

April 29, 2011

Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
Washington, DC 20006-1506

**RE: FINRA Regulatory Notice 11-11: Debt Research Reports**

Dear Ms. Asquith:

This letter is submitted by the undersigned on behalf of D.A. Davidson & Co., Merriman Capital, Inc. and ThinkEquity LLC (the "Firms") in response to the request for comments by the Financial Industry Regulatory Authority ("FINRA") in Regulatory Notice 11-11 ("the Proposal") proposing structural safeguards and disclosure requirements for the publication and distribution of debt research reports.<sup>1</sup>

The Firms are registered broker-dealers and members of FINRA, with active equity research departments, as well as personnel who provide analytic support to their equity and other trading operations. Each of the Firms has designed and implemented policies and procedures reasonably designed to comply with the current rules requiring separation of equity research and investment banking functions, and each of the Firms has invested substantial human and financial resources to implementing and overseeing compliance with those policies and procedures by research personnel, investment bankers, and sales and trading personnel who may interact with research analysts.

In March 2011, FINRA released the Proposal, which proposes a concept of regulation for debt research that differs in many ways from the structure currently in place for regulation of equity research and equity research analysts' activities. As discussed below, the Firms appreciate FINRA's efforts, and believe that some of the ideas contained in the Proposal may have merit. However, the Proposal also reflects stated and unstated concepts that would disrupt the current landscape for preparation and delivery of valuable information to customers, particularly institutional customers, of FINRA member firms. The Firms urge FINRA to consider whether current market practices could sustain the disruption that these changes would create.

While the Firms are not significant producers of debt research today, we are concerned that the concepts articulated in the Proposal reflect FINRA's evolving outlook on general research regulation and are a prototype for a regulatory scheme that could ultimately apply to both equity and debt research activities. Therefore, please consider our views as follows.

---

<sup>1</sup> FINRA Regulatory Notice 11-11, "Debt Research Reports," March 2011.

## **I. Background**

As FINRA recognizes, the Proposal includes concepts for regulation of debt research beyond the current scope of regulation of equity research in NASD Rule 2711 and NYSE Rule 472.<sup>2</sup> The most obvious additions are the proposed communication firewalls that would apply to all research analysts preparing debt research, and the proposed restrictions on interaction and evaluation of research analysts who prepare debt research that will be distributed to retail customers by sales and trading personnel. Other sections of the Proposal, while not explicitly beyond the scope of Rule 2711, raise concerns as well. In particular, the Proposal's definition of "debt research report" would track the definition of "research report" set out in Rule 2711, which on its face could be read to include commentary, trade ideas, and other written analyses prepared by a salesperson or other non-research department employee.

## **II. FINRA Should Clarify that Commentary, Trade Ideas and Other Analyses Prepared by Non-Research Personnel are not "Research Reports"**

The Guiding Principles of the Bond Market Association ("Guiding Principles"),<sup>3</sup> which FINRA has said "serve as a helpful reference point" for research practices,<sup>4</sup> describe the value of employing individuals to support firms' debt sales and trading desks, to provide analytic information and to generate trading ideas that are provided to institutional investors.<sup>5</sup> Debt traders use this analytical information to perform their trading and market making functions and to ensure that they can provide liquidity to investors. The analytical information may include commentary on topics such as trading volume, market sentiment and supply, market prices and relative value of debt securities.

As FINRA notes in the Proposal, when an institutional investor interacts with a broker-dealer it essentially assumes the role of counterparty, maintaining an arms-length relationship with the broker-dealer.<sup>6</sup> Institutional counterparties are sophisticated market participants and understand that trading commentary is an inherent sales and trading function that does not constitute "research." For this reason, the Guiding Principles treated "trading ideas" as outside the definition of research covered by the principles. Institutional counterparties also understand that a firm's trading desk likely has an interest in the security being analyzed by the trading desk support staff and that such analysis should not be viewed

---

<sup>2</sup> The Proposal, fn8. FINRA proposed revisions to NASD Rule 2711 and NYSE Rule 472 in its regulatory Notice 08-55, although FINRA has not submitted those proposed changes to the equity research rules to the SEC for approval.

