Regulatory Notice 12-42

Debt Research

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

Comment Period Expires: December 10, 2012

Executive Summary

FINRA seeks comment on a revised proposal addressing debt research conflicts of interest that includes amended exemptions for research distributed to certain institutional investors and for firms with limited principal debt trading activity. The revised proposal also includes other changes in response to comments on the prior proposal set forth in *Regulatory Notice 12-09*.

The text of the proposed rule can be found at *www.finra.org/notices/12-42*.

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 December 10, 2012.

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

Financial Industry Regulatory Authority

October 2012

Suggested Routing

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

Key Topics

- Conflicts of Interest
- Fixed Income
- Research
- Trading

Referenced Rules and Notices

- FINRA Rule 2111
- FINRA Rule 4512
- NASD IM-2440-2
- NASD Rule 2711
- Regulatory Notice 11-11
- Regulatory Notice 12-09

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 as they are received.[1]

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the FINRA Board of Governors, and then must be filed with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA).[2]

Background and Discussion

In February 2012, FINRA requested comment on a proposal to address debt research conflicts of interest. That proposal, set out in *Regulatory Notice 12-09*, generally provided retail customers with the same extensive protections provided to recipients of equity research, while exempting debt research distributed solely to eligible institutional investors (institutional debt research) from many of those structural protections, as well as prescriptive disclosure requirements.

The proposal defined "institutional investor" as an "institutional account" in FINRA Rule 4512(c).[3] Eligible institutional investors were required to affirmatively notify a member firm in writing if they wished to receive institutional debt research and forego the "retail" protections of the rule.

The proposal also included an exemption from the review, supervision, budget and compensation provisions for broker-dealers that engage in limited investment banking activity. The *Notice* further asked for input on a potential exemption for firms with limited principal trading activity or revenues generated from debt trading.

In response to comments and other industry feedback, FINRA has revised the proposed exemptions as detailed below. FINRA invites comment on the scope and content of each of the proposed exemptions and specifically requests cost/benefit data to help assess the appropriateness of those exemptions or any alternatives.

Institutional Debt Research Exemption

Several commenters raised issues regarding the provision that requires otherwise eligible institutional investors to affirmatively elect to receive institutional debt research. These commenters asserted that the provision is unnecessarily burdensome and may result in excluding a significant number of institutional investors from receiving the debt research that they receive today.

In response, FINRA is proposing to establish a higher tier of institutional investors that could receive institutional debt research without their written agreement. Instead, the broker-dealer could obtain agreement by way of negative consent, if the institutional investor chose not to notify the firm that it wishes to be treated as a retail investor. The higher tier exemption would be available to an institutional investor that:

1. meets the definition of Qualified Institutional Buyer (QIB);[4] and
2. satisfies the new FINRA Rule 2111 institutional suitability standards that require that:
   i. the member firm has a reasonable basis to believe that the institutional investor is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a “debt security” or “debt securities,” as defined in the proposed debt research rules; and
   ii. the QIB has affirmatively indicated that it is exercising independent judgment in evaluating the firm’s recommendations pursuant to the suitability rule, provided such affirmation covers transactions in debt securities.

The affirmation need not specify transactions in debt securities but must be broad enough to fairly encompass such transactions.

Other institutional investors that meet the definition of FINRA Rule 4512(c) but do not satisfy the higher tier requirements could still affirmatively elect in writing to receive institutional debt research. Retail investors could not choose to receive institutional debt research.

FINRA believes that this approach responds to commenters’ concerns by maintaining the flow of debt research to a substantial number of institutional investors and allowing firms to leverage existing compliance efforts, while ensuring that those investors who receive institutional debt research through negative consent have a high level of sophistication and experience in evaluating transactions involving debt securities. FINRA notes that its current mark-up policy exempts transactions with a QIB that is purchasing or selling a non-investment-grade debt security when the dealer has determined that the QIB has the capacity to evaluate independently the investment risk and in fact is exercising independent judgment in deciding to enter into the transaction.[5]

FINRA requests comment on this approach. In particular, FINRA asks the following:

- To what extent can firms use existing compliance systems and procedures to identify and track persons that meet the proposed higher tier requirements?

