July 14, 2017

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: Comments in response to Regulatory Notice 2017-16 – Desk Commentary Safe Harbor ("Regulatory Notice")

Dear Ms. Piorko Mitchell:

The Regulatory Notice soliciting comment on a safe harbor for desk commentary is an important first step in initiating a dialogue with the industry that hopefully will result in guidance that FINRA members and its staff can use to identify written communications that require the protections of Rules 2241 and 2242 ("Research Rules") and those that do not but nevertheless remain subject to FINRA's various rules governing communications. For the reasons discussed below, this can be accomplished by formally adopting a definition of desk commentary in FINRA's Communications Rule (Rule 2210). If such an approach is adopted, a safe harbor is unnecessary and thus will avoid some of the complications the current proposal presents.

FINRA's Proposal

FINRA is seeking comments on proposed amendments to the Research Rules to create a limited safe harbor for specified brief, written analysis distributed to eligible institutional investors that is authored by sales and trading or principal trading personnel but that may rise to the level of a research report (desk commentary). The proposed safe harbor would be subject to conditions, including compliance with a number of the Research Rules provisions designed to mitigate research-related conflicts. In addition, the proposed safe harbor would require firms to include a "health warning" on desk commentary and to obtain negative consent from eligible institutional investors to receive such commentary Individuals producing desk commentary that satisfied the safe harbor provisions would not be required to register as research analysts and, among other things, would not need to be physically separated from sales and trading and principal trading personnel.

Summary of Comments

- Desk commentary identifies trading opportunities whereas research reports assist in investment decisions. These communications serve two different fundamental purposes and thus the approach to regulating them should recognize these differences.

- A solution attempting to differentiate desk commentary from research reports that is based on the definition of the term "research report," and continues to treat the authors of desk commentary in many respects as research analysts, does not differentiate these communications but instead invariably links them, which can have unintended consequences, including preventing such persons from fulfilling their important role in the capital raising process.

- A definition of the term "desk commentary" that identifies those aspects that differentiate these communications from research reports will create a clear principle that can be easily applied by FINRA and its members. Including this definition in the Communications Rule will further distance and distinguish these communications from research reports.

Desk Commentary (Identifies Trading Opportunities) versus Research Reports (Identifies Investments)

To achieve a result that facilitates the free flow of trading ideas to institutional clients generated by FINRA member sales and trading desks while ensuring a loophole is not created that could be exploited to publish research reports without the protections of the Research Rules the analysis must start by recognizing the difference between the two types of communications and why the Research Rule protections are not necessary for the former but are justifiably appropriate for the latter. As FINRA has recognized in the proposed content standards for the safe harbor, desk commentary is used to identify short-term trading catalysts or opportunities.[1] Research reports, on the other hand, are used to present fundamental analysis of a company Said differently, one identifies a trading opportunity, which may have nothing to do with the performance of the company's business, whereas the other assists in an investment decision based on an analysis of a company's business. The various definitions of "research report" incorporate this distinction.

The two key elements in the research report definitions are the requirement that there be analysis and that it supports an investment decision. The term "research report" is defined in FINRA Rules 2241 and 2242, and Rule 500 of Regulation Analyst Certification ("Regulation AC"). Rule 2241(a)(11) defines "research report" as follows:

> "Research Report" means any written (including electronic) 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 [subject to certain exceptions delineated in the Rule].

Rule 2242 (a)(3) defines "debt research report" as follows:

> "Debt research report" means any written (including electronic) communication that includes an analysis of a debt security or an issuer of a debt security and that provides information reasonably sufficient upon which to base an investment decision, excluding

[1] *See* Regulatory Notice at page 2.

> FINRA understands that many institutional investors value the timely flow of information and trade ideas from desk personnel but do not base their investment decisions on the commentary Instead, these investors, which are capable of exercising independent judgment in evaluating recommendations and reaching investment decisions, selectively incorporate the information as a data point into their own analysis and trading process. FINRA further understands that oftentimes, the desk commentary never reaches the portfolio manager or others who make the investment decisions. Rather, it may inform buyside traders' timing in executing orders to carry out previously made investment decisions.

> communications that solely constitute an equity research report as defined in Rule 2241 (a)(11) [and certain other communications excepted under the Rule].

Rule 500 of Regulation AC defines "research report" in a similar manner:

> "Research report" means a written communication (including an electronic communication) that includes an analysis of a security or an issuer and provides information reasonably sufficient upon which to base an investment decision.