<sup>3</sup> "Guiding Principles to Promote Integrity of Fixed Income Research," May 2004, available at <http://www.sifma.org/research/item.aspx?id=21505>.

<sup>4</sup> NASD Notice to Members 06-36, "Research Analysts and Research Reports," p. 1, July 2006.

<sup>5</sup> Guiding Principles, p. 6.

<sup>6</sup> The Proposal, p. 5.

as impartial research.<sup>7</sup> These two points are especially important in light of FINRA's willingness to draw a distinction between institutions, that are more sophisticated and less in need of regulatory protection, and retail investors who are in greater need of regulatory protection.<sup>8</sup>

It is in this light that we urge FINRA to recognize the Guiding Principles' conclusion that institutional counterparties recognize the distinctions between trade commentary and official research reports. Trade ideas and commentary produced by non-research personnel are not intended for, and do not reach, retail investors - they are products intended for institutional investors. These ideas and commentary therefore are not, and will not be, mistaken by institutional investors as objective "research reports." We urge FINRA to recognize that there is no justification for including trade commentary and ideas provided to institutional investors in the definition of research report when FINRA proposes a rule for regulation of debt research.<sup>9</sup>

Furthermore, sales and trading personnel rely on trade commentary, ideas and analysis produced by trading desk analytic staff in order to trade effectively. Without up-to-date information on market trends, supply, and value, traders would be at a significant disadvantage when deciding on particular trading strategies. If this information were considered "research" within the meaning of FINRA research rules then it would become unavailable to sales and trading personnel, placing an undue burden on them and rendering the information effectively useless.

While treating trade commentary as "research" would significantly inhibit firms' trading functions, it would simultaneously fail to achieve offsetting policy goals. FINRA cited misconduct in the sale of auction rate securities ("ARS") as a "concrete example" of the need for regulation of debt research.<sup>10</sup> The wrongdoing in the ARS cases involved the allegedly compromised independence of firms' research analysts and the supposedly biased nature of ensuing research reports, which investors then relied on in the mistaken belief that the research reports were unbiased and objective.

The same threat to investors is not present in the case of trade ideas and commentary provided by trading desks to institutional investors. As described above, such materials are only distributed to institutional investors, who understand that ideas and commentary are produced to support trading functions and are not objective research products. In the absence of a public belief that these materials are objective research reports on which to base investment decisions, increased regulation would fail to achieve

---

<sup>7</sup> Guiding Principles, p. 6.

<sup>8</sup> The Proposal, p. 5.

<sup>9</sup> We note that while the Proposal includes many of the Guiding Principles' tenets for research practices, the Proposal does not mention the distinction between trade ideas and research reports.

<sup>10</sup> The Proposal, p. 2.

FINRA's public policy goals and would not justify the undue burden placed on firms' sales and trading desks.

We note that the Guiding Principles suggest a series of disclosures to accompany material produced by trading desk personnel. We would support disclosures to the extent necessary to "eliminate the possibility that investors may confuse trading desk material with fixed income research reports prepared by a firm's research department."<sup>11</sup> However, as discussed above, such disclosures may not be needed because institutional investors understand that trade commentary and ideas are not equivalent to "research reports" and should not be relied on as impartial.

In that vein, we urge FINRA to adopt the Guiding Principles' distinction between trade ideas and commentary produced by non-research department personnel and traditional "research reports" produced by a firm's research department.

### **III. FINRA's Proposed Communications Firewalls Would Unduly Restrict Sales and Trading Operations Without Achieving Clear Public Policy Goals.**

The Proposal would apply firewalls prohibiting numerous types of communications between sales and trading personnel and debt research analysts. These firewalls would apply to firms regardless of whether research is distributed to retail or institutional investors, and therefore the scope of impact is potentially quite broad. Therefore, we caution FINRA to consider carefully any firewalls it contemplates requiring firms to implement.