- Is there another higher tier standard that strikes a more appropriate balance between (1) protecting potentially vulnerable investors in debt securities and (2) maintaining information flow—and minimizing the burdens and costs of distributing debt research—to sophisticated institutional investors?
- For example, should FINRA instead adopt a higher tier consisting of persons that satisfy both the definition of Rule 4512(c) and the institutional suitability requirements in Rule 2111 as applied to debt securities without needing to satisfy the QIB standard? If so, why is that a more appropriate standard?
- What would be the advantages and disadvantages and costs and benefits associated with FINRA's proposed approach or an alternative? How would it affect competition among firms and among institutional investors? How would it affect investment performance? How effectively would it protect investors from the negative effects of conflicts in debt research?

Exemption for Firms With Limited Principal Debt Trading Activity

The revised proposal includes for the first time an exemption for firms with limited principal debt trading activity. The exemption extends to firms that have (1) gains or losses (in absolute value) of less than $15 million from principal debt trading activity on average over the previous three years and (2) fewer than 10 debt traders. Firms that satisfy these criteria would be exempt from provisions that require separation between debt research analysts and those engaged in sales and trading and principal trading activities with respect to pre-publication review of debt research, supervision and compensation of debt research analysts and debt research budget determination.

In crafting the exemption, FINRA sought a rational principal debt trading revenue threshold for small firms where the conflicts addressed by the proposal might be minimized. FINRA further considered the ability of firms with limited personnel to comply with the provisions that require effective separation of principal debt trading and debt research activities.

To those ends, FINRA reviewed and analyzed available TRACE and FOCUS data, particularly with respect to small firms (150 or fewer registered representatives). FINRA supplemented its analysis with survey results from 72 geographically diverse small firms that engage in principal debt trading in varying magnitudes. The survey sought more specific information on the nature of the firms' debt trading—the breakdown between trading in corporate versus municipal securities (which are excepted from the proposal) and the amount of "riskless principal" trading—as well as the number of debt traders, whether any of those traders write research or market commentary, and the prospective ability of firms to comply with the proposal's structural separation requirements.

Based on the data, FINRA analyzed the range of principal debt revenues generated by small firms and determined that $15 million would be a reasonable threshold for the exemption.[6] However, because the revenue figure represents a net gain or loss (in absolute terms) from principal debt trading activity, the potential exists that a firm with substantial trading operations could have an anomalous year that yields net revenues under the threshold. Therefore, FINRA added as a backstop the second criterion of having fewer than 10 debt traders to ensure the exemption applies only to firms with modest debt trading activity. Furthermore, based on our assessment, firms with 10 or more debt traders are more capable of dedicating a debt trader to writing research. FINRA notes that only eight of the 72 responding survey firms indicated that they have debt traders that write either research or market commentary—which is excepted from the definition of "debt research report" under the proposal—on debt securities.

For the purposes of the exemption, a debt trader is defined as "a person, with respect to transactions in debt securities, who is engaged in proprietary trading or the execution of transactions on an agency basis." Firms that rely on the exemption must document the basis for their eligibility and maintain for a period of not less than three years records of any communication that, but for this exemption, would be subject to the prohibitions regarding pre-publication review by sales and trading and principal trading personnel.

FINRA requests comment on this proposed exemption. In particular, FINRA asks the following:

- Are gains and losses (in absolute value) from principal debt trading and number of debt traders the appropriate criteria to establish an exemption from the provisions that require separation of debt research and sales and trading and principal trading activities?
- Are the thresholds of less than $15 million in principal debt trading revenues and fewer than 10 debt traders the appropriate metrics to be eligible for the exemption?
- What would be the advantages and disadvantages and costs and benefits associated with FINRA's proposed approach or an alternative? How would it affect competition among firms? To what extent would investors dealing with exempt firms be harmed by receiving unreliable conflicted research? We request quantifications of impacts described by commenters where available.

Exemption for Firms With Limited Investment Banking Activity

The revised proposal maintains an exemption imported from the equity research rules for firms that engage in limited investment banking activity. Specifically, it excludes those firms that during the previous three years, on average per year, have participated in 10 or fewer investment banking services transactions as manager or co-manager and generated $5 million or less in gross investment banking revenues from those transactions. The proposal exempts eligible firms from provisions that require separation between debt research analysts and investment banking personnel with respect to pre-publication review of debt research, supervision and compensation of debt research analysts and debt research budget determination.

FINRA reviewed and analyzed deal data for calendar years 2009 through 2011 to determine whether it should make any adjustments to these exemption standards. The review included firms that either managed or co-managed deals and earned underwriting revenues from those transactions during the review period. The analysis found that 155 such firms—or 49 percent—would have been eligible for the exemption. The data further suggested that incremental upward adjustments to the exemption thresholds would not result in a significant number of additional firms eligible for the exemption. As such, FINRA believes the current exemption produces a reasonable and appropriate universe of exempted firms.