Although "analysis" does not appear to be defined for purposes of FINRA's rules or Regulation AC, the Merriam-Webster and Oxford online dictionaries define "analysis" as follows:

> Analysis - (1) a detailed examination of anything complex in order to understand its nature or to determine its essential features: thorough study;[2] (2) detailed examination of the elements or structure of something.[3]

Based on the foregoing definitions, an analysis of a company, and by extension an analysis of its equity and debt securities, for the purposes of reaching an investment decision entails a detailed examination of a company This examination would include, for example, the sources and magnitude of its revenues and expenses, its strengths and weaknesses as compared to its competitors, and its opportunities in the near and long term. Whether a company will be a good or bad investment can be determined only after such analysis is conducted and the research analyst understands the components of the company's business and how they interact and react to internal and external forces. The research analyst's conclusion is then compared to an analysis of competing companies to ultimately decide whether the company is a buy, sell, or hold.

The inclusion of the term "investment decision" in the definitions is important and thus distinguishes these reports from those that support a trading decision. This distinction between investing and trading is best exemplified by arbitrage and algorithmic trading, which is not based on the fundamentals of a company but instead on momentary trading opportunities. In contrast, when making an investment decision there is a relationship between the investor and company that presumes the investor will benefit from the performance of the company as an economic entity over some period of time, whether through dividend payments or an appreciation in value. Any communication containing thorough research and detailed and extensive analysis that may serve as a basis for a longer-term investment in a company's securities should be protected by the FINRA Research Rules.

As discussed above, desk commentary focuses on catalysts or opportunities that have nothing to do with the economic prospects of a company but instead identify temporary trading opportunities. For example, a company experiences an incident with a customer that causes a public relations problem. In the immediate aftermath of the incident the stock may trade down and then return to its typical pre-incident trading range. An opportunistic trader may buy on this momentary downturn and then sell once they have made a profit – all the time completely

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[2] http://www.merriam-webster.com/dictionary/analysis

[3] http://www.oxforddictionaries.com/us/definition/american_english/analysis

unconcerned about the company's value as an economic entity Desk commentary would identify this buying opportunity

Another example would be when two companies are involved in a merger or similar business combination. Desk commentary addressing these events provides an analysis of the catalyst for a trade, namely the event (*e.g.*, announced merger), and strategies for trading it, such as arbitrage. Any discussion or analysis of the companies involved in the event is in the context of the business combination and the relationship that currently exists between them because of the event. The communication does not focus on the current or future business opportunities for the companies.

Specifically, this commentary does not contain opinion on whether the companies involved are good investments as standalone companies, nor take a position as to whether the combined companies will be a good or bad long-term investment. The commentary simply provides information about the likelihood of an event happening and the potential return if the described arbitrage strategy is pursued. In formulating the commentary, desk personnel review the relationship between the participating companies based on the event and describe the potential return if the event occurs (*e.g.*, the merger closes). The potential return is merely an arithmetic calculation. Furthermore, there is no discussion or analysis of the fundamental prospects for the companies if the event does not occur.

An additional distinction between a research report and desk commentary is that commentary is received by sophisticated clients in the midst of many other trading ideas generated by sales and trading desks. A trading idea is just one more data point among hundreds or even thousands of data points that a trader might consider in deciding when or whether to make a trade. Trading ideas are therefore much like dynamic dialogue between sophisticated market participants who have an ongoing relationship. This communication needs to be protected at a basic level to assure it is not fraudulent, but because it does not contain fundamental analysis supporting an investment decision it does not rise to a level requiring the same regulatory protection as research. The history and background for the Research Rules and Regulation AC support this distinction as well.

Research Rules Protections versus Communications Rule Protections

NASD Rule 2711 (the predecessor of Rule 2241) and Regulation AC were adopted to address the conflicts of interests that may impact "the integrity and objectivity of research" when analysts "recommend securities in public communications." [4] Specifically, there were concerns that firms were using favorable research reports to obtain investment banking business, and thus the definition of what constitutes a "research report" was carefully drafted to capture only those types of communications that presented the opportunity for this conflict of interest.[5] Likewise, Rule 2242 was adopted, but with a tiered approach, that "would provide retail debt research

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[4] Regulation AC, Exchange Act Release No. 47384 (Feb. 20, 2003)(hereinafter, "Reg AC Adopting Release"); Order Approving Proposed Rule Changes by the NASD and NYSE Relating to Research Analyst Conflicts of Interest, Exchange Act Release No. 45908 (May 10, 2002)(hereinafter, "2711 Adopting Release").