As discussed above, if FINRA intends ultimately to deem all communications that include analysis and information "research reports" then much of the analytic and trading idea information that is produced by personnel on sales and trading desks may be research reports based purely on strict reading of the definition without regard to purpose. As a result, the contemplated firewalls generally would have the effect of shutting down these useful activities. Furthermore, the proposed firewalls appear to reflect a misunderstanding by FINRA of appropriate interactions between research analysts and sales and trading personnel.

FINRA proposes to prohibit debt analysts from "identifying or recommending specific potential trading transactions to sales and trading personnel that are not contained in such debt analyst's currently published research reports." It is unclear what harm FINRA seeks to address with this proposed prohibited communication. FINRA may be seeking to articulate a clear rule that a research analyst should not provide recommendations to sales and trading for trades that would be contrary to recommendations in existing research reports, but the proposed firewall reaches well beyond such a rule. Indeed, FINRA appears poised to prohibit research analysts from recommending any trade that might benefit a firm, or its customers, even if consistent with, or not inconsistent with, existing research, even if the recommendation will never appear in a research report or other materials produced by the research analyst.

---

<sup>11</sup> Guiding Principles, fn44.

This proposed prohibition essentially would eliminate a core function of a research analyst in a broker-dealer - supporting the sales and trading department. Research analysts are not academics confined to a distant ivory tower - rather, they are an important part of member firm operations. Analysts possess specialized expertise that add significant value to the offerings of a firm. To the extent that a research analyst's idea is not contrary to the analyst's published or pending research, we suggest that it is unnecessary to prohibit the analyst from communicating with sales and trading personnel, and that to prohibit such communication would dramatically decrease the analyst's utility within the firm. This proposed firewall essentially equates conversations between sales and trading personnel and research analysts with improper conversations between research analysts and investment bankers. The Firms ask, therefore, if a research analyst's idea is not destined for or contrary to his or her published or contemplated research, then what harm does FINRA seek to address by preventing the research analyst from sharing potential trading ideas with sales and trading personnel?

The proposed firewalls also would prohibit debt analysts from "disclosing the timing of, or material investment conclusions in, a pending debt research report [to sales and trading personnel]." We believe that this firewall is reasonable if FINRA intends to prevent research analysts from unfairly relaying the content and timing of their pending research reports to sales and trading personnel to the benefit of the firm's proprietary trading accounts - essentially the equivalent of current FINRA Rule 5280. This proposed firewall would not, however, be acceptable, without further clarification as follows.

The SEC adopting release for Rule 5280 specifically limits the rule's coverage to "any written information *from the research department* that a reasonable person would expect to result in a transaction based on that information."<sup>12</sup> Therefore, any corresponding firewall in a debt research rule also should be explicitly limited to communications coming from firms' research departments. Trade commentary created for the express purpose of supplementing the firm's sales and trading activities should not be impacted by this firewall - the conclusions of such material simply must be disclosed to sales and trading personnel in order for firms' structure to make any sense at all. Furthermore, we request that FINRA clarify that any firewall will apply only to "research reports" as ultimately defined in any debt research rule, and not to other materials produced by research departments.

Finally, debt analysts are prohibited from "having any communication for the purpose of determining the profile of a customer to whom research should be directed." As a threshold matter, the plain text of this proposed firewall is unclear. If FINRA is seeking to prohibit debt analysts from obtaining information from sales and trading personnel about their customers' desired market goals to prevent research analysts from targeting research reports to those specific market sectors in an effort to make the reports appealing to those customers, we would suggest that there is no clear danger caused by this activity. We also are not aware of practices suggesting that this is commonplace. As long as the information in published research reports is accurate and consistent it is not clear to us what public policy goals would be gained by this firewall to offset the burden it would impose on firms. Of course, it should be noted that if

---

<sup>12</sup> SEC Exchange Act Release No. 59254 (January 15, 2009), p. 4, available at <http://www.sec.gov/rules/sro/finra/2009/34-59254.pdf>.