FINRA requests comment on this proposed exemption. In particular, FINRA asks the following:

- Are the criteria and thresholds appropriate?
- What would be the advantages and disadvantages and costs and benefits associated with maintaining FINRA's proposed approach or an alternative? How would it affect competition among firms? To what extent would investors dealing with exempt firms be harmed by receiving unreliable conflicted research? We request quantifications of impacts described by commenters where available.

Other Changes

The revised proposal also makes clarifying and conforming changes in response to comments received on the proposal in *Regulatory Notice 12-09*. These include:

- **Definition of "debt research report"—**conforms the definition of "debt research report" to the SEC's Regulation Analyst Certification definition and clarifies that the definition covers an analysis of either a debt security or an issuer and excludes reports on types or characteristics of debt securities. The proposal also includes all of the exceptions to the definition in the rule text.
- **Disclosure of Conflicts—**requires disclosure of material conflicts that are known or should have been known by the member firm or debt analyst at the time of publication or distribution of the report. This standard replaces the requirement in the previous proposal to disclose "all conflicts that reasonably could be expected to influence the objectivity of the debt research report."
- **Compensation Disclosure for Foreign Sovereign Debt—**provides that, in lieu of disclosing investment banking compensation received by a non-U.S. affiliate from foreign sovereigns, firms may instead implement information barriers between that affiliate and the debt research department to prevent direct or indirect receipt of such information. However, disclosure still is required if the debt analyst has actual knowledge of receipt of investment banking compensation by the non-U.S. affiliate.

- **Road Show Prohibition—**clarifies that the prohibition applies only with respect to road shows and other marketing activities on behalf of an issuer "related to an investment banking services transaction."
- **Prohibition on Joint Due Diligence—**deletes the provision that prohibited joint due diligence by debt research analysts and investment banking personnel, conforming to the equity research rules and a change to the Global Settlement.
- **Valuation Method Disclosure—**requires explanation of "valuation method used" only where a specific valuation method has been employed.
- **Research Analyst Interactions with Sales and Trading—**adds clarifying language to the rule text that, in determining what is inconsistent with an analyst's published research, firms may consider the context, including that the investment objectives or time horizons being discussed differ from those underlying the analyst's published views.[7]

Request for Comment

FINRA requests comments on the revised proposal. We specifically request comments on the economic impact and expected beneficial results of the entire proposal, including the portions proposed previously and not amended in this proposal. Are the proposals well designed to reduce conflicts arising in current preparation of debt research? Are the costs imposed by the rule justified by the concerns arising from the potential for debt research? How will the rule change business practices and competition among firms underwriting and trading debt instruments, whether U.S. or non-U.S. based? What second order impacts could result? We request quantified comments where possible.

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* *Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.

2. *See* SEA Section 19 and the rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes, however, take effect upon filing with the SEC. See SEA Section 19(b)(3) and SEA Rule 19b-4.

3. Thus, the proposed definition 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.

4. A QIB includes an entity acting for its own account or that of another QIB, that owns and invests on a discretionary basis at least $100 million in the securities of unaffiliated entities. It also includes: a dealer that owns or invests on a discretionary basis at least $10 million in unaffiliated securities; a dealer acting in a riskless principal capacity on behalf of a QIB; a registered investment company that is part of a family that owns at least $100 million in unaffiliated securities; and a bank, savings and loan association or foreign bank that owns or invests $100 million in unaffiliated securities and has audited net worth of at least $25 million. *See* Rule 144A of the Securities Act of 1933.

5. *See* NASD IM-2440-2.

6. FINRA made reasoned assumptions regarding principal debt trading revenues where data was unavailable or incomplete. For example, many small firms report trading revenues on FOCUS Part IIA, which has a single line item for combined debt and equity trading. Many of the firms surveyed provided an actual or estimated breakdown of their debt and equity trading revenues. In other circumstances, FINRA assumed for the purposes of the analysis that all of the reported revenues on that line item came from debt trading. This underestimates the population of firms eligible for the exemption.

7. *See* *Regulatory Notice 11-11* (FINRA Requests Comment on Concept Proposal to Identify and Manage Conflicts Involving the Preparation and Distribution of Debt Research Reports) at note 12.