[5] *See* 2711 Adopting Release ("We note the SROs have tailored the definition to capture the communications that are most likely to benefit from the coverage of the rules").

recipients with extensive protections similar to those provided to recipients of equity research" under Rule 2241 [6]

The Regulation AC Adopting Release sheds additional light on the types of communications, or "research reports," the SEC were concerned about. The SEC noted that a research report generally will contain thorough and extensive analysis, providing:

> Research reports generally contain an analyst's summary rating of the security based on his or her particular firm's rating system, as well as an analysis. The summary rating or recommendation is often one word (e.g., buy, sell, overweight), while the analysis explains the basis for the rating and ***provides extensive supplementary information***, which, in some instances, significantly qualifies or conditions the stated rating. (Emphasis added)

The Research Rules and Regulation AC focus on communications containing extensive information and analysis, which is logical given that it is through this breadth of information and analysis a research analyst could attempt to influence the management of a company seeking investment banking services. For example, a thorough and detailed analysis by a research analyst that is supportive of the company's management and trumpets their business plan and prospects, when coupled with a buy\outperform rating, could be used to influence the company's management to send investment banking business to the research analyst's firm.

In contrast, desks commentary does not trumpet a company's business model or other metrics for determining if the company is or will be successful, nor does the commentary otherwise directly drive demand for the company's security that an analysis coupled with a buy\outperform rating could bring about. Quite simply, the desk commentary is mostly reactive – responding to trading catalysts – and does not provide the long-term, in-depth analysis that may allure investment banking business. Desk commentary would not, on its own, influence company management and, accordingly, does not raise the potential concerns the Research Rules and Regulation AC are designed to address.

Desk commentary, as long as it does not contain the type of fundamental analysis discussed above, should continue to be regulated as any other communication with the public, and not subject to the additional requirements designed to address a specific conflict of interest. For example, the FINRA Communications Rule and Rule 2220 (Options Communications) impose, among other things, training, review and recordkeeping requirements and content standards on member firm written and electronic communications. In addition, FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade) and the anti-fraud rules of FINRA and the SEC (including FINRA Rule 2020 - Use of Manipulative, Deceptive or Other Fraudulent Devices, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder) govern a member firm's business conduct in general, and thus apply to the publication of desk commentary This robust regulatory regime that governs the content and production of desk commentary affords sufficient

[6] Order Approving Proposed Rule Changes by FINRA Relating to Debt Research Analysts and Debt Research Reports, Exchange Act Release No. 75472 (July 16, 2015).

protections to the recipients of the pieces, particularly in light of the fact that distribution could be limited to institutional accounts.[7]

Alternative Approach - Proposed Definition of Desk Commentary and Supporting Interpretive Material

FINRA can use the proposed content standard for the safe harbor as a basis for a definition of desk commentary that would distinguish such communications from research. Including the definition in the Communications Rule would further disentangle these communications from research reports ("alternative approach").

The following definition could be adopted:

> *"Desk commentary" means a written communication (including electronic). (i) produced by sales and trading and principal trading personnel that includes a statement it is not a product of the member's research department, (ii) whose distribution is limited to institutional investors (as such term is defined in Rule 5412), and (iii) whose content is limited to a discussion, analysis, or identification of catalysts for trading opportunities (including specific trades), expected to occur within six months from the date of the desk commentary and the basis for the catalyst is observed or expected trading activity, market conditions, economic statistics, company results, company or industry related news, or an arbitrage opportunity involving multiple companies. Desk commentary must not include fundamental analysis of a company, unless such fundamental analysis is published in a research report produced in compliance with Rules 2241 or 2242, which has been previously provided or is concurrently provided with the desk commentary.*

The following Interpretive Material for the definition would provide further guidance as to what is considered desk commentary and what is not.

> *Interpretive Material*
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> *FINRA interprets the definition of "desk commentary" as written communications (including electronic) designed to identify trading opportunities as opposed to investment opportunities. As such, desk commentary cannot contain a detailed analysis of a company, its products, its management, the sources and magnitude of its revenues and expenses, or its strengths and weaknesses as compared to its competitors. Further, any trading opportunity identified must not be based on a projection or conclusion about the company's prospects (favorable or unfavorable) as an economic entity. However, this restriction would not prevent a member from identifying a trading opportunity or trade idea based on a*

[7] For example, desk commentary would continue to be subject to the content standards in FINRA's Communications Rule, including the prohibition on making any false, exaggerated, unwarranted, promissory, or misleading statements or claims. Therefore, desk commentary containing exaggerated statements about a company to garner favor with company management would violate the Communications Rule.

research report that was prepared by a research analyst in compliance with Rule 2241 or 2242 as long as the recipient of the desk commentary was previously provided a copy of the research report or the report is provided concurrent with the desk commentary, whether through attaching the full report or providing a link to the full report.

