸

Thus, the staff envisions that the debt research rule would:

- ▶ Generally require member firms to establish, maintain and enforce policies and procedures reasonably designed to identify and effectively manage conflicts of interest related to:
 - ▶ the preparation, content and distribution of debt research reports;
 - ▶ public appearances by debt research analysts; and
 - ▶ the interaction between debt research analysts and those outside of the research department, including investment banking department personnel, sales and trading department personnel, subject companies and customers.
- ▶ Prohibit prepublication review, clearance or approval of debt research by investment banking and sales and trading, as well as restrict (or prohibit) prepublication review, clearance or approval by a subject company (except for fact checking) or by member firm personnel who are not directly responsible for the preparation, content and distribution of debt research.
- ▶ Prohibit input by investment banking and sales and trading into the determination of the research department budget.
- ▶ Limit the supervision and compensatory evaluation of debt analysts to persons not engaged in investment banking services or sales and trading.
- ▶ Require the review and approval of debt analyst compensation by the same type of committee required to review equity analyst compensation, and prohibit compensation based on specific investment banking or sales and trading transactions or contributions to the member firm's investment banking or sales and trading activities.
- ▶ Restrict or limit debt analyst account trading in the securities, derivatives and funds related to the securities covered by the debt analyst, including to:
 - ▶ ensure that debt analyst accounts, supervisors of such analysts and associated persons with the ability to influence the content of research reports do not benefit in their trading from knowledge of the content or timing of a debt research report; and
 - ▶ prohibit trading contrary to the analyst's recommendations (except in cases of financial hardship). Member firm policies and procedures also would be required.
- ▶ Prohibit promises of favorable debt research coverage.
- ▶ Prohibit retaliation against debt analysts by investment banking personnel or other employees as the result of an adverse, negative or otherwise unfavorable research report or public appearance.
- ▶ Restrict or limit activities by debt analysts that can reasonably be expected to compromise objectivity, including participation in pitches, road shows and certain three-way meetings involving debt analysts and customers where either investment banking personnel or issuer management are present.

- ▶ Prohibit investment banking from directing debt analysts to engage in sales or marketing efforts or any communication with a customer about an investment banking services transaction.

Likewise, the staff envisions that the disclosures applicable to equity research largely should apply to debt. They include disclosure of personal and firm financial interests; the receipt of investment banking services compensation from the subject company; and the meaning of each rating employed in any rating system used by the member firm in the research report.⁹ The staff also believes that the supervisory review and disclosure obligations applicable to the distribution of third-party equity research should similarly apply to third-party retail debt research.

Institutional Investor Exemption

FINRA staff understands that, unlike in the equity market, institutional investors trading in debt securities tend to interact with broker-dealers in a manner more closely resembling that of a counterparty than a customer. Based on discussions with industry participants, the staff further understands that these institutional investors value the timely flow of analysis and trade ideas related to debt securities, are aware of the types of potential conflicts that may exist between a member's recommendations and trading interests, and are capable of exercising independent judgment in evaluating such recommendations (and instead incorporate the research as a data point in their own analytics) and reaching pricing decisions.

Given these unique aspects of the debt market and the needs of its participants, the concept proposal exempts debt research disseminated solely to institutional investors from most of the structural safeguards and disclosures described above for retail debt research. However, firms availing themselves of this institution-only exemption would be required to provide on the first page of a debt research report a prominent "health warning" disclosure, including that:

- ▶ the research is intended for institutional investors only and is not subject to all of the independence and disclosure standards applicable to research provided to retail investors;
- ▶ if applicable, that the firm trades the securities covered in the research for its own account and on behalf of certain clients; such trading interests may be contrary to the recommendations offered in the research and the research may not be independent of the firm's proprietary interests; and
- ▶ if applicable, that the research may be inconsistent with recommendations offered in the firm's research that is disseminated to retail investors.

The staff believes that this approach appropriately acknowledges the arm's-length nature of transactions between trading desk personnel and institutional buyers. The staff also notes that this approach alleviates the need for a firm to determine whether any particular communication sent only to institutional investors meets the definition of "debt research report." Of course, if a communication does not meet the definition of "debt research," these contemplated rules would not apply, irrespective of whether disseminated to retail or institution-only investors. Firms that avail themselves of this institutional carve-out would be required to clearly distinguish such research from debt research disseminated to retail investors. However, the staff believes that not all institutional investors are necessarily alike and therefore an important part of the proposed regulatory scheme is to allow for such investors to opt out of this exemption.

Notwithstanding the sophistication of institutional debt investors, the staff believes certain of the basic safeguards applicable to retail research should apply to all debt research; specifically the prohibitions/restrictions on:

- ▶ promises of favorable research;
- ▶ debt research analyst involvement in pitches, road shows and other marketing;
- ▶ certain three-way meetings about an investment banking services transaction that involve debt analysts and customers where either investment banking personnel or issuer management are present;
- ▶ input into research coverage by investment banking personnel;
- ▶ retaliation against debt research analysts for unfavorable research;
- ▶ review of research by the subject company (beyond fact-checking) or investment banking personnel; and
- ▶ investment banking directing debt research analysts to engage in sales or marketing efforts or any communication with a customer about an investment banking services transaction.

The staff notes that other FINRA rules would continue to apply to member conduct in connection with debt research, including research disseminated pursuant to the institutional investor carve-out (*e.g.*, FINRA Rules 2010 and 2020). In addition, nothing in this concept proposal obviates a member's obligation to comply with the antifraud provisions of the federal securities laws.