FINRA were to categorize trading desk support personnel as “research analysts” by virtue of their production of trade commentary and ideas, then this proposed firewall also would prohibit those employees (whose explicit job description is to support trading desk personnel) from communicating with trading desk personnel about the profiles of trading customers.

#### **IV. FINRA Should Not Restrict Sales and Trading Input Even When Research Reports are Distributed to Retail Customers**

A core component of FINRA’s Proposal is the proposed differentiation between research provided to retail investors and research provided to institutional investors. The most significant consequence of this proposed approach would be the imposition of restrictions on the relationship between research analysts and sales and trading personnel similar to those that currently exist for investment banking personnel and equity research analysts under NASD Rule 2711 and NYSE Rule 472.<sup>13</sup> Specifically, sales and trading personnel would be prohibited from influencing the research department budget, supervising research analysts and providing compensatory evaluation for research analysts. If these restrictions were instituted as part of a unified research regulatory scheme for equity as well as debt research activities, it would be difficult, if not impossible, for smaller firms to evaluate research analysts and perhaps even maintain an economically viable research department.

Firms use various methods to evaluate the effectiveness of their research departments. One of those methods is input from trading personnel. Trading personnel are uniquely positioned to assess the accuracy, utility and customer interest in research reports. Without the ability to refer to trading and sales personnel for research desk evaluation, firms will essentially only be able to compare their research department’s materials with statistical information about the performance of various securities, which paints an incomplete picture at best. Trading personnel are able to provide valuable human insight into possible discrepancies between a security’s performance and a research analyst’s recommendation. Therefore, we fail to understand why the Proposal would prohibit sales and trading evaluation of research analysts as a component of compensatory decisions when the research analysts’ reports are distributed to retail investors.<sup>14</sup>

Firms also rely on their sales and trading departments to establish a concrete link between research analyst performance and compensation. If research analyst compensation cannot be linked to an analyst’s contribution to investment banking or sales and trading activities, firms will have little remaining substance on which to base an analyst’s compensation. This restriction would likely make it difficult for firms to compensate research analysts competitively, or perhaps at all, and analysts may leave member

---

<sup>13</sup> The Proposal, p. 4.

<sup>14</sup> We further note that in the realm of equity research, committees that consider research analyst compensation are *required* to examine ratings received from the member’s sales force. NASD Rule 2711(d)(2)(C). It is not clear to us why FINRA is proposing that compensatory evaluation of research analysts by sales and trading personnel be mandatory for equities research and prohibited for debt research.

Marcia E. Asquith  
April 29, 2011  
Page 7

firms in favor of non-regulated entities which are not subject to similar regulations. This would be an unfortunate consequence and surely is not FINRA's intention.

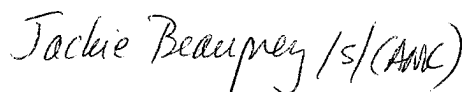
#### **V. Conclusion**

We urge FINRA to consider carefully the likely impact of the Proposal generally and the concepts discussed above. We are available to discuss the concerns addressed in this letter with FINRA staff. Please do not hesitate to contact the undersigned or our counsel for this matter Amy Natterson Kroll (202-373-6118) and Hardy Callcott (415-393-2310) of Bingham McCutchen LLP.


Sincerely yours,

Handwritten signature of Harriet Britt in cursive, followed by "/s/(AMC)" in parentheses.

Harriet Britt  
Chief Compliance Officer  
ThinkEquity LLC  
Telephone: (415)-249-6321  
hbritt@thinkequity.com

Handwritten signature of Jackie Beauprez in cursive, followed by "/s/(AMC)" in parentheses.

Jackie Beauprez  
Vice President & Associate General Counsel  
D.A. Davidson & Co.  
Telephone: (303)-764-6039  
jbeauprez@dadco.com

Handwritten signature of Howard Bernstein in cursive, followed by "/s/(AMC)" in parentheses.

Howard Bernstein  
Chief Compliance Officer & Associate General Counsel  
Merriman Capital, Inc.  
Telephone: (415)-262-1377  
hbernstein@merrimanco.com