FINRA also believes a written communication (including electronic) that identifies an arbitrage opportunity between two or more companies involved in a publicly announced proposed business combination (e.g., merger or acquisition) would be consistent with the definition of desk commentary even if the catalyst and trading opportunity would extend beyond six months as long as the expected date of one or more catalysts is publicly known. For example, the date for a shareholder vote or regulatory approval is set or expected on a date more than six months after the date of publication of the desk commentary.

FINRA expressed its concern that firms might transfer the research function to their sales and trading desks to avoid the Research Rules and thus incorporated the author, content, and recipient conditions in the safe harbor.[8] The definition and accompanying interpretive material proposed above retain these conditions and thus address the concerns identified by FINRA.

The definition and interpretive material also include factors designed to differentiate the content from that of a research report and limit it to the types of communications that would not raise the conflict of interest concerns addressed by the Research Rules. For example, by requiring desk commentary to focus on catalysts for trading opportunities or specific trades the definition precludes a fundamental analysis of the company and the six month limitation further differentiates it from research, which normally is an analysis of a company's expected performance over the next twelve (12) months. The one exception to the six month condition would be for those circumstances where the catalyst for a trading opportunity extends beyond that timeframe and the timeframe for the catalyst is publicly expected or known (e.g., date of shareholder vote).

This alternative approach not only addresses FINRA's concerns and is consistent with FINRA's goal to provide "safeguards commensurate with the context and scope of the communications and the experience and sophistication of [the] recipients," but it also untangles the concept of desk commentary from the definition of "research report" and the complications associated with a safe harbor approach.[9]

Comments on Safe Harbor Approach

The alternative approach borrows liberally from FINRA's proposed safe harbor, with the main differences being the construct of the relief (a defined term in the Communications Rule as

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[8] *See* Regulatory Notice at page 5 ("Moreover, FINRA believes that the author, content and recipient threshold conditions would effectively preclude firms from migrating the research function to the desk to avoid the requirements of Rule 2241 or Rule 2242.").

[9] *Id.* at page 3.

opposed to a safe harbor from the Research Rules) and the elimination of the Research Rule conflict of interest provisions. These distinctions are important for several reasons. First, incorporating the relief in the Communications Rule would make it clear that a written communication complying with the proposed definition and interpretive material is not a research report and thus the authors are not research analysts. Creating a safe harbor based on the Research Rules will further blur the lines between desk commentary and research by continuing to use the terms "research" and "research analysts" when referring to communications and authors of desk commentary

Second, the conflict of interest provisions, which are unnecessary, could complicate sales and trading personnel's ability to fulfill their roles in assisting companies in raising capital. Sales and trading personnel have varied roles within firms, with producing desk commentary being just one of them. However, an extremely important responsibility they have is assisting in the capital raising function by contacting investors to gauge their interest in buying securities and providing feedback to companies about questions investors may have while considering an investment. Several of the safe harbor's proposed conflict of interest provisions could unnecessarily impede this important process.

Under the proposed safe harbor approach, sales and trading personnel who prepare desk commentary would not be permitted to physically attend (i.e., in person) the presentations designed to educate them about a company and the securities being sold. This restriction will clearly chill interactions between sales and trading personnel and investment bankers and company management. Placing a physical barrier between interactions creates an atmosphere of uncertainty and leaves the impression that such interactions are inherently risky or impermissible, which is not the case. Firms will be left in the unenviable position of having to explain to company management that the persons responsible for selling the company's securities are not allowed to meet with them face to face.

Faced with such circumstances, firms could be forced to choose between producing safe harbor desk commentary, with its attendant complications, or continuing with the current state and attempting to limit these communications to content that does not rise to the level of a research report (i.e., contain "information reasonably sufficient upon which to base an investment decision") so that sales and trading personnel can continue to perform a core function – assisting companies in raising capital.

Conclusion

The most difficult aspect FINRA members confront today when trying to determine what is research and what is not is interpreting the phrase "information reasonably sufficient upon which to base an investment decision." By creating a definition in the Communications Rule that recognizes the difference between a communication containing fundamental analysis supporting an investment decision and a communication identifying catalysts for a trading opportunity FINRA would establish a clear principle by which members, and FINRA itself, can objectively distinguish desk commentary from research and disconnect the issue, as much as possible, from the definition of research report and the phrase "information reasonably sufficient upon which to base an investment decision."

Sincerely,

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[10] Mr. Geraghty is a former chief compliance officer and in-house counsel for several FINRA member firms that issued desk commentary The views expressed in this comment letter are his own.