Communication Firewalls Unique to Debt

The staff's discussions with industry members illuminated certain necessary communications between debt analysts and sales and trading personnel to allow each to perform their primary functions.¹⁰ Therefore, the concept proposal delineates the permissible interactions between debt analysts and sales and trading personnel. Expressly permitted communications would include the following:¹¹

- ▶ Sales and trading personnel seeking information from debt analysts regarding the creditworthiness of an issuer (and other information regarding a debt issuer that is reasonably related to the price/performance of the debt security), so long as, with respect to any covered issuer, such information is consistent with the debt analyst's published research. All such communications would have to be consistent with the types of communications the analyst might have with customers.¹²
- ▶ Debt analysts seeking information from sales and trading personnel regarding a particular bond instrument, current prices, spreads, liquidity and similar market information relevant to the debt analyst's valuation of a particular debt security.
- ▶ Sales and trading personnel providing input to Research Management regarding debt research coverage decisions, provided that final coverage decisions are made by Research Management.

The following would be expressly prohibited communications:

- ▶ Sales and trading personnel attempting to influence a debt analyst's opinion or views for the purpose of benefiting the trading position of the firm, a customer or a class of customers.
- ▶ Debt analysts identifying or recommending specific potential trading transactions to sales and trading personnel that are not contained in such debt analyst's currently published reports; disclosing the timing of, or material investment conclusions in, a pending debt research report; or otherwise having any communication for the purpose of determining the profile of a customer to whom research should be directed.

Request for Comment

FINRA welcomes all comments on the concept proposal, and specifically encourages buy-side investors to comment on the proposal's tiered approach. Among other things, FINRA is interested in comments on the following:

Definitions

- ▶ Is the definition of "debt security" overbroad or under-inclusive?
- ▶ FINRA recognizes that no "institutional investor" definition is a perfect proxy for sophistication and has proposed the same definition as found in FINRA's suitability rule as a starting point for discussion. Are there other definitions more appropriate in the context of debt research conflicts of interest that would better identify those individuals and entities that would benefit from the protections proposed for retail investors?

Opt-In/Out Provision

- ▶ Should this option be structured as an "opt-in" or an "opt-out" provision? Should fund managers be permitted to opt-in/opt-out on a fund-by-fund basis?

Effect on Availability of Retail Debt Research

- ▶ How might the institution-only carve-out impact the availability to retail customers of certain types of debt research, such as research on foreign sovereign debt? Would firms with both retail and institutional clients reduce or eliminate debt research provided to retail investors due to the differing regulatory requirements? Are there certain categories of debt research that should be exempted from all of the contemplated rules for both retail and institutional investors?

Disclosures for Institutional Debt Research

- ▶ Should there be additional disclosures required for members to avail themselves of the institution-only carve-out? For example, should members be required to disclose to institutional investors any substantial proprietary acquisitions or divestments in the covered debt security immediately prior to the issuance of an institution-only report on that security?

Comments must be received by April 25, 2011.

Endnotes

- 1 FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. See *NASD Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.
- 2 Section 19 of the Securities Exchange Act permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily temporarily suspend these types of rule changes within 60 days of filing. If the SEC takes such action, the SEC shall institute proceedings to determine whether the proposed rule should be approved or disapproved. See Exchange Act Section 19 and rules thereunder.
- 3 Joint Report by NASD and the NYSE on the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules (December 2005).
- 4 In 2005, the BMA merged with the Securities Industry Association (SIA) to form the Securities Industry and Financial Markets Association (SIFMA).
- 5 *NTM 06-36* (July 2006).
- 6 See Securities Exchange Act Release No. 63325 (November 17, 2010), 75 FR 71479 (November 23, 2010) (Order Approving File No. SR-FINRA-2010-039 to adopt FINRA Rule 2111 (Suitability) in the consolidated FINRA rulebook) (“Suitability” rule).
- 7 The staff does not envision proposing with respect to debt research the ban on research analysts receiving pre-IPO shares or the imposition of quiet periods around the issuance of research reports.
- 8 The staff notes that *Regulatory Notice 08-55* proposed changes to current NASD Rule 2711. Generally, *Regulatory Notice 08-55* sought to streamline the NASD Rule 2711 provisions and apply several overarching principles for the management of conflicts of interest in connection with member firm research. This concept proposal builds on that approach, and further proposes additional safeguards in connection with debt research not included in current NASD Rule 2711 or *Regulatory Notice 08-55* (e.g., the prohibition on investment banking and sales and trading input into the determination of the research department budget). FINRA will consider whether any of these additional safeguards are appropriate for debt.
- 9 However, the staff believes that certain disclosures must be modified in light of unique characteristics of the debt market. Thus, instead of member firm disclosure if it acts as a market maker in the subject security, the rule would require disclosure if the member firm generally engages in principal trading in the subject debt security. And while the envisioned rule provides that the rating distributions and related disclosures also apply to debt research, the staff believes that minor modifications would be appropriate because the lack of daily closing information may otherwise make a price chart difficult to create for debt securities.
- 10 The staff understands that the uniqueness of the debt market as compared to equities (e.g., limited last sale transparency information) necessitates communication between analysts and traders in certain fundamental regards.

Endnotes continued

- 11 Communications between debt research analysts and sales and trading personnel that are not related to sales and trading or research activities may take place without restriction.
- 12 A debt analyst's communications with sales and trading personnel would not be deemed "inconsistent" with the analyst's published research where the investment objectives or time horizons being discussed differ from those underlying the analyst's published views.